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Comment Letter No. 747

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Dear Sir/Madam

RESPONSE OF THE ACCOUNTING COMMITTEE OF CHARTERED ACCOUNTANTS IRELAND

EXPOSURE DRAFT: LEASES

The Accounting Committee (‘AC’) of Chartered Accountants Ireland welcomes the opportunity to comment on the proposals contained in the above document.

Whilst AC accepts that there will often be valid business reasons for selecting a relatively short lease (currently accounted for as an operating lease) over a longer lease (currently accounted for as a finance lease), the effect of both is to make an asset available to the lessee for the duration of the contract to use in whatever manner the lessee so determines. AC believes that there should be a consistency in accounting treatment for the period that the asset is available to the lessee and that the current distinction between operating and finance leases is artificial and open to manipulation.

AC notes that a relatively small number of differences remain between the IASB and FASB’s proposals. Whilst it would be preferable if full convergence could be achieved, and therefore there may be merit in considering whether the differences are of sufficient significance to warrant divergence, AC accepts that convergence is a wider issue than individual convergence issues arising in a new leasing standard.

Should you wish to contact us about any of our comments please feel free to do so.

Yours faithfully

Mark Kenny
Secretary to the Accounting Committee

THE ACCOUNTING MODEL

The exposure draft proposes a new accounting model for leases in which:

a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

Question 1: Lessees

a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Yes, AC agrees with the right of use approach and the application of such an approach to all leases. There can be many reasons why a lessee will choose to lease rather than buy an asset. In some cases, it may be due to an inability to finance a purchase. In others, it may be due to concerns about the residual value of the asset or concerns about the viability of the market the entity intends to serve. In all cases, however, the effect of both a purchase and a lease is that the entity has an asset available to it to use for a specified period (life of asset for an owned asset or period of the lease for a leased asset). In many cases, the owned and leased assets are used interchangeably. In AC's opinion, excluding both the asset available to the entity and the liability to pay for that asset from the statement of financial position (which is the current treatment for operating leases) understates the assets and liabilities of the entity. In addition to this conceptual basis, AC considered the fact that analysts make notional adjustments to assets and liabilities to capitalise operating leases is a clear indication that current accounting does not meet the needs of users.

b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Yes, AC agrees with the amortisation of the asset and the recognition of interest on the liability. Just as depreciation is recognised on an equivalent owned asset over its useful life, a lease should recognise amortisation over its right-to-use asset. Similarly, a lessor is compensated for the financing cost of the asset made available to the lessee, just as a bank would be compensated where the purchase is financed by borrowing.

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Question 2: Lessors

a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

In AC's view, the previous distinction between operating and finance leases was artificial and AC supports the lessee accounting proposals which eliminate it. Whilst accepting that there are differences from a lessor perspective between leases where the lessor retains significant exposures and those where the retained exposures are insignificant, the implementation of the Boards' lessor proposals will require the exercise of significant judgement. On balance, AC agrees with the proposed lessor accounting approach, however, some members have reservations and would support a partial derecognition approach.

b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

In its comments on the Discussion Paper, AC expressed concern that the performance obligation approach resulted in a grossing up of the statement of financial position. AC believes that the proposed linked presentation approach in the Exposure Draft is a reasonable compromise and addresses these concerns. Subject to the reservations expressed in (a) above, AC agrees with the proposals for lessor accounting.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

AC notes the Board's concerns about the burden full application of the Exposure Draft's proposals would have on entities with large numbers of short term leases. Leases with a maximum duration of less than 12 months are unlikely to form part of the long term operating infrastructure of most businesses but rather are likely to be incidental to the main income generating purpose of the entity. AC concurs with the proposed treatment for short term leases and, in particular, the optional nature of the proposals. Should an entity wish to apply the full provisions of the standard to its short term leases, it should be permitted to do so. AC believes that the impact of these proposals is unlikely to have a material effect in most cases. However, it is concerned that there may be instances where the impact is material and questions whether the proposed approach would be appropriate in those cases and therefore suggests that the issue of materiality is addressed in the guidance notes.

DEFINITION OF A LEASE

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

Question 4

a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

AC agrees that a lease is defined appropriately.

b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

AC agrees that a transaction involving the transfer of virtually all of the risks and benefits of ownership constitutes a purchase/sale and believes that the criteria for distinguishing a lease from a purchase/sale are appropriate.

c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

AC agrees that the guidance is appropriate.

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SCOPE

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

AC notes that the Boards acknowledge that there is no conceptual reason for excluding intangibles from the proposed standard and that their exclusion is on the basis that it is the Board's intention to consider accounting for intangibles more broadly. AC agrees with the proposed scope exclusions on the basis that excluded assets are either covered by other standards or will be considered in greater detail fairly shortly.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

b) the IASB proposes that:

i. a lessee should apply the lease accounting requirements to the combined contract.

ii. a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

iii. a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

AC would prefer that there was consistency in the FASB and IASB approaches. However, AC does not support the recognition of income from a service component before the service is provided. As a result, AC supports the IASB proposals for lessors who apply the derecognition approach.

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Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

AC agrees that a lease terminates when a purchase option is exercised and that a purchase/sale should be recorded whenever such an event occurs. AC also agrees that bargain purchase options should be considered when determining whether the initial transaction is a purchase/sale or lease. However, AC questions whether it will always be possible to determine whether a bargain purchase option exists. Furthermore, a purchase option which appears to be at a bargain price at the inception of the lease may no longer be regarded as a bargain as the lease progresses. AC believes that guidance is needed on how to determine when a bargain purchase option exists, whether a reassessment is needed throughout the term of the lease and the required accounting if it is concluded that a bargain purchase option no longer exists and/or it is no longer reasonably certain that the option will be exercised.

MEASUREMENT

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

a) assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132–BC135).

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Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

There were mixed views among AC members on the determination of the lease term ranging from agreeing with the Board's proposal to agreeing with Mr Coopers' alternative view, as well as the view that the lease obligation should comprise only the minimum non-cancellable element. Members noted that an inevitable consequence on not bifurcating the option to continue to have the right to use the asset (and the related cost thereof) is the need to consider a longer lease term than the minimum, but also that the Board's proposed 'more likely than not' approach (as set out in the Example) is particularly complex, burdensome and subjective. Members of AC also noted that the proposed approach recognises that the lessor and lessee may account for the same lease over different terms, which is the inevitable consequence of one party (usually the lessee) being in possession of more reliable information on future intentions than the other.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

AC believes that the objective should be that lessees and lessors would record the resulting assets and liabilities at their best estimate of these amounts. It would be counterintuitive if lessees or lessors were required to ignore contingent rentals in circumstances where they fully expect an amount to crystallise. In many cases, however, there are considerable uncertainties in determining an appropriate estimate. AC supports the use of the expected outcome technique. AC notes that the Exposure Draft proposes different criteria for the recognition of contingent rentals by lessees and lessors but does not fully explain why this is the case. AC agrees that the lessee is likely to be in a better position to determine a reliable estimate for contingent rentals than the lessor; however, AC believes that guidance should also be provided for lessees who are in the same position as lessors in being unable to measure contingent rentals reliably.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

AC agrees with the requirement to remeasure assets/liabilities when there are indications of a significant change in the liabilities or assets. AC accepts the concerns expressed about a mandatory reassessment, however, it is concerned that the requirement to reassess only where there are facts/circumstances suggesting a significant change may be too loose. AC suggests that the guidance notes provide guidance/examples on the indicators to be considered in determining when to remeasure.

SALE AND LEASEBACK

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

AC believes that the sale and leaseback criteria are appropriate.

PRESENTATION

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

Question 12: Statement of financial position

a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

AC agrees with the proposed presentation in the draft IFRS in respect of i) ‘right-of-use’ assets i.e. disclose separately within tangible assets as appropriate, and ii) financial liabilities i.e.

disclosure separately within financial liabilities. Inclusion reflects the value in use and funding of such assets in the entity. Separate presentation will facilitate the reader of financial statements in understanding the nature, extent and significance of such transactions in the statement of financial position and reflects the fact that there are fundamental differences between leased and owned assets. However, where the amount of 'right-of-use' assets or lease payment liabilities are insignificant to the total assets and total financing of the entity, then disclosure in the notes is considered adequate.

b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

AC concurs with the proposed presentation in the draft IFRS in respect of a lessor applying the performance obligation approach for the same reasons outlined in (a) above.

c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

AC concurs with the presentation proposals in the draft IFRS in respect of the derecognition approach.

d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Where significant to the financial position of the entity, AC agrees that assets and liabilities arising under subleases should be presented in the statement of financial position; otherwise disclosure within the notes is sufficient.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

AC considers that presentation in the notes to the financial statements is sufficient disclosure. This is consistent with disclosure requirements for (a) depreciation of owned assets currently, and (b) consistent with the presentation and disclosure format of 'interest and other income net' currently in the profit or loss account. Where the amounts in respect of lease income and expense are significant to the overall financial performance of the entity, presentation separately in the income statement may be appropriate.

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Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

AC concurs with the presentation of cash flows arising from leases in the statement of cash flows and considers this consistent with similar items presented in the statement of cash flows currently.

DISCLOSURE

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

a) identifies and explains the amounts recognised in the financial statements arising from leases; and

**b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows
(paragraphs 70–86 and BC168–BC183)?**

Why or why not? If not, how would you amend the objectives and why?

AC concurs with the Board's proposals in respect of disclosures of qualitative and quantitative information that enables the user of financial statements to understand the impact of accounting for leases in the financial statements by lessees and lessors.

TRANSITION

Question 16

a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186– BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

AC believes that the Board's concerns about the burden that will be placed on preparers, if required to adopt and apply a retrospective approach in full, are valid and, accordingly, the proposals of a simplified retrospective approach are considered reasonable.

b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

AC is of the view that full retrospective application should be permitted for entities that choose to adopt that approach.

c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

AC recognises that some entities will have very large volumes of leasing arrangements and accordingly AC recommends that the Board give adequate time to preparers of financial statements to allow for the effort level required to calculate retrospective application to prior year comparatives.

BENEFITS AND COSTS

Question 17

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

AC considers the proposed IFRS to be a significant improvement on current guidance and will result in consistent accounting treatment for all leases irrespective of duration.

OTHER COMMENTS

Question 18

Do you have any other comments on the proposals?

18.1. Worked examples:

There are no presentation formats and disclosure examples in the proposed IFRS of any significance. AC recommends that the Appendix is expanded to include a number of worked examples showing both the required accounting entries and the presentation format in the primary statements and related note disclosures to assist interpretation of the proposed standard by users.

18.2. Calculation of expected outcome:

Paragraph 14 states that 'a lessee shall determine the present value of lease payments payable during the lease term in accordance with paragraph 13 ..... the expected outcome is the present value of the probability weighted average of the cash flows for a reasonable number of outcomes (see paragraph B21).' However, the lease term is defined in paragraph B16-17 as the longest lease term that is more likely than not to occur. AC suggests that a fuller explanation of the rationale for the two different approaches/apparent inconsistency is given.