1850-100
Comment Letter No. 331

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Dear Sir or Madam

Exposure Draft ED/2010/9 - Leases

The Audit Commission welcomes the opportunity to comment on the discussion paper, “Leases-Preliminary Views”.

The Audit Commission is an independent watchdog, driving economy, efficiency and effectiveness in local public services in England to deliver better outcomes for everyone. We appoint auditors to over 700 major public bodies that are moving to prepare accounts under IFRS. Our work across local government, health, housing, community safety and fire and rescue services means that we have a unique perspective. We promote value for money for taxpayers, auditing the £200 billion spent by 11,000 local public bodies. As a force for improvement, we work in partnership to assess local public services and make practical recommendations for promoting a better quality of life for local people.

The Commission’s Response

In broad terms, we support the proposals set out in the exposure draft. However, we have reservations regarding the application of the performance obligation approach by lessors. In our view, this would tend to lead to double counting of assets, even though the net position of both lessor and lessee is the same. In our view, it would be more appropriate for lessors to apply the derecognition approach for all leases.

Our detailed comments on each of the questions asked in the invitation to comment are included in the attached Annex.

Yours sincerely

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Annex – Detailed Responses

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?

(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?

As we stated in our response to the earlier discussion paper, we support the proposed right-of-use approach as it removes the often artificial distinction between operating and finance leases and forces entities to look at the underlying substance of the arrangements entered into. Recognition of the leased asset and the related liability reflects the financial substance of the arrangement entered into. Equally, recognition of amortisation reflects the ‘consumption’ of an element of the asset over the life of the lease, while recognition of interest on the liability again reflects the economic reality of the arrangement.

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? Why or why not? If not, what alternative approach would you propose and why?

(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?

As we outlined in our response to the previous discussion paper, we are concerned that the performance obligation approach would tend to lead to double counting of assets, even though the net position of both lessor and lessee is the same under either approach. In our view, it would be more appropriate for lessors to apply the derecognition approach for all leases. This would be consistent with the accounting treatment applied by lessees and recognises that, during the period of the lease, the lessor does not have a right of use over the asset.

Question 3: Short-term leases

The exposure draft proposes that a lessee 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).

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?

In our view, where the lease is material to the accounts it would not be appropriate to apply a simplified approach and both lessees and lessors should apply the standard in full in such cases.

Question 4: Definition of a lease

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

(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?

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

The proposed definition of a lease is not inconsistent with that used in the current version of IAS 19 and is, therefore, appropriate.

We agree with the proposed criteria for distinguishing leases from a contract that represents a purchase or sale. These are consistent with two of the examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease in the existing standard.

The guidance in paragraphs B1-B4 for distinguishing leases from service contracts is consistent with that in the existing IFRIC 4 and, as such, is sufficient.

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-to-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?

In applying a right-to-use approach in the recognition of leased assets, we agree that it would be appropriate to extend this to right-to use assets in a sublease so that an entity is recognising all assets used in its operational activities.

We also agree with the proposed exclusions of leases of intangible assets, biological assets and those relating to the exploration of non-regenerative assets for the reasons set out in the basis of conclusion.

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 leases 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?

The Commission supports the approach that, where seperable, service components should be recognised separately from the lease component. Where seperability cannot be achieved, we agree that lessees should apply the lease accounting requirements to the combined contract. However, we believe that it would be exceptional for a body to not be able to separate the lease and service components and that, therefore, application of the lease accounting requirements to the combined contract should be the last resort.

As set out in our response to Question 2, we do not support the performance obligation approach for accounting by lessors. However, we believe that lessors should equally apply the lease accounting requirements to the combined contract where seperability cannot be achieved although, as above, we believe this should be an approach of last resort as seperability should be achievable in most cases.

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?

In our view, the proposal goes beyond the recognition point usually used for an asset – that is, reasonably certain. In our view, it would be appropriate to consider a lease as terminated when it is reasonably certain that an option to purchase the underlying asset will be exercised.

Question 8: Lease term

Do you agree that a lessee or 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 lessor should determine the lease term and why?

In our view, the recommendation is inconsistent with the usual basis for asset recognition – reasonable certainty. We believe that the approach in the existing standard, taking options into account when it is reasonably certain they will be exercised, is a more appropriate approach.

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 the 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 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?

We agree that, in determining the present value of lease payments, lessees and lessors should include contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease. We believe such an approach provides a better estimate of the value of future economic benefits.

We also 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. In our view, it will be possible to measure such payments reliably in most cases.

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 terms 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?

We agree with the proposal. Remeasurement would mean that the accounts would reflect the economic reality of the arrangement.

Question 11: Sale and leaseback

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?

We agree with the criteria for classification as a sale and leaseback transaction and think that the proposed approach provides internal consistency within the standard.

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?

(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 43, BC148 and BC 149)? 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?

(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?

(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?

We 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. However, we have no strong views as to whether this information should be presented on the face of the statement of financial position or disclosed in the notes.

As stated previously, we do not support the performance obligation approach for accounting by lessors. However, if such an approach is allowed, we agree that a lessor should present underlying assets, rights to receive lease payments and lease liabilities, totalling to a net lease asset or lease liability. Again, we have no strong views as to whether this information should be presented on the face of the statement of financial position or disclosed in the notes.

Where a lessor applies the derecognition approach, we agree they should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment. Again, we have no strong views as to whether this information should be presented on the face of the statement of financial position or disclosed in the notes.

We also agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position. Again, we have no strong views as to whether this information should be presented on the face of the statement of financial position or disclosed in the notes.

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, 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?

We believe that it would aid transparency if lease income and lease expense is presented separately from other income and expense in profit or loss. However, we have no strong views as to whether this information should be presented on the face of the statement of comprehensive income or disclosed in the notes.

Question 14: Statement of cash flows

Do you think that cash flows from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153, and BC 159)? 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?

We believe that it would aid transparency if cash flows from leases were presented in the statement of cash flows separately from other cash flows. However, we have no strong views as to whether this information should be presented on the face of the statement of comprehensive income or disclosed in the notes.

Question 15: Disclosure

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?

We agree with the proposed disclosures and believe that they are important in enabling a reader of the accounts to gain a full understanding of the assets, liabilities, rights and obligations arising both now an in the future from current and future lease arrangements.

Question 16: Transition

(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?

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

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

We believe that the simplified retrospective approach is appropriate, particularly for those organisations that have a large number of lease arrangements that would need to be considered individually if full retrospective application was required. However, we do not believe it would be appropriate to prevent entities from applying full retrospection if they choose to do so. There are no other transitional issues we believe the boards need to consider.

Question 17: Benefits and costs

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?

We agree with the boards' assessment of the costs and benefits of the proposed requirements.

Question 18: Other comments

Do you have any other comments on the proposals?

We have no further comments that we wish to make.