



Commissioners' Advisory Accountant

4th Floor Ralli Quays Manchester M60 9LB

International Accounting Standards Board 30 Cannon Street London EC4M 6XH

Tel 0870 785 8517

Fax 0870 785 8528

Email matt.blake@hmrc.gsi.gov.uk

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Dear Sirs

Exposure Draft: ED/2010/9 Leases

Thank you for the opportunity to comment on this exposure draft. I would be happy to discuss any of the points raised in this letter if you so wish.

Our perspective

- 1. HM Revenue & Customs (HMRC) administers and collects tax in the United Kingdom. In doing so, we use the general purpose financial statements of every business in the UK, and a number of overseas businesses. The managers and owners of businesses directly use the numbers reported in general purpose financial statements as the basis of their corporate tax liabilities. We check those numbers and the tax liabilities based on them, and we use many of the disclosures in general purpose financial statements to help us to check those and other tax liabilities.
- 2. In the UK, it has long been the case that the starting point for calculating a business's corporate tax liability is its commercial profit. It is enshrined in UK tax law that taxable profits are based on 'profit prepared in accordance with Generally Accepted Accounting Practice' (GAAP). GAAP specifically includes International Financial Reporting Standards (IFRS) should a company prepare its statutory financial statements in accordance with IFRS. Tax liabilities in respect of lease transactions are fundamentally driven by the accounting classification, and income and expense entries in those financial statements.
- 3. Businesses value stability in their tax system such that they are able to plan and price transactions with some certainty of outcome. Businesses and HMRC are critical users of general purpose financial statements in this regard.

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General comments

- 4. We note that the Exposure Draft proposes to remove what seems a sometimes arbitrary distinction between finance leases and operating leases a distinction which leads to a significantly different accounting treatment for transactions with (around the borderline) similar underlying features. The distinction is, however, a long-standing one, is embedded in many business practices, and is well understood and generally well-applied across the broad base of UK business.
- 5. At present, IAS 17 identifies two types of leases: operating leases and finance leases. Whether leases are classified as operating leases or finance leases gives rise to quite different accounting treatments and tax treatments.
- 6. The tax law for lease transactions relies on the differentiation between finance leases and operating leases in accordance with GAAP. For all UK entities that have adopted IFRS, this would be IAS 17. If IFRS no longer contains such treatments then much of leasing tax law will no longer function as intended, or at all. Some entities will simply be unable to comply with the law and complete a tax return. Most entities will be unable to identify whether they can claim tax relief for expenditure incurred under a lease contract. If a standard were issued to the proposed timetable, and an entity were to adopt it early, this may happen as early as for accounting periods commencing 1 January 2011. A much wider constituency of UK entities would be affected if the IASB followed these proposals through into an update of IFRS for SMEs and the UK's ASB proceeded to adopt them into a revision of UK GAAP.
- 7. To introduce tax legislation which uses drivers based on a new lease standard requires its own process involving significant consultation with businesses and their advisors, ministerial decisions and parliamentary time. This is not quick. If there is inadequate time to prepare for any leasing standard changes, there will be tax uncertainty. This uncertainty will affect pricing decisions for new leases, it will result in complex lease accounting and pricing systems not being available or well-understood by users, it will create unexpected transfers of value between lessors and lessees under existing leases (for example, those that contain tax variation clauses), and it will affect the individual tax position of a significant number of lessors and lessees in the UK.
- 8. Because of the uncertainty created by the accounting proposals which may take effect before there is the opportunity to design tax legislation to work with them, HM Treasury published draft legislation on 9 December 2010 which has the effect of "freezing" GAAP for leases for tax purposes. Lessors and lessees in the UK that have adopted IFRS will have to continue to prepare, for tax purposes, lease accounting entries derived from, and use the classifications in, current IAS 17. This will remove uncertainty for tax and enable businesses to file tax returns and to price transactions. We recognise, though, that this is burdensome in many ways.
- 9. The uncertainty and additional burdens imposed by a new standard in the UK could be mitigated by moving quickly to a new leasing standard or a quick decision that there will not be a new standard with a significant time interval (several years) before its mandatory effective date. Overall, we understand the conceptual reasons behind the changes proposed. We note that, however impure, current practice is generally well-understood and deeply embedded within business culture not simply financial accounting, or within the leasing industry for pricing and sales, but across the entire economy as lessees, and as borrowers and lenders (for example, in borrowing covenants based on earnings before interest or asset tests).
- 10. In terms of the detail of the proposed standard, we note that the proposals create new "bright lines" to replace well-understood existing ones. If you proceed in the way proposed, we would expect that you would receive a host of requests for guidance or interpretations around each of the new bright lines as preparers and auditors re-establish practice.

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- 11. We see a number of areas where the proposals are not clear or are likely to lead to uncertainty or practical problems in implementing the proposals to real situations, such as:
 - The classification of the lessee's right to use asset as a tangible or intangible asset is more than a semantic one; the distinction could lead to regulatory issues (such as for banks) and may also have real tax consequences for businesses;
 - The performance obligation approach would appear to gross up the balance sheet, worsening any gearing ratios and implying that the entity has a higher asset base than it does:
 - Short term leases any exclusions from the 'on balance sheet' principles of the proposals is likely to give rise to structuring and inconsistent treatment (between material short term leases and material longer term leases);
 - Lease term if the lease term can include non-committed periods it is not
 consistent with the definition of a liability. This is likely to lead to structuring or
 economic decisions to ensure a contract is a lease or is not a lease to suit the
 particular circumstances of the entity. For example, to circumvent more
 restrictive recognition of liabilities in IAS 37. Indeed we note IAS 37 was
 introduced to prevent over-recognition of liabilities (or measuring them at an
 overstated value) that was prevalent at that time;
 - Transition the proposed simplified transitional arrangements lead to a distortion
 of the lessor and lessee profits both on transition and going forwards until the
 lease transactions unwind. Such distortions will lead to confusion amongst
 analysts, finance providers and other users of general purpose financial
 statements. It will cost businesses to explain these changes and may cause
 operational issues around lease pricing and business performance measures;
 - Commencement and inception there is no guidance around how to treat the transactions in this period (e.g. initial payments or payments to enter into a lease rather than under the lease itself).
- 12. The above points are set out below such that they are aligned with the questions proposed in the Exposure Draft. We have not commented on all questions.

Question 2: Lessors

We do not see how a lessor applying the performance obligation approach would report robust income and expenditure and balance sheet amounts. We cannot see that this would be understandable for users, even sophisticated ones, let alone the broad base of general purpose users. Neither can we see it as practical or easy to do.

Question 3: Short term leases

The introduction of a different accounting method for a short term lease introduces another bright line into the proposals. To the extent that the treatment of short term leases is proposed to be off-balance sheet (as is currently exposed in relation to the lessor treatment) this will lead to an incomparability between entities for nearly similar lease transactions (i.e. those just more than or just less than one year) and will continue the past treatment of material leases being off-balance sheet. We cannot see the logic in allowing the short term lease treatment on a lease-by-lease basis rather than to apply to all short term leases. We see it as most likely that entities would calculate the entries under both bases and select to suit their purpose. The proposals would appear to suggest that doing so is acceptable.

The ED refers to the lessor recognising lease payments in profit or loss. This appears to reinstate cash accounting, which is likely to lead to further structuring of lease terms to achieve desired results. Indeed, in this area, rather than introducing a standard, the proposals appear to take lease accounting into the realm where there is no standard accounting. We fail to see how this is useful to any user.

Question 8: Lease term

It is not clear how the proposed determination of the lease term is consistent with the Framework. The inclusion of lease liabilities for a lessee that do not meet the definition of a liability, as there is no obligation to make payments, would confuse the preparer and the reader as well as making it difficult to apply any principles to more complex lease arrangements. It also recognises, as assets, items that are not assets. If it is believed that the proposals are consistent with the Framework it would be helpful for the Exposure Draft to clearly explain how.

Question 12(a) Statement of financial position

The proposals infer that the lessee's right to use asset is an intangible asset. However, this is not made explicit, nor why it is appropriate. It would be useful for this treatment to be explained.

Question 16: Transition

We share the concerns raised in Mr Cooper's alternative view in the Exposure Draft where he states that 'the proposed approach will lead to a misleading and inappropriate reduction in profit of a lessee on transition and increased profit growth in subsequent periods.' Until all leases unwind and are replaced by new leases, there will be no comparability between lessees. This will be the case for many years. And the same will be true, but the opposite effect will arise for lessors. We cannot see how this helps any user or will lead to financial statements being understandable. If a full retrospective application was required, as with most changes to accounting standards, this would simply not arise.

Question 18: Other comments

It is not uncommon for transactions to occur between lease inception and commencement. It would be useful if application guidance was provided around transactions occurring during, or even prior to this period, for instance "lease premiums", advance deposits, payments to enter into a lease but not under an explicit term of the lease, and other such arrangements.

I hope you have found these comments useful. I would be happy to discuss these in more detail with you if you so wished.

Yours faithfully

Matt Blake, FCA

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Commissioners' Advisory Accountant