

14 December 2010

The International Accounting Standards Board 30 Cannon Street London EC4M 6XH Our ref: tp/tg/1412

Dear Sirs

Response to IASB consultation on the accounting for leases

We are pleased to respond to your request for comment in respect of the exposure draft on the accounting for leases. The exposure draft, which would replace IAS 17, 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;
- 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).

In effect, the proposals would remove the difference in accounting treatment between operating leases and finance leases and therefore promote consistency of accounting treatment. Whilst understanding the technical benefits of such an approach, we do have concerns in respect of its application in practice.

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?

On balance, we disagree with the above. This is for two distinct reasons. Firstly we believe that the cost of compliance with this standard may be overly onerous for smaller companies who currently recognise the costs of operating leases, such as those for rent of premises or for hire of office equipment, as operating expenses. To comply with the measurement requirements for a lease of 5 years charging a simple £1,000 per calendar month – and which under IAS 17 would simply be charged to profit or loss on that basis – would require the lessee to produce a justifiable calculation

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of the present value of minimum lease payments using an incremental borrowing rate with an estimation of the most likely lease term, reassessing the incremental borrowing rate on for each accounting period and adjusting the lease liability and asset as appropriate.

Whilst it could be argued that following the above course has technical merit, we believe that this would be too onerous a requirement for small and medium size entities to reflect what is in substance a straightforward accounting transaction. We would however be willing to revisit this opinion were the Boards to consider a simplified approach, which we have discussed further below.

Secondly, the presentation of additional assets and liabilities will significantly gross up entities statements of financial position, and may therefore affect the view of a number of users of the accounts. It may also be confusing as it will mean that assets will be recognised in the statement of financial position in respect of assets which in substance the entity does not own. Whilst we recognise that the recognition of a right to use asset in respect of a lease does not equate to recognising the asset subject to that lease, it may be interpreted in this way. In addition, the current accounting for finance leases recognises the assets subject to the lease in the statement of financial position because the substance of the arrangement is that the lessee does own the asset. Clearly, under the proposals, the asset subject to the lease is not itself recognised until any option to purchase is exercised – which could be argued places form over substance.

We understand the Boards' aim to encourage consistency in the accounting for leases, and note their comments in respect of investor perception; however we believe that adequate disclosure is already provided within the financial statements of operating lease liabilities such that the user of the accounts can understand their effect on the entity.

We do understand the technical merits of the right-to-use approach, particularly in respect of the recognition of a liability for the minimum lease payments in respect of all leases, and were it not for the practical issues associated with implementing this approach we would be more inclined to support it. We also recognise that in time users of the financial statements such as financial institutions and would grow accustomed to the grossed up balance sheets and adjust their views to take into account their effect. We also will concede that once the use of electronic tools to compare financial information such as XBRL are more widespread then the impact of disclosures of operating lease commitments may be hidden by simple comparisons of balance sheets.

However we believe that the technical arguments for the proposals are outweighed by the practical considerations, particularly for smaller entities and in respect of short term leases which would currently be classified as operating leases.

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 stated in our answer to 1(a), we disagree with this position. Like some other correspondents we are concerned about the way amortisation and implied interest on operating leases would be accounted for. This would remove operating expenses, such as rent of property or hire of office equipment, from an entity's EBITDA. In addition to this, for certain short term leases (essentially, those which are currently classified as operating leases) we also disagree with the use of the effective interest method which front loads the cost of leases to the start of the lease, when the reality is that costs are evenly spread over the term of the lease.

We would like to refer the Boards to our answer to question 3 below, where we encourage the Boards to consider expanding the proposed exemption for short term leases.

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?

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?

Notwithstanding our answer to question (1), if the Boards do decide to adopt the right-of-use model, we agree with the technical principles behind the derecognition approach.

We disagree with the use of the performance obligation approach because it creates a lack of symmetry in accounting for a lease, as an asset is recognised in respect of the same item in both the lessee and lessor's accounting records.

Accounting for both the asset and the right to receive payments in respect of a lease appears to be double counting. Logically, the entity either has the right to derive economic benefit from the asset as a whole or the right to future lease payments – not both simultaneously.

The argument in the Basis for Conclusions (BC26) states that if a lessor retains exposure to significant risks or benefits associated with the underlying asset, it would be inappropriate to apply an approach that derecognises part of the asset. We encourage the Boards to reconsider this assertion to eliminate the double counting.

For example, consider a five year lease for a piece of land which has a market value in 2010 of \$1m and theoretically has an indefinite useful life. It may be very unlikely that the land will have a value of less than \$1m at the end of the five year lease in 2015. However a valuation of land is typically based, or partly based on the present value of expected future cash flows associated with the asset. If the asset valuation was reassessed excluding the cash flows 2010-15, it would be lower, even though the asset's value is not truly diminished over the five years. The difference in the assessed value between the land including the present value of cash flows in 2010-15 and the value excluding those amounts should be derecognised. The same principle may be used broadly for all assets which under current proposals would be accounted for under the performance obligation approach.

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 shortterm 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?



We agree with the Boards' motivation for providing an exclusion for leases with terms less than 12 months, and if the proposals above are adopted then this would be the most efficient way of accounting for short term leases.

However, we would also argue that this could be the best way of accounting for many leases which are currently accounted for as operating leases and where the risks and rewards of ownership have clearly not been transferred to the lessee. If the Boards are not prepared to consider this 'across the board', we would strongly encourage the Boards to expand the scope of this exclusion to encompass a wider range of leases. In this situation, we believe it would result in disclosures which for a majority of companies that enter into operating leases which would be substantially similar to those required by the full right-of-use model. We suggest:

- Expanding the scope of a short term lease to leases with terms less than three years; and/or
- b) Allowing a specific exemption allowing for immaterial leases to be accounted for in this way, regardless of the lease term (perhaps with a defined de-minimis threshold).

Where the rental payments are variable based on government interest rates or inflation figures, an adjustment in the initial recognition amount of the asset & liability should be made to take these into account, with subsequent adjustments only affecting the liability and recognised in profit and loss.

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?

We agree. The definitions are broadly in line with those in IAS 17 and IFRIC 4.

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?

We are concerned, as some other correspondents are, that the use of the caveat that an entity "transfers all but a trivial amount of the risks and benefits associated with the underlying asset" — requires judgemental decisions being made leading to a potential lack of clarity. We encourage the Boards to consider quantifying a threshold for which the risks are not trivial.

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?

We agree that the guidance is sufficient to make the distinction.

Question 5: Scope exclusions

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?

Like a number of other commentators, we are unsure as to why the Board has omitted intangible assets from the scope of the standard. As BC36 points out there is no conceptual reason why leases for intangible assets should be excluded.

We agree with all of the other exclusions and inclusions discussed in BC33-46.



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:
 - 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?

We agree with the principle to split contracts which contain distinct lease and service components.

However, where the components are not distinct we are satisfied with the FASB's position that it should be accounted for under the lease accounting rules. The IASB position differs in only one respect – that lessors applying the derecognition approach should account for the lease component under lease requirements and the service component using the proposed revenue recognition standard. As other correspondents have pointed out, this position is illogical – if there are no distinct lease and service components then this approach cannot possibly be followed.

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?

We broadly agree with the Boards' proposals – taking into account bargain purchase options being recognised as part of the process of determining if a transaction is a lease or a sale.

However we suggest the Boards make specific reference to the situation where at the end of a long term lease a lessor will allow ongoing rentals at a peppercorn (nominal rent) into the future. This has traditionally been seen in the UK for certain leases of commercial property. For example, a lease requires payments for 25 years at £20,000 per annum, then for the next 75 years at £1 per annum. Assuming the building's useful economic life is less than 100 years, then the charge of a peppercorn rent over the last 75 years means that although the legal form indicates a lease is still in place, in substance this is no longer correct. We recommend the Boards take account of these arrangements.



This should be considered distinct from the situation referred to in B18(a) which refers to a bargain option to extend the lease term.

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?

We disagree. We agree with the position stated in BC 116, that recognition of a possible extension of the lease would result in liabilities being recognised which do not meet the definition of a liability. We recommend that leases initially be recognised at the minimum lease term, and only adjusted once the option to extend the lease has been exercised.

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?

We believe that expected payments under term option penalties and residual value guarantees specified in the lease should only be provided for if they meet the criteria for provision under IAS 37. The key principle of the IAS 37, to recognise a liability if there is a present obligation arising from a past event and it is probable a transfer of economic benefits will result, should be applied when accounting for a lease liability.

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?

We do agree, however we would like to see some additional guidance within Appendix B regarding the judgement of whether a change is significant or not.

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?

We do agree with the criteria in the exposure draft, however we would like to reiterate the point made in our answer to question seven above regarding peppercorn rents.

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?

We do agree as it appears reasonable to distinguish balances relating to leases and would be straightforward for entities to comply with.

(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?

As noted above we disagree with the performance obligation approach, however, if it were to be adopted the presentation above appears logical.

(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?

We agree, as this provides symmetry with the Boards' proposals for lessee accounting.

(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 lessors in a sublease should disclose assets and liabilities that arise form a sublease separately because this provides greater transparency of leasing arrangements.

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?

We agree that a distinction should be made, though we agree there seems no need to require separate presentation on the face of the statement of comprehensive income.

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?

We agree that cash flows from leases should be presented separately. This will, if the right-for-use model is adopted, allow users to distinguish interest elements of leases from other interest cash flows.

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?

We agree that the disclosure requirements are reasonable, however if the Boards follow our suggestion that use of a simplified model should be extended beyond leases of less than 12 months, then we encourage the Boards to consider reduced levels of disclosures.

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?
- (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 have no specific objection to the approach proposed for transition, although we see no reason why full retrospective application should not be permitted.

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?

Please see our answer to question (1) above.

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Question 18: Do you have any other comments on the proposals?

We have no other comments to make on the proposals. Should you have any questions on our response, then please contact either Tessa Park or Timothy Gonzaga.

Yours faithfully

KINGSTON SMITH LLP