

11 September 2013

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom
Email: CommentLetters@ifrs.org

Dear Sir/Madam

SAICA SUBMISSION ON ED/2013/6 – LEASES

In response to your request for comments on ED/2013/6 – *Leases*, attached is the comment letter prepared by Accounting Practices Committee (APC) of The South African Institute of Chartered Accountants (SAICA). This comment letter results from deliberations of the APC, which comprises members from reporting organisations, regulators, auditors, IFRS specialists and academics.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours faithfully,

Sue Ludolph
Project Director – Financial Reporting

cc: Paul O’Flaherty (Chairman of the Accounting Practices Committee)
Prof Danie Coetsee (Deputy Chairman of the Accounting Practices Committee)



GENERAL COMMENTS

In our view this exposure draft on leases provides a pragmatic approach to accounting for leases and do not largely reflect a principles-based approach.

Given the shortcomings of the existing leases model which provided entities with structuring opportunities, we do not entirely believe that this risk will be mitigated by the proposals. Existing structuring opportunities would be replaced by new structuring opportunities. These new structuring opportunities are outlined in the responses to questions where we have also provided examples to illustrate the issues.

Our constituents had diverse views on the proposed leases model, however, the majority were in support of the proposed recognition, measurement and presentation of expenses and cash flows arising from a lease. Whilst the majority supported the proposed lease accounting, it did not seem apparent why there is a lack of symmetry on the application of the standard for a lessee and lessor. Our preference is that the application of a proposed standard that considers the treatment for both parties to an arrangement should scope either both or neither party into the standard.

We note that the proposed disclosure requirements for leases are onerous and we recommend that the International Accounting Standards Board (IASB) consider the volume of disclosures proposed in light of its recent Feedback Statement on the Discussion Forum on Financial Reporting Disclosure issued in May 2013.

Our comments, concerns and suggestions with the proposed leases model have been set out under the responses to each question and the ‘Other comments’ section set out below.

SPECIFIC COMMENTS

Question 1: identifying a lease

This revised Exposure Draft defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration”. An entity would determine whether a contract contains a lease by assessing whether:

- (a) fulfilment of the contract depends on the use of an identified asset; and*
- (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.*

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

In reading the proposed definition of leases in conjunction with the illustrative examples provided in the exposure draft, we felt that there was a disconnect between the definition and some of the illustrative examples provided. As a consequence, the conclusions reached in

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these illustrative examples seem to be inconsistent with the proposed definition of leases. We compared and contrasted the examples below:

- Example 2 on the contract for coffee services. Whilst we are in agreement with example 2 that the contract does not contain a lease, we are unclear as to how the IASB differentiates between the incidental nature of the supplier's consumables in this example on the contract for coffee services and example 3 on the contract for medical equipment. In example 3, the customer has the ability to use other consumables, but is prohibited from doing so under their agreement with the supplier. Therefore, the ability to substitute is not substantive. Our recommendation is that IASB review the responses for both of the above-mentioned examples to establish whether there could potentially be a tension between these two examples as well as the definition of leases.
- Example 5A on the contract for energy/power. In our discussions we had difficulty understanding the reason why the conclusion to this example and example 2 are different. In both these examples the ownership of the assets (coffee machine and power plant) rests with the supplier, but in example 2 the coffee machine is considered as incidental to the delivery of the coffee services. It could also be argued that the power plant is incidental to the delivery of electricity.

To further assist in understanding the application of the definition of leases, we request that the IASB consider including an example to illustrate how the definition would be applied to a time charter similar to that provided in the Staff Paper of the IASB/US Financial Accounting Standards Board (FASB) meeting held on 1 and 2 February 2011 on 'Leases – Examples to distinguish a service from a lease: Education Session' and the Staff Paper on IASB/FASB meeting held during the week of 11 April 2011 on 'Leases – Definition of a lease – application examples'.

There was a view by some of our constituents that the use of the wording "*ability to direct the use*" should be reviewed as it does not seem to capture what was intended by the IASB. These constituents interpreted this wording as meaning directing the asset as opposed to directing how the asset is being used. This was particularly evident in attempting to understand the differences between example 5A and 5B. To eliminate any ambiguity, we request that the IASB consider revisiting this wording in the proposed definition.

We propose that the IASB consider providing a definition of executory contracts to make it easier to distinguish between a lease and an executory contract. Our constituents struggled to follow the subtleties between example 5A and 5B and therefore a clear definition as to what constitutes an executory contract would assist. Further, some of our constituents questioned whether the exposure draft's definition of a lease was sufficiently clear in determining whether the procurement of services, such as consulting services, would require accounting in terms of the exposure draft or as an executory contract. Our constituents believe that if examples are needed to clarify a definition within the proposed exposure draft then the definition has shortcomings that should be addressed in the final standard.



Our constituents recommend that the use of phraseology similar to that in IFRS 10 – *Consolidated Financial Statements*, where agent and principal are dealt with, may assist in distinguishing a service contract (executory contract) from a lease contract.

The scope of the proposed leases standard excludes leases of intangible assets for lessors (paragraph 4) and appears to allow for an accounting policy choice for a lessee. It is unclear why there is a lack of symmetry of the application of the standard for a lessee and lessor. Our preference is that the application of a proposed standard that considers the treatment for both parties to an arrangement should scope either both or neither party into the standard. We concur with the IASB's conclusion (as set out in BC81) "*that a separate and comprehensive review of the accounting for intangible assets should be performed before requiring leases of intangible assets to be accounted for under the proposed leases requirements*".

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

The majority of our constituents agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should be different for the different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

We do however envisage that entities may experience difficulties in applying the proposed recognition and measurement requirements in practice. For example, a lessee may have a contract where the measurement amount for the statement of financial position presentation is zero as all the payments are variable payments not linked to an index or rate. There was uncertainty amongst some constituents as to how these payments should be reflected in the statement of cash flows. Further, some believe that entities may treat these contracts as executory by default because the lease contract falls outside the measurement criteria for the statement of financial position.

There was also a minority view that only one approach to the accounting for leases should be followed, similar to Type A leases, as the consumption of the underlying asset is not relevant in accounting for leases. In all leases, the lessee has a right of use of an asset and the right of use should be amortised. The consumption of the asset is not relevant to the financial results of the lessee, it is only the right of use that is relevant. Supporters of this view also believe the accounting for Type B leases creates a disconnect between the statement of financial position and the statement of profit or loss, as a lease liability is created and interest charged to the liability that is accounted for as part of the lease expense in the statement of profit or loss and not as an interest expense. Similarly, in both Type A and Type B leases a right of use asset is created. The right of use of Type A leases is amortised to the statement of profit or loss but the amortisation of Type B leases is classified as a lease expense (with the related interest charge) and is not amortised in a manner that reflects the consumption of the expected future economic benefits of the right of use asset. Supporters of this view further argue that the



introduction of Type B leases complicates the application of the lease standard significantly as it requires the classification of leases on an individual lease basis to allow differential treatment.

We further recommend that there should be an alternative to the “*incremental borrowing rate*” definition. The incremental borrowing rate requires the rate to reflect the lease payments, the lease term, the security attached to the lease, the nature of the underlying asset and the economic environment. Many entities do not have secured borrowings, as the majority of their borrowings are from the corporate bond market or other long term unsecured markets and thus would be attempting to create a hypothetical interest rate. Accordingly we suggest that the IASB consider allowing the use of the rate that already exists in International Financial Reporting Standards (IFRSs) and thus already understood by users.

Question 3: lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

In line with our response to question 2 above, the majority of our constituents, in principle agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. A minority of our constituents are of the view that there should be only one lease model to reduce complexity and mirror the view expressed for lessee accounting. The method proposed by this minority view is similar to a Type A lease as presented in the exposure draft, including the additional comments presented below.

However, there is concern that the underlying asset is reflected on both the lessee and the lessor’s statement of financial position in a Type B lease, notwithstanding that one is recognised as a tangible asset and the other as a right of use asset. We do not believe that users would necessarily understand this accounting result.

The majority of our constituents are also concerned with the level of complexity that is likely to be involved in implementing the proposals for lessor accounting for Type A leases, particularly where the arrangement includes variable lease payments. We believe that the exposure draft’s proposals in this regard will be difficult to implement for lessors. We further believe that the calculation of the residual asset, as proposed in the exposure draft, seems unnecessarily complex. The gross residual asset should be an allocation of the carrying amount of the asset without the requirements to apply discounting. The IAS 16 – *Property, Plant and Equipment*, determination of the residual value is consistent with this method. Our recommendation is that the IASB consider simplifying the calculation of the gross residual asset by aligning it with the IAS 16 approach for determining the residual values.

Similarly, we disagree with how the total profit is determined for lessors for Type A leases as outlined in paragraph 74 of the exposure draft. Our preference is that this profit be determined as the difference between the present value of the lease payments and the portion of the asset



that will be derecognised, which is the carrying value of the asset less the residual value of the asset. This is in line with the requirements of IAS 16. The assumption with this approach is that the lease payments include an estimate of all variable lease payments.

Question 4: classification of leases

Do you agree that the principle on the lessee’s expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

The majority of our constituents agree that the principle on the lessee’s expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34 of the exposure draft, which differs depending on whether the underlying asset is property. We note that the prohibition from reassessing the classification of the lease subsequent to the commencement date could be subjected to structuring opportunities as illustrated in this scenario:

- In South Africa some entities utilise a 364 day lease that was structured for IAS 17 – *Leases*. This contract has no option or extension clauses and thus contractually terminates on day 364. The lessor is theoretically at risk, but the contract relates to assets where there is only one potential lessee and should the lessee not decide to enter into a new lease arrangement then this may cause a financial effect on the future operations of the lessee.

In addition, it is unclear as to us whether the IASB envisages that situations are likely to occur where economic compulsion may result in a lease and the contractual arrangements may need to be overridden.

Given that the exposure draft concentrates on the enforceable rights of the parties to the contract and in the above ‘real life’ example there are no enforceable rights at the end of the 364 day period, this appears to be a structuring arrangement that will not be captured by the exposure draft without a redrafting of the definition of a lease to capture this anomaly.

Any redrafting would then potentially require a re-examination of the variable lease definition. We have concluded that this anomaly may not be capable of being captured within the exposure draft without a similar change to IFRIC 21 – *Levies*, given the arguments presented as to why there was no accrual at the year-end for the type of payments covered under IFRIC 21.

Further, we recommend that an example covering “*in-substance fixed lease payments*” should be included. To explain by means of an example: a large retailer that is an anchor tenant in a shopping centre may negotiate with its lessor to structure all its lease payments as variable lease payments (say 1% of revenue), while in economic reality, taking into account past performance and revenue forecasts, the lease payments will never fall below R10 000 per annum, as the retailer’s revenue would not fall below R1 million per annum. In this instance a portion of these lease payments therefore have the nature of “*in-substance*” fixed lease payments.



Question 5: lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Whilst we appreciate that there may be measurement issues which entities might have to deal with in practice, we agree with the proposals on the lease term.

Moreover, we would like to have more guidance in the final standard on what is meant by “significant economic incentive”. The guidance could also clarify whether the assessment should be performed for each individual lease or a portfolio of leases where some leases may not be profitable, but required for the profitability of the cash generating unit.

Question 6: variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

The majority of our constituents do not agree with the proposals. The proposals on the measurement of variable lease payments are not conceptually sound and only provide a practical expedient. Even with the practical expedient we are convinced that entities are still likely to encounter measurement issues. For example: a large retailer may have a 100% variable lease payment rental agreement where the percentage rate applicable to the lease was negotiated and concluded when the contract terms and conditions were established. Indisputably the retailer considered the percentage rate inherent in the variable payment when considering whether to enter into the contractual arrangement. It would seem logical that the budgets of the entity are the best proxy to determine what is an “in substance” fixed rental. If the variable lease payments are not included we believe that opportunities for structuring could arise.

A minority were in agreement with the proposals that most variable lease payments should be excluded as these are service contracts.

The definition of variable lease payments refers to payments that are “other than the passage of time”. We suggest that the IASB provide greater clarity on what is meant by “other than the passage of time”. For instance, this reference appears to imply a linkage to an interest rate for the compensation of time value of money, but would not be the case since paragraph 39(b) specifically includes market interest rates in such payments.

Question 7: transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?



We agree with the proposals as set out in paragraphs C2-C22. In addition, we propose that the IASB should consider providing entities an exemption from applying the proposals in respect of leases that no longer exist at the effective date, similar to the exemption provided in IFRS 10.

Question 8: disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

The proposed disclosure requirements seem to be onerous. The IASB should consider, in future, these disclosure requirements in light of the disclosure framework that is yet to be developed. We further urge the IASB to consider the volume of disclosures proposed in light of its recent Feedback Statement on the Discussion Forum on Financial Reporting Disclosure issued in May 2013.

In line with the objective of the proposed leases standard to report useful information to users of financial statements about the amount, timing and uncertainty of cash flows arising from a lease, we request that the IASB require entities to provide additional disclosures about their lease agreements for which they have a business practice to renew, but the lease agreement does not specifically contain a renewal option. This is highlighted in our answer to question 4 where we provided an example of the 364 day lease.

Paragraph 67 of the exposure draft suggests a maturity analysis similar to that as required by IFRS 7 – *Financial Instruments: Disclosures*, yet it specifies the required time periods. We suggest that the exposure draft rather require disclosure by time period on a consistent basis with that used for the contractual maturity analysis for financial instruments in terms of IFRS 7. We also believe that the disclosure of a reconciliation between the undiscounted cash flows to the amounts presented in the financial statements should not be required (consistent with IFRS 7).

Paragraph 106 suggests that lessors provide a maturity analysis of the lease receivable reflecting the undiscounted cash flows to be received and to provide a reconciliation between that amount and the amount reflected on the statement of financial position instead of the disclosures as required by IFRS 7, paragraph 37(a). In this regard:

- We question whether the reference to paragraph 37(a) is appropriate since that paragraph requires disclosure of “*an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired*”;
- We suggest that a maturity analysis is not specified, but rather that it be consistent with that provided for lease liabilities and financial liabilities (IFRS 7); and
- We also believe that the disclosure of a reconciliation between the undiscounted cash flows to the amounts presented in the financial statements should not be required (consistent with IFRS 7).



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Question 9 (FASB-only): non-public entities

To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for non-public entities:

(a) To permit a non-public entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.

(b) To exempt a non-public entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for non-public entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

We have no comments.

Question 10 (FASB-only): related party leases

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

We have no comments.

Question 11 (FASB-only): related party leases

Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

We have no comments.

Question 12 (IASB-only): Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

We agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property.

Paragraph 82 of the consequential amendment to IAS 40 states “when an entity first applies this Standard, the adjustment to the opening balance of retained earnings includes the



reclassification of any amount held in revaluation surplus for investment property”. Some of our constituents have suggested that the words “*retained earnings*” in the above mentioned paragraph be replaced with the word ‘equity’ or ‘a component of equity’.

OTHER COMMENTS

Impact for leases on regulated entities

We propose that the IASB should consider the impact and consequences of the leases proposals on regulated entities as we are of the view that these proposals will have a significant effect on such entities. We have provided below an illustration of the impact of the leases proposals on banks, as we see it.

The most significant difference, as compared to the current IFRS requirements, relates to the accounting treatment of operating leases from the lessee’s perspective. Currently operating lease payments are recognised as an expense on a straight-line basis over the lease term. The exposure draft proposes the recognition of a lease liability, for the present value of the expected lease payments, as well as a right-of-use asset for all leases that have a contractual period of more than 12 months. The right-of-use asset attempts to reflect the lessee’s right to consume a portion of the underlying asset, rather than merely paying for the use thereof. The lessor model under the exposure draft is similar to the current lease accounting with a few subtle differences with respect to the recognition of revenue and recognition of a residual asset. Such treatment will result in a gross up on the statement of financial position. From a South African regulatory perspective, the increase in both assets and liabilities will have an impact on the prudential requirements of banks as follows:

- The right-of-use assets will attract a risk weighting of 100% for purposes of determining capital requirements in support of these assets;
- Given the long term nature of the right-of-use assets, the right-of-use assets is expected to be categorised under Basel III as “Other Assets” and will attract a 100% stable funding requirement; and
- Liabilities arising from the lease agreement will increase the bank’s total liabilities, resulting in a reserving requirement of 2.5% of the balance, as well as a liquid asset requirement of 5% of the balance. The liability does not contribute to the stable funding Basel III requirement.

Clarification of the words “*significant*”, “*insignificant*”, “*major*”, “*material*” and “*substantially all of*”

We also urge the IASB to clarify the meaning of these terms “*significant*”, “*insignificant*”, “*major*”, “*material*” and “*substantially all of*” because it is unclear as to how these terms correlate with one another.

Reassessment of the lease liability and lease receivable: foreign currency

The exposure draft contains guidance regarding the accounting requirements for the reassessment of the lease liability and lease receivable. We recommend that the exposure draft

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be clearer in requiring that foreign denominated lease cash flows should, for this purpose, be required to be assessed in foreign currency, with all changes in foreign currency rates being accounted for in terms of IAS 21 – *The Effects of Changes in Foreign Exchange Rates*.

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