Response to the IASB Exposure Draft
Leases

13 September 2013
INTRODUCTION

ICAS welcomes the opportunity to comment on the IASB’s Exposure Draft ED 2013/6: Leases.

The ICAS Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The ICAS Accounting Standards Committee has considered the Exposure Draft and I am pleased to forward their comments.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Technical Policy and Secretary to the Accounting Standards Committee.

RESPONSE TO THE EXPOSURE DRAFT

KEY COMMENTS

We continue to support the development of a new standard on lease accounting and would like to commend the IASB on the current Exposure Draft which demonstrates that it has taken on board much of the feedback from previous consultations and addressed stakeholder concerns. This has resulted, in our view, in improvements in many areas of the proposed standard, such as the treatment of the lease term and variable lease payments. Whilst it is likely that the implementation of the proposed standard will increase costs for preparers, we believe the current draft is more logical than previous versions and therefore should be easier to implement.

As we have expressed in our responses to earlier consultations, we support the ‘right-of-use’ model which succeeds in addressing one of the key criticisms of existing lease accounting in that it brings lease assets and liabilities onto the balance sheet of lessees. However we are disappointed that the proposals have not resulted in a single income measurement model for all leases which would have fully addressed criticisms of the current ‘bright line’ between operating and finance leases. The proposed dual approach creates further complexity and the potential for new structuring opportunities. We find the approach taken for Type B leases conceptually weak, and hence likely to limit the effectiveness of the proposals in general. While we appreciate that the IASB has taken a pragmatic approach in order to produce a result that is acceptable to stakeholders, we dislike exceptions from principles and for this reason would prefer a single approach for all leases.

RESPONSE TO EXPOSURE DRAFT QUESTIONS

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.
Response:
Overall we agree with the definition of a lease and the proposed requirements for how an entity would determine whether a contract contains a lease. We believe that the focus on the right to use a specified asset rather than one of a number of assets of a particular specification is the correct one, as it ties into the common-sense and widely-understood definition of a lease. We support the material on the substitutability of an asset. As there is a risk that contracts could be structured to include a substitution clause in order to avoid applying lease accounting, we believe that the IASB should consider adding wording to emphasise that all relevant factors should be taken into account in assessing whether a contract contains a lease, to ensure that the overall economic substance and business purpose of the contract is appropriately reflected in the accounts.

We support the changes to the application guidance on 'the right to control the use of an asset' to align this with the concept of control used in other projects.

As stated in BC105(d) the definition of a lease will narrow the scope of the proposals so that some contracts that were previously considered leases will no longer meet the definition. In light of this, we believe the IASB should consider whether existing disclosure requirements would provide sufficient information about an entity's obligations under service contracts that would no longer be classified as a lease.

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?

Response:
We are not convinced that the recognition, measurement and presentation of expenses and cash flows from a lease should differ for different leases, and find the conceptual reasoning for this decision rather weak. We believe that a dual approach will introduce complexity, will be confusing for users and will increase opportunities for structuring. As one of the major criticisms of the current lease accounting model is the bright line between operating and finance leases, we are concerned that another dual approach will not deliver the desired improvements in financial reporting.

We understand that the approach the IASB has taken is a pragmatic one, which allays the concerns of some stakeholders about the front-loading of property lease expense, but it is disappointing that it has not been possible to arrive at a single approach for all leases. We agree with the statement in BC38 that it is impossible to develop a lease accounting model that all stakeholders would agree to, therefore it would be preferable to retain a single lessee accounting model which would be conceptually more coherent, and easier to understand and implement.

We are not persuaded by the reasoning behind distinguishing between different types of leases based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. The only justification presented for this approach seems to be that a straight-line lease expense is supported by property lessees and ‘some users.’ This desire to arrive at a straight-line lease expense for property leases results in inconsistencies in the accounting model which weaken the conceptual basis of the proposed standard and could result in structuring opportunities and a lack of comparability and consistency in the accounting for similar leases by different entities.

The concept that the useful life of the underlying asset is relevant to the accounting treatment of the lease expense is at odds with the central concept that the lessee obtains a ‘right-of-use’ asset that is distinct from the underlying asset, and which the lessee consumes over the lease term. The result of this, for Type B leases, is that there is a mismatch between the balance sheet and income statement treatment of the same lease, while the amortisation of the right of use asset is essentially meaningless as it is a balancing figure.
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?

Response:
As noted above, we are not convinced by the reasoning for a dual model, and have concerns about the accounting approach for type B leases which extend to lessor accounting as well. The accounting for a type B lease by a lessor and lessee is asymmetrical i.e. the lessee recognises a right of use asset, but the lessor does not derecognise the relevant portion of the underlying asset. This only serves to demonstrate the problems caused by the lack of a clear conceptual approach to the treatment of type B leases. We note that the lessor accounting for type A leases will be complex to apply, but we are content that it is the correct conceptual approach.

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?

Response:
As stated above, we do not support the classification of leases between type A and type B and would prefer to see a single accounting approach. We believe that the use of terms such as ‘insignificant’, ‘major part’ and ‘substantially all’ may create complexity and inconsistencies in how leases are allocated between the two categories. If the IASB decides to proceed with the dual approach, we would recommend changing the terminology of ‘Type A’ and ‘Type B’ which is uninformative – it would be more straightforward to refer simply to ‘property’ and ‘non-property.’ Furthermore, we do not believe there is adequate justification for using a different economic life to test whether a lease is type A or type B – i.e. for non-property it is the total economic life, while for property it is the remaining economic life (paragraphs 29 (a) and 30 (a)). We believe the remaining life should be used in both cases, as this reflects the underlying asset that is being leased.

We also believe that further work is required around the definition of property as there are a number of items which could give rise to inconsistencies in classification, for example, mobile phone towers. In the illustrative examples, it would be more helpful to include cases which rebut the principles i.e. a non-property item that is treated as Type B and a property treated as Type A.

We disagree with the requirement in paragraph 33 that if a lease component contains both land and a building, it is the economic life of the building that is used as the economic life of the underlying asset. We do not believe this will always be appropriate as there are cases where it is land that is the primary asset, for example, a golf course, and therefore the economic life of the land is the more relevant figure.

A further area of concern is that leases cannot be re-classified between type A and B if, for example, an option is exercised that changes the substance of the lease. We believe that this demonstrates the weakness of the dual approach.

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?
Response:
We believe that the proposals on lease term are conceptually and operationally more effective than those in the 2010 Exposure Draft. We were concerned that the previous proposal based on the most likely lease term could lead to the recognition of assets and liabilities that did not meet the definitions in the conceptual framework. The revised approach, based on the inclusion of periods covered by options which the lessee has a significant economic incentive to exercise, should result in a lease term being recognised that reflects the underlying economic reality.

We agree with the requirement to reassess the lease term, but believe this could be fairly onerous for lessors and lessees. The IASB should consider emphasising materiality in this regard, so that preparers do not perceive that there is a requirement for reassessment even for relatively minor changes in relevant factors.

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?

Response:
We agree with the proposals on the measurement of variable lease payments. We believe that the exclusion of variable payments based on future performance is correct, as these do not meet the definition of a liability. In example 17C, the solution as currently drafted gives the impression that the entity would be free to choose either of the two measurement amounts: this should be amended to make clear that the appropriate measurement is the lower of the two amounts.

As we have stated in relation to the reassessment of the lease term, we believe it is worth emphasising materiality in relation to changes in an index or rate which would trigger a reassessment.

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?

Response:
Given the wide-ranging impact of the lease proposals and the complexity of first-time implementation, the IASB should allow sufficient preparation time before the implementation date. There is a need to recognise that the extent of the knock-on effects from the implementation of the proposals - for example, lessees may need to renegotiate covenants, bodies such as credit agencies will need to make adjustments to incorporate the new accounting information that will result, and new IT systems may be needed by lessors and lessees.

In general we support full retrospective application of new standards, but we also agree with the specific reliefs proposed. We note that in C8 paragraphs (a) and (b) the measurement date is different (effective date vs. commencement date) – a preferable rate would be the rate at the beginning of the earliest comparative period.

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?
Response:
We agree with the disclosure objective for lessees and lessors as set out in paragraphs 58 and 98, although we would prefer to see the wording ‘The disclosure objective is…’ rather than ‘the objective of the disclosure requirements’. The former gives more prominence to the high-level objectives instead of the detailed requirements. We also welcome the wording in paragraphs 59 and 99 which is a useful reminder to preparers to consider the materiality of their disclosures. However, the disclosure requirements that follow are still fairly extensive and may encourage a ‘checklist’ approach by preparers. We would prefer disclosure requirements to be presented in a more summarised format, and perhaps being presented as examples of the types of disclosures required, to avoid the impression that all requirements are mandatory.

We agree that under the dual approach that it will generally be necessary for presentation and disclosure purposes to give separate information for Type A and Type B leases. However, this would be unnecessary and the requirements simplified if a single approach was used for all leases.

Questions 9, 10, 11 – FASB only

Question 12 – 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?

Response:
We agree with the proposed amendments to IAS 40, which remove an option currently available in IFRS. This will improve consistency and comparability.

Additional comments:
We support the exemption for short-term leases but think this material should be presented more prominently towards the beginning of the standard so that preparers are not required to read the full standard before discovering that the exemption is available.