



THE ASSOCIATION  
OF INTERNATIONAL  
ACCOUNTANTS

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## ASSOCIATION OF INTERNATIONAL ACCOUNTANTS

### Response to IASB – Basis for Conclusions on the Exposure Draft Leases

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*Company number 00264086. The AIA is a Recognised Qualifying Body for company auditors in the UK.*

## Introduction

These comments are submitted by the Association of International Accountants and written by John Dunn, AIA technical adviser and lecturer at the University of Strathclyde.

## About AIA

The Association of International Accountants (AIA) was founded in the UK in 1928 as a professional accountancy body and from conception has promoted the concept of 'international accounting' to create a global network of accountants in over 85 countries worldwide.

AIA is recognised by the UK Government as a Recognised Qualifying Body for statutory auditors under the Companies Act 2006, across the European Union under the Mutual Recognition of Professional Qualifications directive and as a Prescribed Body under the Companies (Auditing and Accounting) Act 2003 in the Republic of Ireland. AIA also has supervisory status for its members in the UK under the Money Laundering Regulations 2007.

AIA promotes and supports the advancement of the accountancy profession both in the UK and internationally. The AIA exams are based on International Financial Reporting and International Auditing Standards and are complimented by a range of variant papers applicable to local tax and company law in key jurisdictions together with an optional paper in Islamic Accounting.

AIA members are fully professionally qualified to undertake accountancy employment in the public and private sectors.

## Response to IASB – Leases

### 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?

The AIA believes that the recognition of a right-of-use asset and a liability to make lease payments is a practical response to the difficulties associated with accounting for leases and leased assets. The distinction between finance and operating leases has been problematic in the past. The present proposals appear to provide a realistic basis for ensuring consistency in this area.

(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?

The AIA agrees with this proposal. It is important to recognise that lease liabilities are essentially liabilities and that their associated finance charges should be treated in a manner that is consistent with the charges on the other liabilities.

#### 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?

The AIA believes that there is some merit in distinguishing finance leases and operating leases from the lessor's perspective (which is essentially what is happening here). There does not appear to have been the same degree of controversy over lessor accounting for leases as there has been for lessee accounting. Furthermore, lessors are likely to have much greater sensitivity to the accounting treatment of leases than lessees because leasing is likely to provide a much greater proportion of a lessor's business. That both justifies the availability of greater flexibility for lessees and should mean that users of lessors' financial statements should be more alert to the nature of the leasing business conducted. Accounting for the provision of a pool of assets that is available for relatively short-term use is a much different business model to the provision of long-term finance for specific lessees.

The AIA agrees that the two models proposed by the draft standard provide a logical basis for the treatment of the two categories of lease.

(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?

The AIA recognises the possibility that the proposals may leave a degree of discretion in the recognition of assets and revenues. However, that is not viewed as a reason to disagree with the proposal.

The logic underlying the proposed treatments appears to be consistent with the definitions of the elements in the Framework document.

#### Question 3: Short-term leases

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?

The AIA supports this treatment of short-term leases. The twelve month cut-off is sufficiently short to minimise the scope for creative accounting. The only danger is that some lessees may use this provision to get round the spirit of the standard. There could be a limited possibility

that several "generic" assets such as company cars could be leased for, say, 11 months and returned to the lessor at the conclusion of that period, with replacements being leased on the same basis from a different lessor. The AIA considers such behaviour to be unacceptable, but there is no realistic means to prevent lessees from going to such lengths if they are determined to avoid the rules. It would be difficult for the leasing industry to create such avoidance schemes for more specialised assets because lessors would have to take the risk that assets returned at the end of each short-term agreement would remain unused.

#### 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?

The AIA supports the proposed definition. It is sufficiently broad to make it difficult to avoid.

The definition is potentially very slightly inconsistent with the logic underlying the treatment of service contracts where the separate service contracts cannot be distinguished (B5-B8). The AIA supports the treatment of service contracts in this way and accepts that it is probably better to leave the potential inconsistency as it stands rather than making the definition of a lease more complicated.

(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?

The AIA supports this distinction. In the event that the contract is defined as a purchase/sale then the lessee will have to recognise both an asset and a liability. Given that the purpose of this proposed standard is to ensure that liabilities are recorded as such in the financial statements, there can be no harm in this distinction. Furthermore, it would be unfortunate if hire-purchase agreements and similar contracts were treated as leases.

(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?

The AIA believes that it would be difficult to exploit the distinction in order to avoid the spirit of the draft standard. That suggests that the guidance is sufficient.

#### 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?

The AIA supports the proposed scope of the draft standard. The exclusions are all either cases for which a more specific standard is required (para 5) or for which there is a clear logic (paras 5-9)

#### Question 6: Contracts that contain service components and lease components

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 AIA supports this treatment because the provision of outsourced services that were designed in such a way as to make them difficult to unbundle is an obvious way in which the draft standard could otherwise be avoided. For example, logistics companies could agree to provide delivery services that involved the exclusive use of vehicles in the contractees' livery. In that case there would be no explicit contract for the vehicles and so no lease, but the contractee would enjoy the risks and rewards of their ownership.

#### Question 7: Purchase options

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?

The AIA supports this proposal on the grounds that the draft makes it clear that the option will be accounted for earlier if it is clear that exercise is almost certain to be exercised. The concept of substance over form would also come into play in deciding how a purchase option should be accounted for.

#### 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?

The AIA supports this requirement on the grounds that it closes a potential avoidance loophole. Clearly, the external auditor of any entity that was intent on misstating its intentions in this area would find it difficult to ensure that the standard was complied with. Unfortunately, there is no viable alternative because any lease could, in theory, be extended indefinitely.

#### 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?

The AIA supports this provision on the basis that it is consistent with the concept of substance over form and reduces the scope for avoidance. The fact that "expected outcome" may be difficult to determine in some cases does not undermine the validity of the treatment.

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?

The AIA believes that this treatment is consistent with the treatment of contingent gains in other standards and so it supports this proposal.

#### 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?

The AIA supports the need for reassessment if only because of the potential for a lease to span many years and for relevant facts to change.

#### 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?

The AIA supports the proposed criteria. There is sufficient scope in the criteria to ensure that it would be difficult to avoid recognition.

#### 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?

The AIA supports the separate presentation of assets and liabilities because their nature may be important to a reader who wishes to understand the entity's gearing and/or capacity to provide collateral for further borrowing. The AIA believes that it would be sufficient for such separate presentation to be in the notes to the financial statements rather than on the face of the statement of financial position, but that the manner of presentation is hardly a material question. Arguably those readers who will not be able to digest the information provided in the

notes will be unlikely to fully appreciate the significance of the information if it is stated on the face of the statement.

(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?

The AIA does not believe that this is a significant matter provided that the separate components are disclosed by note so that readers can see what assets and liabilities are in the financial statements. There is, however, a danger that offsetting balances in this manner will be viewed as a precedent in future matters.

(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?

The AIA supports the right to present assets in this manner, if only because the right to receive a lease payment could be a current asset that may take some time to be collectable. Readers may be misled as to the liquidity of the lessor.

(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?

The AIA believes that such a distinction is important because of the question of the ultimate ownership of the underlying asset, which may be significant in terms of securing the financial asset.

#### 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?

The AIA does not believe that there is any need to present these figures separately on the face of the income statement. This is, clearly, an important disclosure but it is sufficient to ensure that the figures are provided in the notes.

#### 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?

The AIA does not believe that it is necessary to adopt any specific treatment in the statement of cash flows. Arguably, the accounting issues associated with leases are primarily associated with the financial position of the entity.

#### Disclosure

#### 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?

The AIA believes that these disclosures are extremely important. One argument may be that the whole question of accounting for leases has been heavily contested over the years and the disclosure of lease payments has been the one consistent fact that has been available to users for much of that time. Arguably, the present draft has been developed in response to the use to which users have put the disclosure of costs associated with operating leases.

#### 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?

The AIA believes that the proposed transitional arrangements in paragraphs 88–96 are sufficient and that they are a pragmatic approach to implementing the new standard.

#### 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?

The AIA does not believe that the costs associated with this proposal should be unduly onerous for many entities. There may be a need for some to revisit the terms of debt covenants, but even then such entities will almost certainly have had to disclose major commitments to their lenders.

Given the importance of this topic in the history of standard setting and the debates about the economic consequences, the AIA believes that improving the accounting treatment of leases would justify the imposition of a certain amount of cost and inconvenience.

#### Question 18

Do you have any other comments on the proposals?

The AIA does not have any further comments.