The Association of Corporate Treasurers

Comments in response to
Discussion Paper, Leases, Preliminary Views
Issued by the IASB,
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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance.   Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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The ACT is in agreement with your overall approach whereby operating leases, that are currently not capitalised as an asset and liability, should be brought on balance sheet. Many analysts already make some sort of adjustment to this effect when analysing accounts and equally companies will often produce "adjusted" numbers in their presentations to investors.

Your approach of recording the asset based on a right of use concept and a liability for the obligation to pay rentals appears reasonable. However when it comes to some of the more complex and detailed calculations required in connection with options and contingent rentals etc there are clearly a variety of approaches possible and in our view the final selected methodology will inevitably be somewhat arbitrary. Nonetheless it is important for all preparers to apply a consistent and set approach.

On these more complex leases including contingent rentals, residual value guarantees and options you will receive responses giving a range of views and indeed because of the range of views likely to be expressed by our own members we do not feel that this is an area where we can take a definitive position. Accordingly for most of the later questions we have refrained from giving an ACT answer.

Your DP has not discussed the issues arising where a lease contains a significant service element that needs to be split out. Notwithstanding IFRIC4 “Determining whether an arrangement contains a lease” and EITF 01-8 “Determining whether an arrangement contains a lease”, there are going to be many operating leases where this question will be raised. We feel it appropriate for any new standard to provide guidance on how any service element should be split from the financing element.

Specific questions

Chapter 2: Scope of lease accounting standard

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?
If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

No comment

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Answer 2
Since we support the approach of recording the asset based on a right of use concept, it would be illogical to exclude non-core and shorter leases. However we suspect that many companies would argue for an exclusion in order to simplify the preparation of accounts. In other words a better basis for exclusion would be to allow it for non-material leases.

Chapter 3: Approach to lessee accounting

Question 3

Do you agree with the boards’ analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Answer 3

The boards identified the rights and obligation in a simple lease as being:
(a) right to use the asset for the lease term,
(b) obligation to pay rentals and
(c) obligation to return the asset at the end of the lease term.

Based on the board’s right of use approach only a) and b) meet the definition of an asset and liability. An alternative approach is to regard the lease as a transfer of the entire rights in the asset for its whole life in which case the asset will be larger and there would be a corresponding additional liability for the obligation to return the asset at the end of the lease.

If the purpose of the new accounting methodology is to ensure that irrespective of whether a company owns an asset or leases an asset the asset being displayed in the accounts is identical than a whole asset approach plus obligation to return the asset would be needed. This would ensure proper comparability of return on assets irrespective of the financing methods for those assets. However if you consider shorter term leases the reasonableness of the whole asset approach breaks down. Having the right to use an asset for just 6 months conceptually can not be regarded as having the whole asset and an obligation to return it for the life in excess of 6 months. The lessee blatantly does not have any rights beyond 6 months.

The fact that for an owned asset and identical leased asset the asset shown will be different is to be expected since the fact is the contractual basis and the economic position is different.

We therefore agree with your analysis of the rights and obligations, and assets and liabilities.

Question 4
The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)
(b) a liability for its obligation to pay rentals.
Appendix C describes some possible accounting approaches that were rejected by the boards.

Do you support the proposed approach?
If you support an alternative approach, please describe the approach and explain why you support it.

Answer 4

As discussed in answer 3 we agree with your "right of use" approach.

Question 5
The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

Answer 5
For more complex leases there can be a range of options built into the lease such as the right to extend the term. There is then a debate as to whether the lessees to should recognise and measure separately these options. From a purely theoretical viewpoint these options probably should be evaluated and recorded and this would be consistent with the approach to financial instruments. However the complexity in accounts preparation and the difficulty in establishing values means that in practical terms a components approach would fall into the "too difficult" category. For many leases we suspect that in the real world there is no market or ready means to realise this sort of option value, but yet for the lessee it does confer a potential economic benefit. The methodologies described elsewhere in your paper do allow an approximation to capture this.

We therefore support your decision not to adopt a components approach.

Chapter 4: Initial measurement

Question 6
Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?
If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Answer 6

The existing IFRS requires lessees to discount the lease payments using the interest rate implicit in the lease if it is practicable to determine that rate and, if it is not practicable to determine that rate the lessee's incremental borrowing rate shall be used. Residual values are often not available or determinable on what have been classed operating leases, so we accept that the use of a borrower's incremental rate is a suitable approximation. However we note that, in the case of a sale and leaseback struck at fair value, it is possible to determine the interest rate implicit in the lease, and the wording in the standard should not preclude using this in preference to the entity's incremental borrowing rate on the grounds that it is better objective information.

Question 7
Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Answer 7
We accept the boards' tentative decision.

However given that the right of use asset is determined as equal to the discounted value of the lease rentals we consider the terminology as to measuring the asset at cost to be of little relevance.

Chapter 5: Subsequent measurement

Question 8
The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.

Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

Answer 8
The accounting approach to recognise a liability in connection with a lease is effectively classing this as equivalent to an interest bearing liability that amortises over its life so that we regard an amortised cost based approach to the obligation to pay rentals as appropriate.

As your paper notes there are alternative ways of looking at this such as re-looking at the right of use asset each year and re-measuring it as linked to the obligation to pay rentals. To an extent the boards' preferred route, which we support, is somewhat arbitrary but nonetheless we believe it to be helpful to establish a set of common approaches which all preparers can apply.

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Answer 9
Generally speaking an entity's own financial liabilities are not fair valued and in the case of some lease obligations it is even questionable whether there really is a ready market value given the linkages with the asset etc. We therefore support your view that there should not be an option to measure the obligation at fair value.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons. If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows?
Please explain your reasons.

Answer 10
Leases are often by nature similar to fixed rate borrowings which are not re-measured to reflect changes in incremental borrowing rates so logically one should

not need to re-measure the lease obligation for such rate changes. We therefore support the FASB approach and disagree with the IASB tentative approach.

While leases are often similar in nature to fixed-rate borrowings, this is not always so. Some leases have payments that flex in line with changes in LIBOR, and are therefore essentially floating-rate leases. It is our view that changes in payment streams resulting from LIBOR changes should be expensed to the income statement. We are concerned that some of the IASB proposals for treatment of contingent rentals would not allow this to happen - indeed could be seen to result in applying something similar to fair value accounting to the lease liability. The FASB approach in 7.21 seems preferable, whereby “the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Changes in amounts payable arising from changes in the indices would be recognised in profit or loss.”

Question 11
In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

No comment

Question 12
Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.
Would you support this approach? If so, for which leases? Please explain your reasons.

Answer 12

Assuming that the standard is attempting to treat all leases as a form of asset ownership it seems logical to record the decrease in right of use asset as depreciation and not record it as a rental expense.

Chapter 6: Leases with options

Question 13
The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term. Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Answer 13
The boards’ tentative decision is to account for leases with options as to term by taking the “most likely” period rather than the alternatives mentioned of
(a) a probability threshold
(b) a qualitative assessment of the lease term
Then when it comes to contingent rentals the IASB (but not the FASB) have opted for taking a probability weighted estimate of rental amounts.
As in so much of this discussion paper there are arguments and rationales for all manner of approaches but the ACT considers that in taking a probability weighted approach to lease term too then you achieve the least wrong outcome or rather you minimise the “expected” (meaning probability weighted) error as compared to eventual outcome.

The ACT would propose use of a probability weighted term and not the “most likely” term.

Questions 14 to 21: No comment

Chapter 8: Presentation

Question 22

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

Answer 22

Your paper proposes that the obligations to pay lease rentals should be disclosed as part of financial liabilities. We agree with this treatment since the entire approach to accounting for leases is to do just that – treat them as equivalent to a form of borrowing. We agree that this lease liability is not sufficiently different to require a separate presentation on the face of the statement of financial position, however we would very strongly support the need for separate disclosure in the notes.

Question 23

This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position?
Please explain your reasons.
What additional disclosures (if any) do you think are necessary under each of the approaches?

Answer 23

The basis of accounting for leases is to treat them as a liability and a corresponding asset. For the user to understand what assets are employed in the business they need to be provided with a categorisation according to the nature of the leased item so that leased motor vehicles are included alongside owned motor vehicles. However because as discussed in the paper and this response the contractual rights to a leased asset are technically different from full ownership it would be helpful for these right of use assets to be identified of a separate line from owned assets.

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The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

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Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .

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