



**LEADING TREASURY
PROFESSIONALS**

The Association of Corporate Treasurers

**Comments in response to
Exposure Draft Lease ED/2013/6
International Accounting Standards Board
May 2013**

September 2013

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 believes this second Leases exposure draft (ED) is an improvement on the first ED, with the lease term better defined and some of the unnecessary complexity now removed.

Consistent with our response to the August 2010 Leases Exposure Draft the ACT is generally in agreement with the overall approach to a 'right-of-use' accounting model whereby both lessee and lessor record assets and liabilities arising from lease contracts. However we believe that the right of use model is not appropriate for all leases, particularly property leases, and hence these should not result in lessees capitalising these assets. The capitalisation of Type B or property leases proposed by the IASB has



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focused on recognising the lease liability without due consideration as to whether the resultant capitalised leased asset is a meaningful figure.

Specific questions

Question 1: Identify 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 the 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?

Some assets could be restructured as service contracts and kept off balance sheet.

The definition of a lease in the revised Exposure Draft (ED) provides the opportunity for contracts to be structured as service contracts in order to keep assets off balance sheet. The definition specifies that the lessee should have “the right to control the use of the identified asset.” Consequently a contract where the lessor has the right to substitute the asset for another equivalent asset could be deemed to be a service contract.

The definition requires significant judgement.

Paragraph 12 of the ED defines the “*right to control the asset*” as having both direct use of the asset and deriving the benefits from use of the asset. “*Benefits from use of the asset*” is in turn defined as the right to obtain substantially all of the potential economic benefit from use of the asset. There will be situations where both the customer and supplier can and make decisions on how the asset is operated. For example in a time charter of a vessel, typically the owner still manages the vessel but the charterer decides where the vessel will go. Whilst it may appear that the charterer has the right to control the use of the asset, it requires judgement to determine which of the two parties’ decisions significantly affect the economic benefit to be derived from the use of the asset.

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 exposure draft proposes that the principle for determining which approach to apply is based on the amount of consumption of the underlying asset. A lessee typically consumes a part of any equipment or vehicle lease because the asset is depreciating, over the economic life of the asset. The lessor prices the lease to recover the value of the part of the asset consumed as well as obtaining a return on its investment in the asset. For property leases (i.e. leases of land and/or a building) the lessee uses the asset without consuming a significant part of it (ignoring special-purpose, short-life structures, etc.).

The ACT believes that the right of use model is not appropriate for all leases, particularly property leases, and hence these should not result in lessees capitalising these assets. The resultant capitalised leased asset amount is not a true economic asset but rather an intangible contract right. The amount or size of the asset is significantly impacted by the length of the lease and will distort key ratios such as Return on Capital Employed (ROCE). Additionally these lease assets would not be regarded as assets under bankruptcy law.

Please note, the following comments are based on the assumption that the capitalisation of Type B leases remains for lessees as described in the ED:

- Single lease expense for Type B leases.

Paragraph 56 of the ED requires separate disclosure of the unwinding of the discount on the lease liability from the amortisation of the asset for Type A property and equipment leases. For Type B land and building leases the unwinding of the discount on the lease liability is presented together with the amortisation of the asset for Type B land and building leases. We believe that the lease expense for Type B leases should be accounted for like Type A i.e. the finance element of property leases should be charged to interest expense.

- Classification of lease payment in the Statement of cash flows

Paragraph 57 of the ED requires that repayments of the principal portion of the lease liability arising from Type A property and equipment leases is disclosed within Financing activities in the Statement of Cash Flows and that the unwinding of the discount on the lease liability arising from Type A leases is classified in accordance with the requirements relating to interest paid. However it also states that Type B lease payments are recorded within Operating activities within the Statement of Cash Flows.

We believe this inconsistent treatment is misleading. Your proposal for Type A is that consumption of the asset element of the lease payment is presented in Operating activities. We agree with this. The lease payment in a Type B lease is described in the ED as “a charge for the use of the asset” however given the debt-like lease liability on balance sheet we believe it would be more consistent to include the charge as an interest expense and hence we would suggest it should be included within Financing activities.

However if you adopt our recommendation that Type B leases are not capitalised then your proposed classification as an Operating activity seems appropriate as the lease payment is effectively contractual rent.

- Calculation of amortisation for Type B leases
Paragraph 50 of the ED calculates the amortisation of the right-of-use asset for Type B leases as “the difference between the following: (a) the periodic lease cost...” and “(b) the periodic unwinding of the discount on the lease liability.” This is clearly a balancing item and may or may not reflect the true pattern of consumption for land and buildings. Given this, it is questionable what the carrying value of the “Right of use: land and building asset” i.e. the asset less accumulated amortisation, represents. This is consistent with and reinforces our point that Type B lease assets are not true economic assets but rather an intangible contract right.

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 alternatives would you propose and why?

For Type A property and equipment leases a lessor shall derecognise the underlying asset at commencement and recognise a lease receivable, a residual asset, and any resulting profit or loss.

For Type B land and building leases a lessor continues to measure and present the underlying asset in accordance with other accounting standards and recognises lease payments as rental income in profit or loss.

Inconsistent approach

The inconsistent approach proposed by the IASB supports our argument that the Right of Use approach is not applicable for all types of leases. The right of use model would suggest that the right to use the underlying asset is transferred to the lessee at the point of commencement of the lease. Hence we cannot understand why the lessor does not reflect this transfer and derecognise a portion of the asset for both Type A and Type B leases.

Back to back leases

Type A equipment back to back leases end up with very different results than Type B land and building leases. When a Type A asset is leased the lessee capitalises the right-of-use asset, and then when sub-leasing the same underlying asset, as a lessor the asset is derecognised and a lease receivable recognised. When a Type B asset is leased the lessee also capitalises the right-of-use asset however when sub-leasing the underlying asset remains on the balance sheet. This results in an overstatement of Type B lease assets when sub-let.

We would recommend that the accounting treatment of Type B sub let assets is modified to remove this anomaly.

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?

Paragraphs 28-34 classify leases as Type A or Type B. Assets that are not property are Type A unless the lease term is insignificant compared to the economic life of the asset, or the PV of lease payments is insignificant compared to the FV of the asset.

Property leases and those that don't meet the requirements above are Type B unless the lease term is for the major part of the remaining economic life of the underlying asset, or the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

Whilst the guidance is based on the nature of the underlying asset and should be relatively easy for users to apply, the criteria for the exceptions include terms which don't appear to be defined. These are "insignificant," "major part of," and "substantially." We would ask for additional guidance.

Question 5: Lease term

Do you agree with the proposals on the measurement of variable lease payments, including reassessment 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?

A substantive modification to lease terms and provisions would create a new contract at the date that the modification becomes effective. Substantive modification includes changes to the contractual lease term. Renewal options will be only included in the lease term where there is a "significant economic incentive to extend". We believe this is an improvement on the last exposure draft which included renewal options on a "more likely than not" basis. However the current drafting may incentivise the structure of renewal options to avoid including the renewal period in the capitalised lease term. Hence we recommend there should be clear and concise disclosure of renewal options that would have a material impact but have not been capitalised in the notes to the accounts.

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?

Variable lease payments that depend on an index or a rate would be included in the lease liability, however forward rates and forecasting techniques would not be considered. Hence there may be an incentive to structure payment terms in order to receive the desired accounting outcome. In a similar manner to renewal options above the reader of the accounts needs to be made aware of what material variable lease payments have not been included in lease liability hence disclosure in the notes to the accounts is necessary.

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?

The ACT welcomes the Boards' modified retrospective approach which uses 'shortcut' calculations to initially measure the lease related assets and liabilities. However we note that implementation is on a lease by lease basis and for corporates with a significant volume of leases this will be a costly exercise.

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 payment; reconciliation 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?

We agree with the proposed disclosures.



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The Association of Corporate Treasurers

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Guidelines about our approach to policy and technical matters are available at <http://www.treasurers.org/technical/manifesto>.

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