The Association of Corporate Treasurers

Comments in response to
Exposure Draft Leases ED/2010/9
International Accounting Standards Board
August 2010

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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 to a 'right-of-use' accounting model whereby both lessees and lessors record assets and liabilities arising from lease contracts.

We acknowledge that this represents three significant changes:

- operating leases, which are currently not recorded on the balance sheet will be, ensuring one accounting model for all leases;
- accounting for lessors based on whether there has been a transfer of significant risks or benefits of the underlying asset; and

- leases accounted for based on their expected lease term, which includes options to extend or terminate, rather than the current minimum lease term (for finance leases only).

Specific questions

The accounting model

The exposure draft proposes a new accounting model for leases in which:

a) *a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments. The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.*
b) *a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease.*

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?

We agree with your 'right-of-use' approach which ensures that assets, no matter how they are financed, are on the balance sheet. We recognise that currently rating agencies, relationship banks and analysts will sometimes make adjustments to reflect the assets and liabilities arising from operating leases.

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?

We agree that the asset should be amortised and that interest should be charged on the liability.

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?

Conceptually it is difficult to understand why one accounting model covers all lease situations from the lessee's perspective whilst the same lease contracts require two different accounting models for the lessor. The performance obligation approach results in the asset being capitalised onto the balance sheet of two different parties, the lessee and the lessor.

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?*

It is difficult to understand how the lessor is able to determine the longest possible lease term that is more likely than not to occur without having insider knowledge of the lessee's strategies and business plans.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

a) *At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term.*

b) *At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term.*

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 simplified requirements provide little relief for lessees with short-term leases. Under the proposal, lessees will have to identify and track expected lease payments for all short-term leases which includes non-core assets, such as cars and photo copiers.

Even so we recognise the IASB's reason for not wanting to scope these out of the standard i.e. "short-term leases can give rise to material assets and liabilities and if scoped out and not accounted for then the financial position would be incomplete and would not be a faithful representation of those short-term leases" (paragraph BC43). Accordingly we accept the Board's proposed treatment.

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration. The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale and on distinguishing a lease from a service contract.

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?

Above definition appears reasonable.

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 no, what alternative criteria would you propose and why?

Above criteria appears reasonable.

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?

Refer summary of paragraphs B1 – B4 above.

Scope

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to exposure for or use minerals, oil, natural gas and similar non-regenerative resources.

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If no, what alternative scope would you propose and why?

No comment

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in 'Revenue from Contracts with Customers' to a distinct service component of a contract that contains service components and lease components. If the service component is a contract that contains service components and lease components <u>is not</u> distinct:

a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
b) The IASB proposes that:
   i. A lessee should apply the lease accounting requirements to the combined contract.
   ii. A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
   iii. A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in 'Revenue from Contracts with Customers.'

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?

Among lease contracts, there are leases where the lessor maintains and repairs the leased item or provides services related to the use of the item. Examples include the lease of automobiles where services can include the maintenance and repair of vehicles.

When services cannot be purchased separately, lessees are unlikely to have information to allocate payments reliably, however we believe an estimate of services should be made and accounted for separate to the lease contract.

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised.

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?

Interestingly the exposure draft proposes that an option to extend a lease is treated differently to the option to purchase above. If a lease has both the option to extend or an option to purchase then if the lease is more likely than not to be extended the lessee recognises the asset and liability over the extended period, however if the lessee is expected to exercise the option to purchase the asset the lessee will only recognise the asset and liability over the defined period in the lease. The net result is that a lessee that expects to purchase the asset at the end of the lease will have a lower liability on its balance sheet, even though the purchase price could be higher than the previous example i.e. extending the lease. We disagree with this resultant anomaly.

Measurement

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

a) *Assumes that 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.*

b) *Includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique. Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.*

c) *Is updated 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.*

Question 8: Lease term

Do you agree that a lessee or 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?

We believe this approach makes sense as it allows the preparer to use their judgement rather than having a rigorous set of rules that may or may not be appropriate. A number of our members who are lessees have mentioned the practical difficulty in making these assessments and judgement calls. We note that determining the longest possible lease term that is more likely than not to occur is even more difficult for a lessor without insider knowledge of the lessee's business strategy. Some definition of "option extension" and implementation guidance would be useful.

We also believe guidance should be given for option extensions that exist beyond the legal end of a lease. For example, under general landlord and tenant law in the UK or under widely accepted market practice such as in France where property lease terms are generally two to three years, however in practice these are routinely renewed.

We note the following two issues with the above approach and believe these should be addressed:

- The option to extend does not meet the definition of a liability based on the Conceptual Framework as the lessee does not have an unconditional obligation to pay as long as it does not exercise the option. The same issues arise with the lease asset; and
- Complex judgements are required which could increase P&L volatility when the likelihood of extending is reassessed.

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?

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?

We agree that contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of assets and liabilities using an expected outcome technique.

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?*

We agree that assets and liabilities should be reassessed on a continuous basis and material changes adjusted for.

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee.

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 proposal requires that both the seller/lessee and the buyer/lessor assess whether the transfer meets the definition of a sale. If the transfer meets the definition then the seller/lessee derecognises the asset and will recognise the lease whilst the buyer/lessor will recognise the asset and apply the performance obligation model to the lease

We believe what constitutes a sale/purchase should be consistent across all accounting standards. The revenue recognition proposal states that a sale is dependent on transfer of control whilst in a sale and leaseback contract a sale is defined as "transfer to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits..."

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows.

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. 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?

We agree with the above proposal as there are differences between assets that are owned and assets that are leased and between lease liabilities and other financial liabilities justifying separate disclosure.

We do not believe that these require separate presentation on the face of the statement of financial position and should be disclosed separately in the notes.

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? 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?*

We agree with the “linked approach” showing the asset and liabilities together and believe as with 12 (a) that this should be shown in the notes to the accounts and not clutter up the face of the financial statements.

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? 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?*

As with 12 (a) above we believe the lease assets should be disclosed separately as there are differences between lease receivables and other financial assets and residual assets and property, plant and equipment.

We do not believe that these require separate presentation on the face of the statement of financial position and should be disclosed separately in the notes.

d) *Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?*

We do not believe that these require separate presentation on the face of the statement of financial position and should be disclosed separately in the notes.

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? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

No comment

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? Why or why not? If not, do you think that a lessee or lessor should disclose this information in the notes instead? Why or why not?

No comment

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?

Why or why not? If not, how would you amend the objectives and why?

We welcome additional disclosure that will assist the users of the accounts understand the role and impact that leases have had on the company.

Transition

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. 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?

No comment

Benefits and costs

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?

No comment

Other comments

Question 18

Do you have any other comments on the proposals?

No comment

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The Association of Corporate Treasurers

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