



## Accounting Standards Board

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Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

17 December 2010

Dear David

### **IASB Exposure Draft *Leases***

I am writing on behalf of the UK Accounting Standards Board (ASB), to respond to the Exposure Draft (ED) *Leases*.

The ASB's responses to the 'Questions for respondents' in the ED are provided in Appendix A. Whilst the ASB is supportive of the proposals set out in the ED, it has some significant concerns. In particular, the ASB considers that:

- The International Accounting Standards Board (IASB) should take more time to finalise the proposals, in view of their potentially significant implications, by extending the June 2011 deadline. In particular, the IASB should assess whether or not the proposals in the ED represent an improvement to current lease accounting requirements and, if they do represent an improvement, whether it is worthwhile implementing the proposals in view of the one-off and ongoing costs that they may give rise to. This assessment should consider whether improved disclosure would address concerns regarding the current model without giving rise an unnecessary cost burden on preparers. (Refer to the response to question 17.)
- A single partial derecognition to lessor accounting should be adopted, not the performance obligation approach and not a 'hybrid' approach. (Refer to the response to question 2.)
- The lease term should be determined to be the minimum lease term in accordance with the current definition in IAS 17 *Leases*, but the IASB should

explore further the possibilities for addressing option periods via either enhanced disclosure or separate recognition, with the aim of ensuring that all possible liabilities are identifiable in either the statement of financial position or in the notes. (Refer to the response to question 8.)

- Only “unavoidable” contingent payments, as defined in paragraph BC124 of the Basis for Conclusions on Exposure Draft (BCED), should be included in the lease asset and liability, not “avoidable” contingent payments. Contingent payments which are included in the measurement of the lease asset and liability should be measured by choosing the most likely outcome, not the expected amount as proposed in the ED. (Refer to the response to question 9.)
- The short-term lease provisions for lessees should go further, to permit such lessees to apply an accounting treatment similar to that set out in IAS 17 for operating leases. (Refer to the response to question 3.)

If you would like to discuss these comments, please contact Grant Chatterton on 020 7492 2426, e-mail [g.chatterton@frc-asb.org.uk](mailto:g.chatterton@frc-asb.org.uk), or me.

Yours sincerely

A handwritten signature in black ink that reads "Roger Marshall". The signature is written in a cursive, slightly slanted style.

**Roger Marshall**  
**Chairman**

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## Appendix A: ASB responses to 'Questions for respondents' in the IASB Exposure Draft *Leases*

### The accounting model

#### 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?
- (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?

#### *ASB Response:*

- 1 The ASB agrees that a lessee should recognise a right-of-use asset and a liability to make lease payments. Arguments for this are as follows:
  - This ensures that all elements of leases that meet the definition of an asset or a liability are recognised in the statement of financial position. The ASB does not support the current accounting practice whereby operating leases, as defined in IAS 17 *Leases*, are not reflected in the statement of financial position, as this is inconsistent with the definition of an asset or liability in the IASB Conceptual Framework. Refer to paragraphs BC6(a) and BC6(d) of the BCED.
  - It will no longer be necessary for users of financial statements to adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases. Refer to paragraph BC6(a) of the BCED.
  - Leases will be accounted for consistently, thus increasing comparability. Under the current accounting practice, the accounting treatment for finance leases is different to that for operating leases; there is a "bright line" distinction between the two types of lease, which can give rise to situations whereby the accounting treatment for two similar leasing transactions is very different. Refer to paragraph BC6(b) of the BCED.
- 2 The ASB agrees that a lessee should recognise interest on the liability to make lease payments, as this will reflect the economic substance in that a lease transaction provides financing.

- 3 The ASB agrees that a lessee should recognise amortisation of the right-of-use asset. However, the ASB considers that the proposed standard should represent faithfully the substance of a leasing transaction by referencing IAS 16 *Property, Plant and Equipment* instead of IAS 38 *Intangible Assets* in setting out the amortisation method to be used, and that it should specify that the amortisation method applied to a right-of-use asset must be consistent with the depreciation method applied to a corresponding owned asset in the same asset class. This approach will increase comparability between leased and owned assets, and will ensure that the accounting treatment of the right-of-use asset is consistent with the accounting treatment that the entity would have applied to the underlying asset had the entity purchased that asset outright, thus reflecting the fact that leasing an asset is an alternative to purchasing it. This will result in more useful information for the users of the financial statements.

### **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 do you propose and why?
- (b) Do you agree with the board's 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?

#### *ASB Response:*

- 4 The ASB has concerns regarding the requirement that a lessor should apply 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 the derecognition approach otherwise. The ASB favours a single partial derecognition approach, for the following reasons:
- The performance obligation approach recognises a lease receivable without derecognising part of the underlying asset, so it 'grosses up' the statement of financial position and thus results in double counting of the same asset (refer to paragraph BC24 of the BCED).
  - The proposed 'hybrid' accounting treatment gives rise to a "bright line" distinction between the performance obligation approach and the derecognition approach, which may provide an incentive for lessors to structure leasing transactions.

- A 'hybrid' approach to lessor accounting is inconsistent with a single approach to lessee accounting. In particular, the lessee requirement to recognise a right-of-use asset and a lease liability implies that a transfer has been executed by the lessor, so the lessor should therefore derecognise an asset or part of it.
  - Although some might argue that the derecognition approach to lessor accounting will result in lessors recognising revenue for services that have not yet been delivered to the lessee, the ASB notes that this concern is addressed by the IASB requirement that a lessor applying the derecognition approach shall apply the Exposure Draft *Revenue from Contracts with Customers* to the service component of a contract even if that service component is not distinct.
- 5 The ASB broadly agrees with the IASB's proposals for the recognition of assets and liabilities, income and expenses for the derecognition approach to lessor accounting; as explained above, the ASB considers that the performance obligation approach should not be applied at all. The ASB does, however, have the following views:
- That the IASB should finalise the lessor accounting treatment at the same time as the lessee accounting treatment, not subsequently, as this will enable the IASB to ensure that the lessor and lessee accounting treatments are fully consistent with each other.
  - That the residual asset that is recognised under the derecognition approach to lessor accounting should be initially measured at the future value amount that the entity would expect to obtain from the disposal or use of the asset at the end of the lease term. This accounting treatment avoids the complexities associated with accreting the residual asset over the lease term, and it also avoids the profit catch-up at the end of the lease term that may arise if the asset is neither pre-accreted nor accreted over the lease term. Instead, pre-accreting the residual asset means that the 'profit catch-up' is recognised on initial recognition of the residual asset.

### **Question 3: Short-term leases**

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements for 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 (paragraph 64).

- (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 (paragraph 65). (See also paragraphs BC41-BC46.)

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?

*ASB Response:*

6 The ASB agrees with the short-term lease provisions set out in the ED for lessors. However, the ASB considers that the short-term lease provisions for lessees should go further, to permit such lessees to apply an accounting treatment similar to that set out in IAS 17 for operating leases. In addition, the ASB considers that the following additional provisions should also be included in the final standard, in order to provide greater clarity and consistency:

- A lessor should not be permitted to apply the short-term lease accounting treatment for lessors that is set out in the ED “on a lease-by-lease basis” (paragraph 65 of the ED), but should instead be required to make an accounting policy choice whereby it applies the short-term lease accounting treatment for lessors to all short-term leases for which it is the lessor, or one where it does not apply the short-term lease accounting treatment for lessors at all. Where the lessor adopts an accounting policy choice whereby it applies the short-term lease accounting treatment for lessors to all short-term leases, that lessor should be required to disclose an estimate of the impact of this accounting policy choice on the assets and liabilities recorded in the statement of financial position at the end of the financial period.
- Similarly, a lessee should not be permitted to apply the short-term lease accounting treatment for lessees that is set out in the ED “on a lease-by-lease basis” (paragraph 64 of the ED), but should instead be required to make an accounting policy choice.

## **Definition of a lease**

### **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?
- (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?

- (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?

*ASB Response:*

- 7 The ASB considers that paragraph 8 of the ED should be amended to state that a contract is a purchase or sale of an underlying asset where it is classified as a purchase or sale under the standard to be finalised following the Exposure Draft *Revenue from Contracts with Customers*.

## Scope

### 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?

*ASB Response:*

- 8 The ASB does not agree with the proposed scope of the proposed International Financial Reporting Standards (IFRS) and with the rationale that the IASB has provided for that scope. The ASB considers that leases of intangible assets should be included in the scope.

### 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 (paragraphs 6, B5-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not 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?

*ASB Response:*

9 The ASB considers that:

- All services can be separated out, by both lessees and lessors, and the distinction between 'distinct' and 'non-distinct' services is not always clear or useful in practice. However, the ASB recognises that lessors can, in certain cases, find it difficult to estimate the service element.
- Both lessees and lessors should be required to account for all services (be they 'distinct' or 'non-distinct') separately, under the proposals in the Exposure Draft *Revenue from Contracts with Customers*.<sup>1</sup>
- Lessees and lessors should make disclosures concerning the services element of lease contracts, so that it is clear, for example, what commitments an entity has entered into for the next few years.
- If the IASB was to disagree with the above ASB suggestion to require that all services be accounted for separately, and thus were to maintain that some services should be accounted for as part of a combined contract, the ASB would suggest that various indicators (to be defined by the IASB) should be used to assess whether the combined contract is primarily a lease contract with attached services or primarily a services contract with an embedded lease component.

10 The ASB has concerns regarding both the Financial Accounting Standards Board (FASB) and IASB proposals in the ED for the lease accounting of a contract that contains service and lease components, which the above approach suggested by the ASB overcomes, as follows:

- The FASB proposal is an over-simplification and it may give rise to structuring opportunities.
- The IASB approach has the following disadvantages:
  - It is not sufficiently easy to understand or apply.

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<sup>1</sup> Although the ASB considers that a requirement for lessees and lessors to account for all services separately would be appropriate for companies that apply full IFRS, the ASB recognises that this requirement introduces complexity and thus may not be suitable for entities that apply the IFRS for SMEs (or a derivative of it, for example the proposed FRSME in the UK).

- Requiring a lessor to separate non-distinct services under the derecognition approach, but not under the performance obligation approach, gives rise to inconsistent measurement of the lessor's receivable. The receivable will include an amount for undelivered non-distinct services under the performance obligation approach, but not under the derecognition approach.
- Requiring a lessee to apply the lease accounting requirements to the combined contract assumes that the contract is primarily a lease contract with attached services, rather than a service contract with an embedded lease component, which may not always be the case.

### **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?

*ASB Response:*

- 11 The ASB considers that a lessee or a lessor should account for purchase options only when they are exercised, except where the purchase option is a bargain purchase option as defined in paragraph B10(b) of the ED. The ASB considers that the lessee and lessor should account for bargain purchase options as a purchase or sale upfront, before the option is exercised.

## **Measurement**

### **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?

*ASB Response:*

- 12 The ASB considers that the lease term should be determined to be the minimum lease term in accordance with the current definition in IAS 17: "The *lease term* is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option." The ASB considers that the IASB should explore further the possibilities for addressing option periods via either enhanced disclosure or separate recognition, with the

aim of ensuring that all possible liabilities are identifiable in either the statement of financial position or in the notes.

13 The ASB has the following concerns regarding the proposal in the ED to determine the lease term as the longest possible term that is more likely than not to occur, which the above approach suggested by the ASB overcomes, as follows:

- Determining the lease term in accordance with the proposal in the ED is, unlike the above approach suggested by the ASB, inconsistent with the definition of an asset or liability and thus with the IASB Conceptual Framework.<sup>2</sup>
- A related issue concerning the determination of the lease term proposed by the ED is best illustrated with an example. Consider a 5 year lease with an option to extend the lease for a further 2 years at market rentals, where it is more likely than not that the lessee will exercise the extension option. An expected amount for the possible lease payments relating to the option period is, under the proposals in the ED, included in the right-of-use asset of the lessee. In this example, however, the lease payments in the option period are at market value and thus do not provide the lessee with anything other than that which can be obtained in the open market anyway, so the commercial substance is that this option has no value. This would suggest that the accounting treatment proposed in the ED is flawed, as it requires an amount to be recognised in the statement of financial position for this option period.

### **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?

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<sup>2</sup> The definition of the lease term put forward in the ED would mean that possible lease payments relating to option periods would be included in the lease asset and liability recognised in the statement of financial position, even where the exercise of the option is a possible future event and not a past event; the definition of an asset and liability each refer to a 'past event'. Furthermore, the definition of a liability refers to a 'present obligation', but there is often no present obligation in relation to option period lease payments at the inception of the lease.

- 14 The ASB considers that only “unavoidable” contingent payments, as defined in paragraph BC124 of the BCED, should be included in the lease asset and liability, given that “avoidable” contingent payments do not meet the definition of an asset or liability, and that disclosures concerning the degree of “avoidability” of contingent payments should be enhanced. The ASB also considers that contingent payments which are included in the measurement of the lease asset and liability should be measured by choosing the most likely outcome (not the expected amount, as proposed in the ED).
- 15 The ASB considers that it is appropriate to delete the requirement in the ED that lessors should only include contingent payments in the measurement of the right to receive lease payments if they can be measured reliably, given that it is likely to be possible to measure contingent payments reliably where they are measured by choosing the most likely outcome.<sup>3</sup>

### **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?

*ASB Response:*

- 16 The ASB considers that:
- A reassessment of contingent payments should be fully adjusted for in profit or loss in all cases, not partly via profit or loss (changes relating to current and prior periods) and partly via the statement of financial position (changes relating to future periods) as proposed in the ED under and the performance obligation approach to lessor accounting (refer to paragraph 39(b)) and under the lessee accounting treatment (refer to paragraphs 17(b) and 18), for the following reasons:
    - The accounting treatment proposed in the ED for the derecognition approach to lessor accounting (fully adjusting in profit or loss) is

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<sup>3</sup> Furthermore, a lessor is likely to have made estimates concerning the contingent payments at the inception of the lease, in determining the terms of the lease to offer to the lessee, so a lessor should be able to form a reliable estimate of the amount of contingent payments (refer to paragraph BC126 of the BCED). It might also be argued that the requirement in the ED for lessors (but not lessees) to only include contingent payments if they can be measured reliably will reduce the consistency and comparability of the information in the financial statements.

inconsistent with that proposed for the performance obligation approach to lessor accounting and for lessees (partly adjusting in profit or loss and partly adjusting in the statement of financial position).

- The accounting treatment proposed in the ED introduces complexity and is difficult to apply; the costs of this approach do not outweigh the benefits. Fully adjusting for contingent payments in profit or loss is much simpler.
- The accounting treatment proposed in the ED is inconsistent with the cost model typically applied under IFRS to assets and liabilities which are not financial instruments. In particular, the ED proposes that a reassessment of contingent payments is adjusted for via the lease liability under the performance obligation approach to lessor accounting, and via the right-of-use asset under the lessee accounting treatment. However, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*, for example, require assets to be depreciated/ amortised and sometimes impaired, but they only require them to be revalued if an entity has specifically elected to apply an accounting policy of revaluation and not the cost model.
- The IASB should clarify why an exception to the accounting requirement that a reassessment of the discount rate is not required is made when contingent rentals are based on reference interest rates. (The ASB agrees that contingent rentals should be reassessed to reflect changes in reference interest rates, but is not convinced that the discount rate should also be reassessed.)
- The IASB should reconsider the proposed method of calculating the adjustment to the residual asset on a reassessment of the lease term that has been used in Example 4 in paragraph B30 of the ED, in order to validate that this method of calculation is the most appropriate one. The ASB would suggest that the IASB should, in reconsidering the method of calculation, consider which method best achieves an objective of making the amount of the reassessed residual asset equal to what it would have been if the lease term had originally (at the date of commencement of the lease) been determined to be the length of the reassessed lease term. Example 4 of the ED calculates the reassessed residual asset to be CU241, but one possible logical alternative calculation method would calculate this amount to instead be CU752, as follows:

Reassessed residual asset

= Reassessed carrying value of underlying asset (after depreciation)

*Less* Portion of the reassessed underlying asset transferred to the lessee

= Reassessed carrying value of underlying asset (after depreciation)

*Less* (Reassessed carrying value of the underlying asset

\* (Present value of the reassessed lease payments

/ Reassessed fair value of the asset))

= CU4,500

*Less* (CU4,500 \* (CU5,206 / CU6,250))

= CU752

17 Subject to the above modifications to the detailed proposals in the ED, the ASB agrees 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 since the previous reporting period, for the following reasons:

- To reflect current market conditions and thus provide more relevant information to the users of financial statements.
- Using the lease term and estimated contingent payments established at initial recognition throughout the lease arrangement could be misleading.

## Sale and leaseback

### 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?

*ASB Response:*

18 The ASB considers that the sale and leaseback accounting treatment should be amended to the following:

- It should be determined whether or not the transfer is a purchase or sale of the underlying asset by applying the standard to be finalised following the Exposure Draft *Revenue from Contracts with Customers*. The IASB should check that such transfers are covered by that Exposure Draft.
- If the transfer is determined not to be a purchase or sale of the underlying asset, the arrangement is not a sale and leaseback transaction. The lease contract is accounted for as a new lease under the ED.
- If, on the other hand, the transfer is determined to be a purchase or sale of the underlying asset, the arrangement is a sale and leaseback. The purchase or sale is accounted for under the standard to be finalised following the Exposure Draft *Revenue from Contracts with Customers*, and the lease is accounted for under the ED.

## Presentation

### 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?
- (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?
- (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?
- (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?

*ASB Response:*

19 The ASB has concerns regarding the following proposals in the ED:

- The proposal that a lessor applying the performance obligation approach should present, in the statement of financial position, a total for a net lease asset or lease liability.
- The proposal that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position.

20 The ASB considers that the following disclosures should be included in the notes to the financial statements:

- A summary which shows the underlying assets, rights to receive lease payments and lease liabilities of lessors under the performance obligation approach, if any (refer to the response to question 2), which subtotals the latter two amounts. (This is inconsistent with the ED, which requires a net lease asset or liability disclosure to be made on the face of the statement of financial position, and which requires all three amounts to be totalled.)
- A summary which shows the underlying assets, residual assets and rights to receive lease payments of lessors under the derecognition approach, which calculates the difference between the first two amounts, and which then subtotals the rights to receive sublease payments and this calculated amount. (This is inconsistent with the ED, which does not require this disclosure to be made.)
- A summary which shows the headlease liabilities, underlying right-of-use assets, rights to receive sublease payments and sublease liabilities of sublessors under the performance obligation approach, if any (refer to the response to question 2), which subtotals the latter two amounts. (This is inconsistent with the ED, which requires this disclosure to be made on the face of the statement of financial position.)
- A summary which shows the headlease liabilities, underlying right-of-use assets, residual right-of-use assets and rights to receive sublease payments of sublessors under the derecognition approach, which calculates the difference between the second and third amounts, and which then subtotals the rights to receive sublease payments and this calculated amount. (This is inconsistent with the ED, which requires this disclosure to be made on the face of the statement of financial position.)

21 The arguments for the presentation preferred by the ASB are:

- It avoids excessive and unnecessary clutter on the face of the statement of financial position.
- It ensures that there is equal disclosure for the performance obligation and derecognition approaches, and that all relevant information is disclosed.
- In addition, the arguments in the BCED (paragraphs BC143 to BC145, BC148 to BC150, and BC154 to BC156) for the presentation put forward by the IASB are also applicable to the presentation preferred by the ASB.

### **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?

*ASB Response:*

- 22 The ASB has concerns regarding the proposal in the ED that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss, but this is primarily because it is unclear from the ED whether or not the IASB require this separate presentation to be on the face of the statement of comprehensive income.
- 23 The ASB considers that separate presentation in the notes to the financial statements, or on the face of the statement of comprehensive income if this results in more useful information for the users of the financial statements, should be required for the following items:
- Interest income on the rights to receive lease payments of lessors under the performance obligation approach, if any (refer to the response to question 2), which should be presented separately from other interest income. (\*)
  - Lease income resulting from satisfaction of lease liabilities of lessors under the performance obligation approach, if any (refer to the response to question 2), which should be presented separately from other income. (\*)
  - Depreciation expense on underlying assets of lessors under the performance obligation approach, if any (refer to the response to question 2), which should be presented separately from other depreciation expense. (\*)
  - Lease income and lease expense of lessors under the derecognition approach, which should be presented in separate line items or net in a single line item so that the lessor provides information that reflects the lessor's

business model. Where a net presentation is adopted, narrative information should be included in the notes to the financial statements that provides gross amounts for lease income and lease expense. (This is inconsistent with the ED. Firstly, it is unclear from the ED whether or not the IASB require lease income and lease expense to be presented on the face of the statement of comprehensive income. Secondly, the ED does not include a narrative information requirement to provide the gross amounts for lease income and lease expense when a net presentation has been adopted.)

- Interest income on the rights to receive lease payments of lessors under the derecognition approach, which should be presented separately from other interest income. (\*)

*\*Note:* The asterisked items may or may not be inconsistent with the ED; it is unclear from the ED whether or not the IASB require the asterisked disclosures to be presented on the face of the statement of the comprehensive income.

24 The arguments for the presentation preferred by the ASB are:

- It avoids excessive and unnecessary clutter on the face of the statement of comprehensive income.
- In addition, the arguments in the BCED (paragraphs BC146, BC151 to BC152, and BC157 to BC158) for the presentation put forward by the IASB are also applicable to the presentation preferred by the ASB.<sup>4</sup>

#### **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?

*ASB Response:*

25 The ASB agrees that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows. The ASB supports the arguments in the BCED (paragraphs BC147, BC153 and BC159).

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<sup>4</sup> It should be noted that the ASB is not fully satisfied with the wording of paragraph BC157 of the ED, because some could interpret this paragraph as implying that interest income on lease assets need not be presented separately from other interest income when a lessor applying the derecognition approach presents lease income and lease expense net.

## 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?

*ASB Response:*

26 The ASB agrees with the proposal in the ED, but also has the following specific comments concerning disclosures:

- The disclosure recommended in paragraph 6 of the response to question 3 should be required.
- The words “a lessee’s” should be deleted from paragraph BC180 of the BCED, as both lessors and lessees should be required to provide this disclosure. More generally, it may help to separate the disclosures section of the ED into disclosures that apply to both lessees and lessors, disclosures that apply only to lessors, and disclosures that apply only to lessees.
- The disclosures in the ED are extensive and each disclosure requirement should therefore be reviewed from a cost-benefit perspective. The IASB may also wish to reaffirm that lessees and lessors should apply the concept of materiality in determining whether it is necessary for them to make a specific disclosure.

## 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 (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?

*ASB Response:*

27 The ASB considers that:

- Full retrospective application may be costly to apply and so should not be mandated, but there is no logical reason for prohibiting this accounting treatment.
- It should be clarified that paragraph 91 of the ED refers to lease payments which are not contingent rentals.
- It should be clarified in the ED that, unless full retrospective application is adopted, a lessor's assessment of risks and benefits to determine whether a lease is accounted for in accordance with the performance obligation approach or the derecognition approach should be performed on the date of initial application (as defined in paragraph 88 of the ED), instead of the date of inception of the lease.
- The ED or BCED should clarify that measuring a reinstated underlying asset at fair value, as explained in paragraph BC198 of the BCED, is only permitted where the lessor has an existing accounting policy of applying the IAS 16 revaluation model for the particular class of property, plant and equipment (PPE) asset with which the underlying asset would be associated were it not a leased asset.
- In paragraphs 94(a) and 95(a) of the ED, the term "the rate charged in the lease determined as the date of inception of the lease" should be changed to "the rate the lessor charged the lessee (see paragraph B12) at the date of inception of the lease", so as to avoid a situation whereby a lessor uses a discount rate that was calculated under their previous GAAP and not on a basis which is consistent with IFRS.

## **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?

ASB Response:

- 28 The ASB has not conducted a cost benefit analysis, or an effects analysis, of the proposals in the ED and their potential wider impact. The assessment presented in paragraphs BC200 to BC205 of the BCED is insufficiently comprehensive for the ASB to be able to form a view on whether or not the proposals in the ED represent an improvement to current lease accounting requirements and, if they do represent an improvement, whether it is worthwhile implementing the proposals in view of the one-off and ongoing costs that they may give rise to. For these reasons, the ASB welcomes the publication by the IASB of a questionnaire for users. More generally, the ASB considers that the IASB should take more time to finalise the proposals, in view of their potentially significant implications, by extending the June 2011 deadline.
- 29 The following specific feedback from ASB constituents should also be considered by the IASB, and it reinforces the ASB recommendation to take more time to finalise the proposals:

- *Tax implications and the timing of adoption:*

Her Majesty's Revenue and Customs (HMRC), the UK tax authority, inform the ASB that the proposals in the ED will have significant implications for UK tax legislation. Based on their comments, the ASB considers that the IASB should prohibit early adoption of the final standard. The HMRC comments are reproduced below:

*“A significant part of corporation tax and income tax law relating to leases is based on the accounting treatment of leases. Parts of the tax law rely on the definition of a “finance lease” within Generally Accepted Accounting Practice (GAAP), which for IFRS-adopters, is within IAS 17. If the IFRS for leases no longer contains such a definition or distinction then businesses will be unable to comply with their statutory obligations to submit tax returns, or if they can, the tax consequences will be uncertain.*

*If the proposals go ahead as planned, tax authorities will need to change tax laws, however, those need to be developed in conjunction with business and are subject to a particular legislative timetable. If the adoption date, or ability to adopt early, is too early businesses will face significant doubt as to how existing lease contracts will be taxed which will lead to uncertainty in pricing new leases. Additionally, many leases include clauses that pass the cost or benefit of tax changes to lessees as a pricing adjustment. There will be significant uncertainty for lessors and lessees as to how those take effect where the tax is different because of the accounting change – whether or not tax legislation is changed.”*

- *Business implications:*

The ASB and the Finance and Leasing Association (FLA) jointly hosted a public meeting on 5 November 2010 to discuss the ED. The meeting was chaired by David Loweth (Technical Director of the ASB), and included a presentation of the proposals by Patrick Finnegan (Board Member of the IASB) and Barbara Davidson (Technical Manager at the IASB), followed by comments from George Lynn (Chairman of the FLA Asset Finance Division) and Mark Venus (Chairman of the Leaseurope Accounting Committee), then a Q&A session that was open to the floor. The FLA and other constituents made a number of comments at that meeting, which the IASB may wish to address via an effects analysis of the proposals in the ED. The relevant points were as follows:

- The FLA estimates, based on research by Winchester Business School, that there are £220bn of operating leases in FTSE companies, and that a company holds, on average, £445m of property leases and £18m (4%) of non-property leases. The FLA also believes that 10 companies, which are not included in the averages, hold £10bn of non-property operating leases: BA, BT, C&W, TUI, Vodafone, Arriva, EasyJet, First Group, Stagecoach and Go Ahead.
- The FLA estimates that the proposals in the ED give rise to around 75 “regulatory steps” in accounting for a lease.
- The FLA considers that the proposals in the ED are “entirely disproportionate and damaging for non-property”.
- The FLA considers that the proposals in the ED may be “damaging to business investment” by creating lower supply and demand in the leasing market.
- One constituent noted that the proposals in the ED posed “significant issues for banks in relation to their accounting as both lessors and lessees”.
- One constituent made reference to “industry worries about the operational complexity of the ED proposals”.
- One constituent, from Oxfam, said that “the comments being made about the complexity and subjectivity of the proposals was very welcome, given the operational complexities of running a business owning several hundred shops as well as operating in the field in over 60 countries”.

## Other comments

### Question 18

Do you have any other comments on the proposals?

*ASB Response:*

30 The ASB has the following additional comments on the proposals:

- *Initial direct costs:*

There should be consistent principles underpinning the capitalisation of initial direct costs, so that it is apparent why one accounting standard requires them to be capitalised and another requires them to be expensed<sup>5</sup>. The proposed standard should be consistent with these principles<sup>6</sup>, once established.

- *Impairment:*

There are impairment-related issues specific to leasing which are not addressed in the ED and for which implementation guidance may be necessary. In particular, there is no indication about how to assess the impairment of an underlying asset that arises under the performance obligation approach<sup>7</sup>.

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<sup>5</sup> There is inconsistency across IFRSs concerning whether initial direct costs, which include acquisition costs, are to be capitalised in the statement of financial position or expensed in the statement of comprehensive income. For example, acquisition costs are capitalised under IAS 16 *Property, Plant and Equipment*, but they are expensed under IFRS 3 *Business Combinations*.

<sup>6</sup> The ED proposes capitalising initial direct costs incurred in negotiating and arranging a lease, but the logic for this proposal is not explained in the BCED.

<sup>7</sup> If a preparer were to assume that IAS 36 should be applied to assess the impairment of an underlying asset that arises under the performance obligation approach, they would compare the carrying amount of the underlying asset with its recoverable amount, being the higher of its fair value less costs to sell and its value in use. In calculating the amount of the value in use, however, the preparer should not include the cash flows arising from the lease payments, as these cash flows are already included in the right to receive lease payments. In applying IAS 36, the preparer may conclude that the cash-generating unit to be considered for the purposes of impairment testing should be the underlying asset together with the lease liability, but the ASB considers that the IASB should clarify this via implementation guidance.