



David Humphreys
Practice Fellow
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

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Dear David,

Thank you for the opportunity to respond to the IASB Exposure Draft on Leases.

The CFA Society of the UK represents more than 9,000 investment professionals working across the financial sector. For advocacy purposes, these members are represented by committees that consider proposals relating to Financial Reporting and Analysis Committee.

CFA UK response to the Exposure Draft on Leases

Introductory comments

We agree, in principle, with the attempt to address lessee and lessor accounting at same time, although we are concerned about different models being applied. Not surprisingly, since this was tackled later, there seem to be more issues with the practical impact and workability of the lessor side of the standard. Since there is some urgency in dealing with lessee accounting, we do not believe that this should be held up for any significant length of time through delays in settling issues on the lessor side. However, if a two-speed approach ensues, it is desirable that the solution adopted for lessees does not cut across an optimal outcome for lessors. We still believe that the two should be consistent and symmetrical.

As an investor organisation we view assets and liabilities on the balance sheet as a series of future cash flows that accrue to the entity, or that the entity is obliged to pay. These cash flows arise either via productive use of an asset or via a contractual series of cash flows due from another party ie a financial asset. All assets should represent the NPV of future cash flows. Accordingly, we agree with recognising on a lessee's balance sheet right-of-use assets and liabilities to pay for them.

For the lessor, this means that the granting of a lease should result in the derecognition of the asset's cash flows associated with the period of the lease and recognising the contractual financial asset; a residual asset should remain for the post-lease-period cash flows. Although some of us were initially attracted to the performance obligation approach, we decided that it was more complex and would create more scope for balance sheet manipulation, including double counting. Most leases are a blend of credit and asset risk. Rather than split this into two business models (recreating an operating/financing split), we felt that the derecognition model could capture both elements, so long as the lessor continued to measure, test and disclose underlying asset

values. This model also seems simpler and easier to make symmetrical with lessee accounting.

In more detail on lessees: we agree that a lessee should recognise a right-of-use asset and a liability to make lease payments. Our reservations are twofold:

- a) the "longest possible lease term" may overstate the liability; and
- b) we are wary of mixing into the calculation elements that are unpredictable and may have a binary outcome ie that cannot be measured reliably.

If the "expected outcome" meant the reasonably assured outcome, or one that could be reliably measured, we would be comfortable with that. Absent the uncertainties, probability weighting should deliver that answer, but with them it is likely to deliver an answer that is falsely precise.

The basis for conclusions states that it is difficult to value options to terminate or extend a lease, or to buy the asset at the end of the lease term. However, if a service element can be unbundled from the transaction, why not these options? They are just another component of the price.

For contingent rentals, if there is a pattern that can be reliably measured, then they would be part of the "expected", "most likely" or "reasonably assured" outcome. If not, then a range of possible outcomes could be disclosed in notes.

A key question concerns the availability and reliability of the cash flow measurements and, therefore, the timing of the gain/loss being recognised. We would suggest that where the underlying asset is carried at fair value this gain/loss should be recognised immediately. Where it is carried at cost less impairment then the gain/loss should be recognised as suggested in the ED, if the fair values and cash flows are practically available and reliable. If not, then the entity should derecognise a portion equal to the leased asset and only recognise a gain/loss when it materialises on the residual asset.

Impairment rules should apply to both the leased and residual assets.

For short-term leases, we agree with the need to provide relief for leases of a year or less and for those previously described as rental agreements, as suggested in the ED. It may be desirable to simplify the requirements further eg via a materiality test for the assets/liabilities.

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?

Answer

Yes, with exemptions for short-term and immaterial 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?

Answer

Yes

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?

Answer

We believe a single approach to lessor accounting can be achieved. We do not agree with replacing the operating and finance lease distinction with another distinction associated with performance obligation and derecognition approaches. A focus on underlying cash flows suggests this distinction is unnecessary ie an asset represents the cash flows expected to accrue to the entity and likewise for liabilities.

(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?

Answer

The performance obligation approach is not consistent with our view of asset cash flows and what should be represented on the balance sheet; we do not agree with the 'double count' of asset values on the balance sheet and we do not think this will enhance transparency and understanding of financial statements. Our cash flow view aligns more with the derecognition approach.

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...for which the maximum possible term, including options to renew or extend, is twelve months or less:

(a) At the date of inception...a lessee...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...a lessor...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. [They] 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 (65, 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?

Answer

We agree with the principle of making simplified requirements for short-term leases for lessees and lessors. We would advocate extending this to include where leases are immaterial to the business activity and balance sheet.

We would prefer to see an accounting policy choice for asset categories rather than a lease-by-lease assessment as this is a pragmatic approach that will not compromise transparency or understandability

We would prefer to see in note disclosures minimum lease cash flow information that distinguishes between cash flows associated with those leases recognised in the balance sheet and those not (due to the above simplifications).

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?

Answer

We agree in principle with the definitions and guidance provided in the ED.

Scope

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases...except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (5 and BC33–BC46).

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?

Answer

We agree with the scope exclusions except for the exclusion of intangible assets (ie IAS 38 type assets). Applying a cash flow view of assets and liabilities suggests that intangible assets can be looked at consistently with tangible assets.

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 (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?

Answer

We agree with the principle of separating out service components where these are not time based, are separately identifiable and the corresponding cash flow can be measured or estimated reliably. Service components so separated should be accounted for in accordance with, and consistently with, other revenue standards.

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?

Answer

Yes

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?

Answer

We do not believe that applying an expected value/probability-weighted approach provides a compelling alternative or enhancement to the current principle of estimating the most likely term of a lease arrangement based on the information available at the time of entering into a lease. The proposal introduces additional complexity and may well result in an estimated lease period that is incorrect.

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?

Answer

We agree with including expected payments that can be measured reliably but do not believe the expected value/probability-weighted approach provides a compelling alternative or enhancement to estimating the most likely outcome. Further, we believe the lessors and lessees should apply the same approach to lease payments, and that they both need to be subject to the reliable measurement criteria.

We have sympathy with the alternative view, in particular the concept laid out in AV3 "that options to cancel and extend leases provide a lessee with flexibility to react to changing business circumstances and consequently these features reduce risk." So there are serious questions over the extent to which such assets/liabilities exist beyond the initial lease period and whether they can be measured reliably.

Wouldn't it be better to work on ways to measure the value of the option?

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 [or receive] lease payments... arising from changes in the lease term or contingent payments ...since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Answer

Yes, if significant and has a material impact on reported assets and liabilities.

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?

Answer

Yes

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 (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?

Answer

Yes, although the right-of-use asset could just as easily be seen as intangible.

(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 (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?

Answer

We do not support the performance obligation approach, but if it were to be adopted we would prefer the grossing up to be presented in the notes.

(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 (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?

Answer

Agree with separate presentation in the balance sheet as the lease and residual assets represent separate cash flow streams with differing risks.

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (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?

Answer

We don't believe distinguishing further assets/liabilities under a sublease is necessary if the intermediate lessor will report based on its contractual future cash flow position.

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 (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?

Answer

Yes

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 (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?

Answer

Separately, yes. But the financing/operating split is more problematic.

Lease payments are generally a result of financing. But it does not fit all business models eg a property investment company that invests in leasehold buildings where lease premium payments are likely to best described as investing and ground rents best described as operating.

We would propose that cash flow presentation be aligned with general principles rather than mandatory irrespective of the business model applied.

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?**

Answer

Yes. We believe it is necessary to get a good understanding of the significance of leasing to the entity's business. Assuming best-estimate cash flows are applied to the items recognised in the balance sheet, then an understanding of the potential variability in cash flows against those estimates is important. Where cash flows can be materially different in aggregate to those assumed, then information should be provided for the user to understand the relevant factors, likelihood and potential impact. We support disclosure proportional to the significance and materiality of leasing to the reporting entity and would not advocate standard disclosures for all leases in every entity.

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 (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?**

Answer

We agree with the ED proposed approach.

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?

Answer

We have proposed some simplifications in our comments that we believe would further enhance the cost /benefit assessment.

Other comments Question 18

Do you have any other comments on the proposals?

We hope that these comments have been useful and would be pleased to provide additional feedback in future.

Yours,

Jane Fuller, Chair Accounting Advocacy Committee

Will Goodhart, Chief Executive