CFA Society
United Kingdom

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EFRAG - European Financial Reporting Advisory Group
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Response to Consultation Document:
Revised IASB Exposure Draft (ED) Leases

The Financial Reporting and Analysis Committee (FRAC) of the CFA Society of the UK (CFA UK) welcomes the opportunity to respond to the European Financial Reporting Advisory Group's (EFRAG) Consultation Document on Proposed Revisions to IASB and FASB lease accounting.

CFA UK represents more than 10,000 investment professionals working across the financial sector including asset managers, buy-side analysts, sell-side analysts and credit rating analysts, among others. For advocacy purposes in the field of financial reporting, these members are represented by the Financial Reporting and Analysis Committee.

Executive Summary

We believe there is widespread consensus among investors that long-term leases give rise to liabilities that should be recognised on the balance sheet alongside their corresponding asset. For the sake of comparability across different company accounts and ease of comprehension, we believe investors would favour one approach to income statement accounting for lease costs regardless of whether the underlying asset is partially used up (vehicles and equipment) or not (property).

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. The proposed standard applies this principle to leased assets and the corresponding liabilities. However, we do agree with separating out service components, where this element can be clearly identified and measured or estimated reliably. The examples provided in paragraphs 31-38 of the consultation document, which focus on the difference between a lease and a service contract, suggest that a new area of "structuring" may arise between these two arrangements, as has happened between finance and operating leases. So further clarification may be needed on the way the principle in the leasing standard should be applied to avoid this outcome.

Over the past five years, our organisation has been consulted regularly on this subject by the IASB and our views have been reflected in the proposed standard. The approach adopted this year by the IASB is closer to our consistently held views than the 2013 ED, since we prefer a single measurement (ex short-term leases) approach to the "right-of-use" asset. We believe that users of accounts will not be well served by further delays to this long-awaited change to lease accounting, and so we ask EFRAG to help expedite the finalisation and enactment of the proposed IFRS.

Main response

25. Assume that the Boards maintain the current scope of application of the proposals, do you prefer:

	Yes	No
The IASB approach, that recognises all leases on the balance sheet and in substance treats all leases as finance leases	X	
The FASB approach, that recognises all leases on the balance sheet but, after commencement as follows: • for leases that are in substance purchases: separate finance and amortisation costs in the income statement and right-of-use assets and liabilities in the balance sheet • for leases that are not in substance purchases: a single lease expense in the income statement and right-of-use assets and lease liabilities, separately presenting these liabilities from the liabilities for leases that are in substance purchases, in the balance sheet		X

26. Please provide your reasons for supporting one or the other approach:

	Yes	No
It provides more relevant information	X	
It is easier to understand	X	
It improves comparability of similar transactions	X	
Other reasons (please explain)		

We believe there should be one approach to lease accounting and its presentation in the income statement and balance sheet. Leases (over 12 months) should be treated as a "right of use" asset (and corresponding liability) regardless of whether the underlying asset is property or equipment.

Investors are interested in leasing for several reasons. They look for items that affect a company’s fixed costs in order to better understand its operating performance and leverage. Incorporating leases is necessary to accurately measure the company’s return on capital employed (ROCE), which is critical in determining whether the company’s operations are value creating or destroying. Investors also want a clear picture of a company's obligations: long-term leases create debt-like obligations. Clear disclosure of lease assets/liabilities on the balance sheet and of the income statement impact of leasing is key to these and other assessments of a company's operating performance and financial position.

39. The current definition and criteria to identify a lease are explained above in paragraphs 27 to 30. Based on your knowledge, do you think that some transactions should be excluded from the scope of the Standard and treated as service contracts (i.e., no asset and liability are recognised by the lessee)? If so, please describe the transaction and provide your reasons.

As mentioned above, 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. Accordingly, we agree with recognising on a lessee's balance sheet right-of-use assets and the corresponding liabilities to pay for them. We do not believe that there should be a distinction between different types of lease. We are comfortable with the pragmatic exceptions proposed for less than 12 months and for small items.

Nevertheless, we do agree with the principle of separating out service components, where this element can be clearly identified and measured, or estimated, reliably, provided that the difference between a lease and a service contract is made clear.

Concerning the examples provided in the consultation document: in our view, the principle in the IASB's proposed definition of a lease – as a "right of use" asset – and the scope of the proposed IFRS would take into account the factors necessary to determine what part of a contract or transaction is to be accounted for as a lease, and what part is to be accounted for separately.

However, we offer the following observations about the examples provided in paragraphs 31-38, which describe situations in which the proposed requirements may be difficult to apply. We assume that the examples are for contracts of greater than 12 months.

1. Pars 31-33: these examples concern the use of a ship. We would expect that in the situation in par 31, the ship would be considered a lease and the Customer's personnel costs would be accounted for separately. Using the same principle, in the example in par 32 the ship would be considered a lease and the cost of the crew would be accounted for separately. For the example in Par 33 we would agree that lease accounting should not apply in this situation.

2. On printers etc (pars 34, 35), we think that the proposed definition of a lease and the exemptions for short-term leases and small items should obviate most of these difficulties. However, if the printers do not meet the small asset exemption or have a lease term greater than 12 months, it seems reasonable that the contract would be split into its lease and service components as proposed in the ED.

3. Pars 36-38 on pipelines is a situation that may lead to companies applying the standard differently in practice depending on their particular circumstances. This suggests that further guidance on control, or transfer of risk, is needed. In the 50% example, the Customer does not appear to have control over the physical pipeline but, along with other customers of the Supplier, has the right to use, or control the use of, capacity in the pipeline to transport product. As our view of assets and liabilities is framed in the context of future cash flows we do not believe a physically distinct asset and/or an exclusive arrangement should be prerequisites for the recognition of a right of use (lease) asset. That is, if the Customer has 'control' over the use of an element of capacity that will generate future cash flow then this is best represented as a lease asset and obligation of

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the entity.

We look forward to discussing the issues raised in this response.

Yours sincerely,

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<u>About CFA UK and CFA Institute</u>

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of which more than 90,000 hold the Chartered Financial Analyst (CFA) designation.