Financial Reporting Council

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Chairman
IASB
30 Cannon Street
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Dear Hans

IASB Exposure Draft ED/2013/6 *Leases*

I am writing on behalf of the Financial Reporting Council (FRC), in response to the above Exposure Draft (ED).

The FRC agrees with the objective of the project and in particular the need to report useful information about the amounts, timing and uncertainty of cash flows arising from a lease. We believe that the focus of the ED on providing useful information regarding the unavoidable financial commitments of the entity enables users to better assess the financial flexibility of the entity.

However, the FRC has significant concerns regarding the dual approach to measurement and the complexity this introduces into the proposals. We consider that this complexity reduces users' ability to understand the financial statements. This complexity, together with the extensive record-keeping and disclosure requirements, is also costly for preparers. We question whether the benefits of the proposals outweigh the costs arising from the complexity.

The FRC recognises the need for the IASB to finalise this project and considers that if complexity is substantially reduced, the proposals in the ED would result in an improvement to financial reporting. We include some suggestions to improve the proposals in the Appendix. However we cannot support the proposals in the ED as they stand.

If you would like to discuss these comments, please contact Annette Davis on 020 7492 2322, e-mail a.davis@frc.org.uk, or me.

Yours sincerely

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Appendix: Responses to 'Questions for respondents' in the IASB Exposure Draft ED/2013/6 *Leases*

Question 1: Identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Response:

1. The FRC has concerns regarding the proposals for the allocation of consideration to lease components. The guidance in paragraph 23 proposes a hierarchy of requirements that a lessee must apply without including an over-arching principle. The FRC considers that application of the proposals may result in an accounting treatment that may not reflect the substance of the contract. For example, paragraph 23(c) states that if there are no observable stand-alone prices for any components of the contract, a lessee shall combine the components and account for them as a single lease component. The FRC considers that 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.

2. Furthermore, this accounting treatment does not appear to be consistent with the Revenue Recognition Exposure Draft (ED) where paragraph 70 states that "…an entity shall allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation". The following paragraphs in that ED go on to explain how that principle should be applied and, if a stand-alone selling price is not directly observable, an entity shall estimate it. The FRC believes that a lessee should be able to allocate the consideration in a contract to lease components by using an estimate where there are no observable stand-alone prices for components, in a similar way to the proposed requirements in the Revenue Recognition ED.

3. However, the FRC agrees with the definition of a lease.

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee *is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?*

Response:

4. The FRC agrees that a lessee should recognise a right-of-use asset and a liability to make lease payments as this ensures that all elements of leases that meet the definition of an asset and a liability are recognised in the balance sheet. As a consequence it will no longer be necessary for users of financial statements to adjust the amounts presented in the balance sheet to reflect the assets and liabilities arising from operating leases.

5. The FRC does not agree however, that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, i.e. the proposed dual approach to measurement.

6. The FRC considers that determining the type of lease depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset is one of the main causes of complexity in the ED. We recognise that the IASB is proposing the dual approach based upon feedback from the 2010 ED but consider that rather than try to justify this approach conceptually, it should recognise that this is a pragmatic solution.

7. Given the FRC believes that the dual approach is a pragmatic solution, we recommend, if the dual approach is maintained, the distinction between leases should be based on the distinction between a finance lease and operating lease in IAS 17. Our response to Question 4 explains our reasoning for this proposal.

8. In addition to the above, the FRC considers there are a number of other areas that should be reconsidered:

   a. The complexity of the proposals that is introduced by the necessity for preparers to link their asset and liability systems. This is particularly onerous for preparers with large numbers of small leases.

   b. Whether a portfolio approach using estimation techniques, such as statistical sampling, can be used where an entity has a large number of small leases.

Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

9. The FRC does not agree that a lessor should apply a different accounting approach to different leases, using the classification principle based on the expected consumption of the economic benefits embedded in the underlying asset. As noted in our response above, we believe that the distinction between leases should be based on the

distinction between a finance lease and operating lease in IAS 17. Our response to Question 4 explains our reasoning for this proposal.

10. One reason for not supporting the proposals due to their complexity is the potential for a lessor to apply three different accounting treatments (for type A, type B and short-term leases) to the same asset during its life.

Question 4: Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response:

11. The FRC does not agree with using the classification principle based on the nature of the underlying asset to determine the type of lease. The FRC considers that this approach is difficult to apply in practice as it requires a high degree of judgement in determining whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

12. The FRC believes that having a single approach would maintain the conceptual consistency of the right-of-use model. However, it acknowledges that the IASB developed the dual approach to respond to the demands of some users and that the proposals in the ED are a pragmatic solution.

13. The FRC considers that the proposed dual approach introduces an unnecessary level of complexity, thereby reducing users' ability to understand the financial statements. UK constituents raised concerns on several aspects of the proposed approach, as follows:

    a. Under the proposals property will usually be classified as a type B lease unless one of the rebuttable presumption criteria is met. The second rebuttable presumption is: 'the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date'. This rebuttable presumption may be met for property in markets where prices are depressed compared to historic levels. This would lead to a property being anomalously classified as a type A lease.

    b. The understandability of some of the terms used when determining the classification of a lease. In particular, the use of the term 'insignificant' in paragraph 29(a) where the lease term is for an 'insignificant' part of the total economic life of the underlying asset. The use of the terms 'substantially all' and 'major part' in paragraph 30 in relation to the lease term being for the 'major part' of the remaining economic life of the underlying asset or the present value of the lease payments accounts for 'substantially all' of the fair value of the underlying asset at the commencement date. It does not appear clear whether the meaning of these terms is similar to the way they are applied in existing IFRSs. Differing interpretations of these terms could lead to inconsistent application in practice.

14. The FRC considers that the application of this approach to classification may give rise to situations whereby the accounting treatment for two similar leases is different, which has the potential to confuse users of the financial statements.

15. The FRC believes that, if a dual approach is maintained, the distinction between finance leases and operating leases in IAS 17 should be retained to reduce complexity and increase understandability. Leases that are classified as finance leases in IAS 17 would apply the proposed accounting treatment for type A leases and leases that are classified as operating leases would apply the proposed accounting treatment for type B leases. The benefits of this proposal are that:

    a. the distinctions are well understood;

    b. the assets and liabilities arising from operating leases would be recognised in the financial statements;

    c. this approach would be much less complex to apply than the approach proposed in the current ED and thus easier for users to understand; and

    d. this approach would be less costly to apply.

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Response:

16. The FRC is concerned that the interaction between the reassessment of the lease term and contract modifications is not clear. Paragraph 44(a) requires a lessee to revise the lease payments if there is a change in the lease term and paragraph 43 requires that the amount of this remeasurement is an adjustment to the right-of-use asset. This reassessment of the lease term and remeasurement is illustrated in Illustrative Example 14. In contrast, paragraph 36 uses a change to the contractual lease term as one example of a substantive change. An entity is required to account for a modified lease contract as a new contract where the contractual terms and conditions of the lease have been modified and those modifications result in a substantive change to the existing lease. The entity recognises any difference between the carrying amounts of the assets and liabilities of the existing lease and the new lease in profit and loss. The FRC considers that it is not clear when a change in the lease term should be accounted for as a reassessment of the lease term and when it should be accounted for as a new lease. The FRC suggests that the IASB clarify this point.

17. The FRC is also concerned with the introduction of the term ‘significant economic incentive’ which is used to determine whether or not a lessee is expected to exercise an option to purchase the underlying asset and is a part of the definition of lease term. Despite paragraph BC140, some of our stakeholders do not consider that ‘significant economic incentive’ is a readily understood term and could introduce inconsistency in application. We note that the definition of lease term in IAS 17 uses the term ‘reasonably certain’. We believe it would add clarity to the proposed standard if the explanation is expanded.

18. Notwithstanding the concerns expressed above, the FRC agrees with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors. The FRC believes the proposals most faithfully represent an entity’s reasonable expectation of the duration of the lease.

Question 6: Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Response:

19. The FRC is concerned about the lack of guidance for the term 'in-substance' fixed lease payments. The FRC notes that there is some guidance in Illustrative Example 17 but believes that it is inappropriate to explain a term solely by reference to examples. The FRC's understanding of this term, derived from this Illustrative Example, is that where a lease includes more than one method of determining the variable payment amount a lessee calculates the amounts expected to be paid using each method and the in-substance fixed payment amount is the lowest amount that the lessee must pay. The FRC considers that this term should be explained in the proposed standard otherwise it is likely that there will be differing interpretations of what it means resulting in a lack of comparability between entities.

20. Some UK constituents highlighted the fact that they have leases where no minimum payment amount is specified in the lease contract. Their examples include contracts where the lease payment is wholly turnover-based and where the lease payment is based on the volume processed. These respondents consider that excluding these arrangements from the proposals do not reflect the substance of the arrangement. The FRC considers that the IASB needs to address this issue when finalising the proposals.

21. However, the FRC agrees with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments.

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

Response:

22. The FRC agrees that lessees and lessors can recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. The FRC believes that the modified retrospective approach provides a balance between the costs of implementation whilst ensuring that the amounts recognised are similar to those that would have been recognised using a full retrospective approach.

23. The FRC considers that the modified retrospective approach could include further practical reliefs for lessees, as follows:

(a) For leases previously classified as operating leases, a lessee should not be required to recognise a right-of-use asset and lease liability for operating leases if the lease term has ended before the end of the reporting period in which the new standard is applied.

(b) For leases previously classified as finance leases, a lessee should not be required to subsequently measure the right-of-use asset and the lease liability in accordance with the ED if the lease term has ended before the end of the reporting period in which the new standard is applied. The FRC believes it is sufficient to simply require the entity to reclassify the assets and liabilities held under finance leases as right-of-use assets and lease liabilities arising from Type A leases.

24. Similarly, the FRC considers that further practical reliefs could be included for lessors, as follows:

(a) For leases previously classified as operating leases that will be classified as type A leases under the ED, a lessor should not be required to derecognise the underlying asset, recognise a lease receivable and recognise a residual asset if the lease term has ended before the end of the reporting period in which the new standard is applied.

(b) For leases previously classified as finance leases, a lessor should not be required to subsequently measure the lease receivable in accordance with the ED if the lease term has ended before the end of the reporting period in which the new standard is applied.

25. The FRC is proposing these further reliefs as it believes that the costs of calculating this information for leases that have ended before the balance sheet date outweigh the benefits of providing this information to users.

26. The FRC notes that if debt covenants are linked to the amounts recognised in an entity's IFRS financial statements, some entities may no longer comply with those covenants upon implementation of the proposed requirements. We consider that this issue needs to be taken into account when determining the effective date of the standard. The effective date should be far enough into the future to ensure that entities have sufficient time to assess the effect of the changes on their debt covenants and to negotiate any changes necessary.

Question 8: Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Response:

27. The FRC does not agree with the IASB proposals for the disclosure requirements. The FRC notes that the disclosures are extensive and very detailed. The FRC also notes that the IASB has endeavoured to address the potential for preparers to disclose immaterial information by reminding preparers (in paragraph 59 for lessees and paragraph 99) to consider the level of detail necessary to enable users of the financial

statements to understand the effect that leases have on the entity. The FRC is concerned that, even with this reminder, preparers will disclose all of the information required by the list of disclosures without first considering the materiality of each disclosure requirement for that entity.

28. Some UK constituents expressed their concerns about whether it will be possible to provide meaningful narrative disclosures when an entity has many leases. These constituents consider that the disclosure requirements are onerous. The FRC considers that these comments highlight the need to remind preparers that each disclosure requirement should be judged individually for materiality.

29. The FRC notes that the IASB is currently considering amendments to IAS 1 *Presentation of Financial Statements*, to clarify how the concept of materiality should be applied to specific disclosure requirements in a standard. The FRC considers that the proposed disclosure section is revised as necessary, to be consistent with the outcome of the amendment to IAS 1.

Questions 9, 10 and 11: These are FASB-only questions.

Question 12: Consequential amendments to IASB 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Response:

30. The FRC agrees with the IASB proposals to include the right-of-use asset arising from a lease of property within the scope of IAS 40 *Investment Property*, provided the leased property meets the definition of an investment property. The FRC considers that this amendment will improve comparability between entities by ensuring that all properties that meet the definition of an investment property will now be required to apply IAS 40.