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European Financial Reporting Advisory Group
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Chère Mme Flores

ED/2010/9 Leases

MAJOR POINTS

Our overall view on the proposals

1. ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter, published in October 2010, on the International Accounting Standards Board Exposure Draft ED/2010/9 *Leases*. Our responses to the main issues highlighted by EFRAG are set out below. A draft of our response to the IASB, which has not yet been finalised, is attached to this letter.
2. We second EFRAG's support for the IASB's decision to develop a new lease accounting model to replace the existing requirements of IAS 17. In common with EFRAG we feel that the proposed standard needs further work if they are to be made operational in practice.

Our thoughts on EFRAG's high level comments

3. We agree that the boundary between leases and service contracts is difficult to determine and that the proposed criteria carried forward from IFRIC 4 do not provide a clear enough distinction, meaning classification may be difficult to determine in practice. We have similar concerns about the boundary between leases and contracts that represents a purchase or sale.
4. We agree that the conceptual premise behind the right-of-use approach is not reflected throughout the proposed standard consistently.
5. We agree with EFRAG's concerns about the proposed hybrid model for lessors. Allowing two alternative approaches replicates a number of the problems inherent in IAS 17, such as the lack of comparability and scope for structuring opportunities. It is also inconsistent with requiring a single approach for lessees. We support a single approach for all leases based on the derecognition model. We believe that this approach is a logical reflection of the lessee's right-of-use.
6. We do not share EFRAG's concerns about sale and leaseback transactions. We agree with the IASB's overall approach to sale and leaseback transactions, though we believe that there is a need for more clarity as to the boundary between sale/purchase contracts and lease agreements.
7. We agree with EFRAG's assertion that there is no real relief for lessees under short-term leases, particularly as the burden of identifying and tracking a large number of leases will still be very onerous even if discounting payments under those leases is not required. Therefore,

while we support some simplification for short-term leases, we do not agree that the proposed model is the best solution. Like EFRAG, we would instead propose that the existing requirements of IAS 17 relating to operating leases should be applied to short-term leases.

8. We also broadly agree with EFRAG's concerns about comparability, complexity, the definition of assets and liabilities, optional lease periods, the needs of users and cost-benefit considerations. However, we do not agree with EFRAG's views regarding contingent rental and contracts that contain both lease and non-distinct service components. For information on our views on these matters please see below and the attached draft of our response to the IASB. However, note that our views on contingent rentals are still under deliberation and may change before our final representation letter is published.
9. We are supportive of many of the views put forward by EFRAG on the specific questions raised by the IASB in their exposure draft. More details are provided below where our opinions differ.
10. In certain areas we will raise concerns in our comment letter that have not been addressed in EFRAG's draft letter. These include the following, which we encourage EFRAG to consider reflecting in its final comment letter:
 - The ED does not provide any specific guidance on the treatment or disclosure of prepaid rentals or any payments made between the inception and commencement date even though such payments are common for leases with underlying asset that are under construction during that period.
 - We believe that abandoning the distinction between operating and finance leases will have a potentially disproportionate impact on SMEs when any new leasing standard affects the updating of the IFRS for SMEs. We urge the IASB to develop a simplified model for SMEs that recognises their limited resources and the realistic needs of users.
 - We have concerns about the tax implications of the proposed changes on our UK constituents; concerns that I am sure are shared in other jurisdictions around the EU.
 - The potential impact for regulated institutions also needs to be considered. For example, consideration needs to be given to how the lessee's right-of-use asset will be treated for regulatory capital purposes (ie, is it tangible or not?). While we appreciate that this is primarily a regulatory matter, clarification as to the nature of the asset would be helpful.

NOTABLE DIFFERENCES OF OPINION

IASB question 6

11. We do not agree with EFRAG's proposals that when a contract includes both a lease and non-distinct services, a lessee should identify the predominant component and treat the whole contract accordingly.
12. See also paragraphs 18-19 below.

IASB question 9

13. We accept EFRAG's analysis of different categories of contingent rental. However, on balance we support treating all contingent rent in the same way, as we believe separating contingent rentals into different categories may prove too complex in practice.
14. See also paragraphs 20-21 below.

RESPONSES TO SPECIFIC QUESTIONS RAISED BY EFRAG

EFRAG question 1

Do constituents believe that a distinction between leases and sales/purchases is required? If so, do they believe that the criteria are appropriate?

- 15.** We agree that a distinction between leases and sales/purchases is required. Like EFRAG, we are concerned that the proposed guidance in the exposure draft is not clear enough in this area.
- 16.** We note that the exposure draft identifies sale/purchase contracts as those that transfer 'control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset'. We are concerned that 'all but a trivial amount' is not clearly defined. Unless this is clarified, it could be interpreted inconsistently. Moreover, contracts could be structured to achieve a particular accounting outcome.
- 17.** We are concerned that these proposals are inconsistent with the revenue recognition proposals, which only require the transfer of control as a condition to recognise a sale. A preferable approach would be for the leasing proposals to be consistent with the revenue recognition proposals ie, if a contract meets the definition of a sale per the revenue recognition proposals, it should also be classified as a sale per the leasing proposals without additional reference to risks and benefits.

EFRAG question 2

Do constituents agree with EFRAG's suggestion on the lessee's treatment of a contract that includes non-distinct services? If not, what other approach do you support?

- 18.** As noted in paragraphs 11 above, we do not agree with EFRAG's suggestion.
- 19.** We are in agreement with the proposals contained in the exposure draft ie, that in such circumstances the lessee should apply the lease accounting requirements to the combined contract. However, we believe that in practice there will not be many occasions where services will be considered 'non-distinct', provided the boards clarify the meaning of 'distinct' adequately as part of their revenue project.

EFRAG question 3

Do constituents believe that separating different categories of contingent rentals might be too complex?

- 20.** As noted in paragraph 13 above, we accept EFRAG's analysis of different categories of contingent rental.
- 21.** We are aware that there is an argument for excluding contingent rentals that are dependent on usage from calculations of rent payable, as they may be considered avoidable as the lessee could simply stop using the asset and avoid making any additional payments. However, we believe that excluding such items could create structuring opportunities and therefore believe that they should be included based on management's best estimates of the expected future cashflows.
- 22.** We have some sympathy for EFRAG's view and the alternative view included in the ED, although on balance we support treating all contingent rent in the same way as we believe separating contingent rentals into different categories may prove too complex in practice.

EFRAG question 4

Do constituents agree with the analysis and EFRAG's proposals for the treatment of sale and leaseback transactions?

23. As noted in paragraph 6 above, we do not share EFRAG's concerns about sale and leaseback transactions. We agree with the IASB's overall approach to sale and leaseback transactions.

EFRAG question 5

Paragraph 44 of IAS 7 *Statement of Cash Flows* requires treating the acquisition of an asset by means of a finance lease as a non-cash transaction. The proposals do not change the requirement. Do constituents agree with the treatment? Or do constituents believe that a lease is essentially a financing transaction and therefore should be presented in the statement of cash flows in the same way an entity presents the purchase of an asset financed by way of a bank loan?

24. We do not believe that cash flows from leases necessarily should be classified as financing. In practice entities enter into leases for many reasons, sometimes as an alternative source of finance and sometimes for operational reasons. The boards have acknowledged this dichotomy in their deliberations concerning financial statement presentation. In the meantime we are willing to accept presentation as financing cash flow as an interim measure. However, we believe the interest component should be treated in a manner consistent with other interest cash flows.

Please contact me should you wish to discuss any of the points raised in this letter or the attached draft response.

Yours sincerely



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