

**OUTREACH EVENT**

**PUBLIC CONSULTATION ON *LEASES***

**BRUSSELS**

**15 SEPTEMBER 2014**

## The event

On September 15, EFRAG hosted an outreach event to discuss the questions and the preliminary feedback from the additional public consultation on Leases organised jointly with the national Standard Setters of France, Germany, Italy and the United Kingdom.

EFRAG and the National Standard Setters of France, Germany, Italy and the UK decided, therefore, to conduct an additional public consultation to obtain constituents' views on:

- a) examples of transactions that would qualify as leases under the proposals, but that in the constituents view are in substance services; and
- b) which of the two alternative approaches proposed by the IASB and the FASB at the March 2014 Boards' meeting is more appropriate and/or less costly to apply.

The outreach event was attended by 34 participants, including some that had also responded to the public consultation. IASB and FASB Board and staff members were present at the event.

## Introduction and welcome

The EFRAG Chairman introduced the event and noted that EFRAG had been supportive of recognition of leases on the balance sheet since the start of the project. However, this support was contingent on the IASB drawing the appropriate line between leases and service arrangements. EFRAG believed that the proposed definition of, and criteria to, identify a lease would include transactions that are akin to service arrangements so there was still need for improvement.

EFRAG staff provided a short historical background of the Leases project since the publication of the original ED and noted that the proposals had evolved in many aspects. In particular, there had been extensive debate about the need to differentiate between types of leases and the Boards had explored different accounting solutions moving back and forth between a single model for all leases and a dual model.

## Preliminary results from the public consultation

EFRAG staff also reported the preliminary results from the public consultation among preparers. A majority of participants had expressed a preference for maintaining and improving the current requirements without moving to a right of use model for all leases. In case the Boards decided to move forward, there was a slight majority for the IASB approach. A preliminary analysis of users' replies showed support for the project and also a preference for the IASB model.

## When does a contract contain a lease?

The EFRAG Technical Director opened the debate on how to improve the definition of, and criteria to identify a lease, and asked participants to provide suggestions for improvements and explanations of their views.

*Right to control the use of the asset*

One participant noted that a new definition of lease was needed to overcome the difficulties in IFRIC 4. It was correct to start the assessment from the existence of a right to control the use of the asset.

One participant confirmed that assessing control was difficult in certain cases because both parties share decision-making power.

#### *Unbundling the contract*

One participant noted that leases were becoming increasingly complex. More and more suppliers are providing a business solution rather than delivering an asset. The IASB was requiring entities to separate lease from service components, but in many cases this would prove quite difficult. Some contracts had to be looked on as a single transaction and treated as a service arrangement.

One participant noted that in some cases, such as drilling rigs, suppliers on the market only provide the asset in connection with the services. If there is no market for the asset on its own, the transaction should be not unbundled and should be treated as a service, because the client is interested in receiving a service and not in controlling the asset.

Another participant noted that when the relative value of the lease was not material compared to the total value of the contract, separating the lease component did not provide relevant information. The IASB representative asked what would be the threshold to assess. Some suggested that the entity should not unbundle when the service component was predominant.

EFRAG staff noted that the recently published Revenue Standard included guidance of when the entity should separate performance obligations. Should the same guidance be applied to unbundling contracts including lease and service components, or was there a need for different requirements? Participants had mixed views. One participant noted that under IFRS 15, if the conditions to identify a separate performance obligation were met the entity had to allocate payments even when market prices were not available.

#### *Who is controlling the use of the asset?*

One participant noted that in some cases, such as company cars, it is not the entity that obtains control of the underlying asset but its employees. The car is part of the remuneration package of the employees and should be treated as a payroll cost that accrues over time. A discussion ensued about whether it was relevant if the employee had the right to keep (or buy) the car when leaving the company, or the company had the right to terminate the lease if the employee was leaving.

EFRAG staff asked if the proposed exemption for small leases that the IASB had tentatively supported would apply to company cars. The IASB staff indicated that they were still working on the

exemption but in their view a car would not qualify for it.

*Ability to replace the asset*

One participant noted that assessing which party has control can be difficult so more emphasis should be placed on the notion of replaceability. The IASB however was requiring entities to assess not only if the supplier had the legal right to replace the asset but also if it would obtain benefits from the replacement. This condition had to be removed because the client did not have the information to make the assessment.

*Unconditional obligation*

One participant from the user community preferred to focus on the lease liability. He said that not all contractual commitments should give rise to liabilities - when the client did not have an unconditional obligation to pay, there was no liability. If the client could walk away from the contract, recognising the full contractual commitment did not provide any information to users. He would rather be interested in knowing the amount to pay to cancel the contract. The IASB representatives noted that an entity would usually only recognise unavoidable payments.

*Are leases financing transactions?*

One participant noted that in some cases, such as real estate in shopping malls, the client is not allowed to buy the underlying asset - therefore the decision to lease is not taken as an alternative way to finance the acquisition. When a lease was not meant to provide financing, it should not give rise to an accounting liability.

Participants discussed if lease transactions were (or included) financing. One participant noted that if a client paid all upfront, the amount of the contract would change - this proved that leases provided financing. Other participants argued that, assuming leases gave rise to liabilities, these were part of the working capital and not of the entity's net debt.

## **Comparison between the IASB and the FASB's proposed approaches**

EFRAG Technical Director moved to the second topic of discussion about the merits of the IASB and the FASB approaches. She asked participants to provide arguments in favour of their preferred approach, including an enhanced version of IAS 17.

*IASB approach versus FASB approach*

One participant noted that the FASB model for leases (straight-line cost recognition for leases that are not purchases of the underlying asset) presented both conceptual and practical issues. He was not in the position to assess implementation costs, but logically the removal of the classification test should reduce complexity. He also was concerned about the proposal to retain IAS 17 and simply add disclosures - it seemed in conflict with the perception of a

disclosure overload that is one of the hot accounting topics.

Other participants offered their views, with some arguing that the IASB model offered a more conceptually robust solution and others that the FASB model reflected that there are different types of leases (in-substance purchases versus rentals). One participant noted that the economic theory of transaction cost offered academic support to the FASB approach.

Following questions from participants, IASB and FASB representatives were invited to explain the rationale for each approach. The FASB representative noted that when the client was not exposed to the risk of changes in the residual value of the asset, a straight-line cost pattern reflected the constant benefit that the entity obtains over the lease term. He also hinted at the possibility of introducing some form of reconciling disclosures.

One participant noted that under the FASB approach, there was a high risk of the entity having to recognise an impairment loss on the right-of-use model because depreciation is low at the start.

#### *Recognition versus disclosure*

One participant noted that the Board proposals were in fact adding disclosures and it was incomprehensible why recognition did not result in a reduction of disclosures requirements. The existing principle in IAS 17 was correct - it was a question to ensure the correct application and there could be room to improve the indicators in the Standard. Other participants agreed.

Another participant replied that a disclosure approach was not an optimal solution - the experience showed that when derivatives were not recognised, people underestimated the liquidity risk even if the amounts were disclosed in the notes.

#### *Convergence*

EFRAG Technical Director asked participants how important it was to reach convergence - would they accept a less preferred approach to reach a converged solution? In general, participants considered that the quality of the final Standard was more important than convergence. However, one participant noted that it would be very disappointing to end up with a US standard, an international standard and potentially a 'IAS 17-plus' solution in Europe.

#### *Consistency in presentation*

Some participant noted that it was important to maintain consistency between presentation in the income statement and balance sheet. Liabilities that do not give rise to interest cost should not be presented as financial liabilities.

## Closing Comments

The EFRAG Chairman brought the debate to an end noting that Leases were on the agenda of the next ASAF meeting. EFRAG would illustrate the main findings from the public consultation and the round table. The main messages were that:

- a) more work had to be done on the scope of application;
- b) there were split views on which of the two approaches provides more relevant information and/or is less costly to apply;
- c) the language in the Standard should clearly reflect the Board's intentions and not require entities to interpret the words;
- d) the Boards were encouraged to find a converged solution, but quality of the final Standard was more important than convergence .