EFRAG

European Financial Reporting Advisory Group

Exposure Draft Leases (2013)

Simplifications to the accounting model for lessees

Limited survey conducted by EFRAG

and National Standard Setters

in February 2014

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Executive Summary

Background

1 In May 2013, the IASB and the FASB ('the Boards') published a revised Exposure Draft *Leases* ('the ED').

2 In June and July 2013, EFRAG and its partners (ANC, ASCG, FRC and OIC) conducted a joint field-test on the proposed guidance for leases. The respondents reported a number of aspects of the proposed guidance that created application problems.

3 Constituents generally agreed that the ED would result in application complexity and would not achieve an appropriate cost-benefit balance.

4 At the December meeting of ASAF, the IASB confirmed that in its redeliberations it would explore how to provide relief and alleviate complexities associated with the proposed guidance for leases. The European delegation at the ASAF meeting offered to consult with European constituents and understand which areas needed to be simplified the most.

5 Normally, EFRAG and the national Standard Setters invite constituents to participate with a public consultation. In this case, it was necessary to complete this limited survey within a short period of time so as to be able to provide early results at the ASAF meeting in early March 2014. Therefore, EFRAG and the national standard setters contacted respondents to the prior field-test and other preparers directly.

6 This limited survey was not designed to provide a statistically valid assessment of the proposed simplifications.

Main findings

7 44 respondents from 10 countries have taken part in the limited survey. The vast majority of the respondents were European listed groups. The industries mostly represented were retail, automotive, telecommunication and transport and logistics. A breakdown of the respondents by country and by industry is given below in paragraph 23.

8 Some respondents clarified that their participation in the limited survey should not be considered in any way as a support for changing the existing requirements for leases. They however provided input assuming that the ED is finalised.

9 All respondents except one considered that simplifications were needed on a broad and systematic basis.

10 A majority of the respondents rated the classification of leases into Type-A and Type-B and the scope of the standard as the two primary areas in need of simplifications.

11 A majority of respondents also considered that measurement, separation of components and the determination of the lease term warranted simplifications. Some respondents however observed that the issues of measurement or separation should be considered through a better definition of the scope rather than through specific exemptions. In their view, if the scope was appropriately defined these would be less important issues.

12 The respondents did not identify major areas in need of simplifications other than the ones contained in the limited survey and based on the IASB re-deliberations.

13 A majority of respondents indicated their preference for a single model for all leases and supported a single Type-A model. Some of these respondents considered that having a single model would reduce complexity and implementation costs. Some indicated that they could support a single type A model only to the extent that the distinction between leases and services was improved in the forthcoming standard. These respondents believed that the IASB should primarily work on this distinction to ensure that an appropriate standard is developed. In the absence of such improvement, these respondents indicated that a dual model based on IAS 17 criteria would lead to greater understandability.

14 A few respondents argued that a single model would not reflect the economic differences that might exist between types of leases and, therefore, they opposed a single model.

15 A few respondents, while supporting a single Type-A model for leases in general, were in favour of introducing an exception for leases of properties. These respondents were from industries with a significant number of property leases. On the other hand, opponents to the introduction of an exception for properties considered that:

(a) It would set a rule-based exception that would not be conceptually and economically sound;

(b) a dual model, even limited to properties, would not meet the objective of reducing complexity and cost;

(c) It might be difficult to define what a “property’ is.

16 A majority of respondents were in favour of a recognition exemption for non-core assets as the most efficient way to reduce complexity and implementation cost. They however acknowledged that defining which assets are ‘core’ or ‘non-core’ would be challenging in practice and some of them suggested that further guidance would be needed.

17 A majority of respondents were in favour of extending the short-term exemption for lease terms of more than one year. In their opinion this extension would reduce the implementation costs. A few respondents suggested periods up to five years.

18 Some respondents pointed out that limiting the short-term exemption to leases shorter than twelve months, might not suit all business cycles and business models. They therefore suggested to extend the exemption, and to combine it with an exemption for non-core assets.

19 Some respondents believed that allowing a portfolio approach may reduce complexity and implementation cost. However they believed that further clarification would be needed on applying the approach and define homogenous portfolios.

Detailed findings

Purpose of the limited survey

20 The objective of the limited survey was to consult with European constituents in order to understand which areas of the ED's accounting model for lessees needed to be simplified the most and to assess the usefulness and workability of the simplifications contained in the IASB staff papers for discussion at the IASB meeting in March 2014.

21 Respondents were asked to assess the proposed simplifications, and explain the reasons for the assessments, in the following areas:

(a) Scope of the Exposure Draft;

(b) Classification of leases

(c) Determination of the lease term;

(d) Measurement of the lease liability;

(e) Separation of lease and non-lease components;

(f) Determination of the discount rate;

(g) Other simplifications including:

(i) portfolio approach;

(ii) materiality threshold at asset or agreement level.

22 The report uses the following terms to summarise the findings:

(a) *A few*: less than 25% –from 5 up to 11respondents;

(b) *Some*: between 25% and 50% – 12 up to 22 respondents;

(c) *Majority*: between 50% and 75% – 23 up to 33respondents; and

(d) *Vast majority*: more than 75% –34 respondents or more.

General information about the respondents

23 44 respondents from 10 countries took part in the limited survey. The vast majority of the respondents were preparers (European listed groups).

24 The table below presents the number of respondents by country and by industry:

Number of respondents by country and by industry

Respondents by country:		*Respondents by industry:*	
France	14	Retail	5
Germany	10	Automobiles & Parts	5
Italy	4	Telecommunication	4
Denmark	3	Transports & logistics	4
Finland	3	Industrial goods & services	4
Spain	3	Utilities	4
Austria	2	Food & beverage	2
Poland	2	Health care	2
Switzerland	2	Oil & gas	2
Lithuania	1	Technology	2
		Chemicals	2
		Insurance	2
		Travel & leisure	2
		Financial services	1
		Personal & household	1
		Construction & Materials	1
		Professional organisations	1
	44		**44**

Scope of the Exposure Draft

25 Simplifications relating to the scope of the standard were considered a priority area by a majority of respondents.

26 The respondents were asked to assess the following simplifications relating to the scope:

(a) A lessee should be required to recognise only leases of core assets;

(b) A lessee should be allowed to apply the short-term exemption to contracts that have an option to extend beyond 12 months, when the option does not grant a significant economic incentive;

(c) The short-term exemption in the ED should be extended to a period longer than 12 months (the questionnaire did not indicate a precise period);

(d) The short-term exemption should not be a fixed period for all assets. The length of the exemption should depend on the economic life of the underlying asset.

27 A majority of respondents were in favour of an exemption for non-core assets. They believed that this would be the most effective way to reduce complexity and implementation cost by excluding a large number of leases that are non-core to the business as copiers or coffee machines. One respondent argued that real estate leases would also fall within the category of non-core assets as real-estate leases are generally a support to the activity and generate no income of their own.

28 However, supporters of a non-core exemption acknowledged that defining ‘core’ or ‘non-core’ assets was challenging in practice and some of them suggested that further guidance would be needed to avoid diversity in practice.

29 A majority of respondents also believed that an extension of the short-term exemption for periods beyond one year could reduce complexity and implementation cost by excluding a large number of short and medium term leases such as equipment (e.g. car fleet). A few respondents proposed that short-term definition be extended for periods up to 3 or 5 years, and one respondent even suggested a 10 year limit. Some respondents pointed out that limiting the short-term exemption to leases of less than twelve months might not be suited to all business cycles and business models. They therefore suggested extending the exemption and combining it with an exemption for non-core assets.

30 A few respondents did not support such an extension because they believed it would exclude too many contracts and therefore would misrepresent the financial position of the entity.

31 The alignment of the short-term exemption (option b above) to the definition of lease term received support from some respondents, but it was generally not perceived as providing sufficient relief since preparers would still need to assess each contract individually.

Classification of leases

32 Classification of leases was identified as another primary area for simplifications by a majority of respondents.

33 The respondents were asked to assess the following proposals relating to lease classification:

(a) A lessee should apply Type-A accounting to all leases;

(b) A lessee should use existing indicators in IAS 17 to classify leases (i.e. leases that are currently finance leases would be classified as Type-A; and leases that are currently operating leases would be classified as Type-B);

(c) A lessee should classify leases of assets other than property as Type-A and leases of property as Type-B;

(d) A lessee should choose either Type-A or Type-B accounting as its policy option for all its leases.

34 A majority of respondents supported having a single Type-A model accounting model for all leases. In their opinion a single model will reduce complexity and implementation costs by removing a need of on-going classification of leases and a need to implement two different accounting models. However, some of these respondents indicated that they could support a single Type A model only if the distinction between leases and services was improved in the forthcoming standard. These respondents believed that the IASB should primarily work on a better definition of what is a lease and what is a service contract. In the absence of such improvement, some respondents indicated that they would support a dual model based on IAS 17 criteria.

35 One respondent indicated that the use of a single model should be complemented by an exemption for non-core assets.

36 A majority of respondents also rejected a policy option to apply either Type-A or Type-B at the entity level. They considered that this option would seriously hinder comparability.

37 Some respondents were in favour of a dual model as it acknowledged the fundamentally different nature of leases.

38 Mixed views were expressed as to the nature of the simplifications that would be needed if a dual model was maintained.

39 Some of respondents were in favour of using the IAS 17 classification criteria. They generally considered that the IAS 17 criteria had proven their usefulness and understandability.

40 Some of the respondents believed that applying IAS 17 criteria alone would not provide a significant reduction in cost if not accompanied by other simplifications to the scope or measurement requirements.

Measurement of the lease liability

41 A majority of respondents identified measurement of the liability as a primary area where simplifications are needed.

42 Respondents were asked to assess the following simplifications:

(a) A lessee should be allowed (or required) to use undiscounted amounts for medium-term leases;

(b) A lessee should not reassess contingent payments based on a rate or index;

(c) A lessee should reassess contingent payments based on a rate or index but adjust only the liability and not the right-of-use asset;

(d) A lessee should be allowed to use a ‘display approach’ under which the lessee would only recognise at the reporting datea lease liability equal to the present value of the remaining lease payments, and a right-of-use asset for an equal amount (adjusted for any advanced or deferred payment).

43 A majority of the respondents supported the proposal not to reassess contingent payments that are based on a rate or index as the simpler and most cost effective alternative.

44 A few respondents suggested that that simplification should be applied only to the extent that the impact is not material.

45 A majority of respondents rejected the alternative to adjust only the liability as such approach would have no economic meaning and furthermore it would not relieve the preparers for reassessing contingent payments on a lease by lease basis.

46 The accrual benefits of a display method were not clearly understood by the respondents and a few questioned whether it would provide any relief at all if leases still need to be analysed on an individual basis.

Determination of the lease term

47 Some respondents identified assessing and reassessing the lease term as an area where simplifications are needed.

48 Respondents were asked to assess the following simplifications relating to the lease term:

(a) A lessee should reassess the lease term only if it has exercised an option previously not included in the liability; or forfeited an option previously included;

(b) The ED should include a rebuttable presumption that the lease term is unchanged unless there is evidence of a significant change in relevant factors.

49 A majority of the respondents supported option (a) as the most effective simplification as it would not require a lease by lease assessment.

50 Mixed views were expressed on option (b).Some respondents were in favour of it, but others considered the identification of ‘other factors’ to be burdensome and highly judgmental. In their opinion, the terms ‘significant change’ and ‘relevant factors’ would increase the use of judgement and therefore possibly lead to lesser comparability between preparers.

51 Furthermore, some respondents did not agree that all options meet the definition of a liability under IAS 37.They considered that, if the IASB confirmed its decision to recognise a liability for certain options, they would rather suggest keeping the current approach of IAS 17 in respect of the lease term, as this was already well understood and would enable entities to avoid the reassessment of all contracts in the light of new criteria at the time of transition.

Separation of lease and non-lease components

52 Some respondents assessed the separation of lease and non-lease components as a primary area where simplifications were needed.

53 Some respondents however observed that the issue of separation should rather be considered through a better definition of the scope rather than through specific exemptions. In their view, if the scope was appropriately defined the separation of lease and service components would be a less important issue.

54 Respondents were asked to assess the following simplifications relating to separating lease and non-lease components:

(a) An entity should classify the whole contract based on the primary component;

(b) An entity could classify the whole contract as a lease;

(c) An entity could use reasonable estimates to allocate payments to different components when observable prices are not available.

55 Respondents generally called for a more intuitive and pragmatic approach. They argued that:

(a) The determination by lessees of stand-alone prices of all components would be a cumbersome exercise as most leases contained some form of service components;

(b) If no observable prices were available for any of the components, it might suggest that all components are highly interrelated and the contract was therefore unlikely to contain a lease component.

56 A majority of respondents considered that the use of the primary component as the best alternative to reduce cost and complexity by removing the need to measure and record each component separately. A few supporters of the alternative however suggested using this approach only when the 'non-primary' component was not material.

57 Some respondents expressed concerns about accounting for the whole contract based on the primary component insofar as:

(a) it was sometimes difficult to determine the primary component and this would imply judgement and might impair comparability;

(a) this would not necessarily reflect the economic substance of the transactions.

58 A few respondents proposed that contracts that contain a significant service component should be accounted for as a service agreement. However, they did not specify how to define a significant service component.

Determination of the discount rate

59 Only a few respondents considered simplifications of the guidance on the assessment of the discount rate to be a primary area where simplifications are needed.

60 Respondents were asked to assess the following simplifications relating to the discount rate:

(a) To allow use of credit adjusted risk-free rate;

(b) To allow use of secured borrowing rate;

(c) To allow use of the rate of high quality corporate bonds.

61 A majority of respondents considered that none of the proposed simplifications would provide an actual relief or cost reduction absent other simplifications to the scope or classification requirements.

62 A few respondents indicated that the determination of the discount rate was not in itself a costly exercise and the level of complexity was more related to the sheer volume of items and the discounting process itself.

63 A few respondents however noted that:

(a) Many groups use corporate treasury procedures or cash pooling and therefore the assessment of the borrowing rate should be allowed at the group level;

(b) Assessment of the incremental borrowing rate for long-term contracts would be problematic.

Other simplifications

64 Respondents were asked to assess the following simplifications:

(a) Allowing to apply a portfolio approach for homogenous leases;

(b) Assessing materiality on an individual level (single asset or agreement) rather than on an aggregate level.

65 Neither of the above received strong support from respondents.

66 Some respondents commented that applying a portfolio approach might not significantly decrease complexity or cost as the entity would have to identify and document that leases are homogenous. This might not always be easy considering the wide variety of lease terms and conditions. They also argued that it was not clear how this approach would be applied in practice and how 'homogeneous' portfolios would be assessed.

67 Supporters of a portfolio option also raised similar concerns that this approach would not be necessarily operational and considered that the alternative was promising but needed further investigation.

68 Only a minority of respondents supported an assessment based on a materiality set at individual level. They considered that a materiality based approach would reduce substantially the implementation costs.

69 One respondent suggested that materiality may be calculated as a percentage of the entity's total assets or liabilities. One respondent suggested that materiality could be determined at a portfolio level and separately for each company within the groups.

70 Opponents to a materiality approach considered that:

(a) materiality should not be set at standard level and, to that respect, alternative (b) would set a rule-based precedent that would not be consistent with other IFRSs;

(b) materiality is difficult to apply in practice as the impacts of not applying a requirement must still be assessed and documented;

(c) it could lead to diverging practices or structuring opportunities by 'playing around' the threshold.

71 Respondents were also asked to identify whether other areas that might not have been covered in our limited survey and the IASB re-deliberation papers, were in need of simplifications.

72 Only a few respondents identified other areas in need of simplification, as follows:

(a) Impairment testing for right-of-use assets;

(b) Disclosure requirements;

(c) Lease modifications.

Appendix – List of the respondents to the field-test

Respondent's name	Country	Industry
A.S.A. Abfall Service	Austria	Industrial goods & services
Telekom Austria AG	Austria	Telecommunication
DSV	Denmark	Transports & logistics
Novo Nordisk Group	Denmark	Health care
Maersk	Denmark	Industrial goods & services
Huhtamaki Group	Finland	Industrial goods & services
Kemira Group	Finland	Chemicals
Kesko	Finland	Retail
ORIE	France	Professional organisation
Saint Gobain[1]	France	Retail
SNCF[1]	France	Transports & logistics
PSA Peugeot Citroen[1]	France	Automobiles & parts
GDF Suez[1]	France	Utilities
Thales [1]	France	Industrial goods & Services
Vinci [1]	France	Construction & Materials
Areva [1]	France	Utilities
Air France [1]	France	Travel & Leisure
Groupe Foyer [1]	France	Insurance
Michelin [1]	France	Automobiles & Parts
Axa [1]	France	Insurance
Air Liquide [1]	France	Chemicals
Accor	France	Travel & leisure
Beiersdorf	Germany	Personal & household
Daimler	Germany	Automobiles & parts
Deutsche Post	Germany	Transports & logistics
Fielmann AG	Germany	Retail
Hornbach Baumarkt AG	Germany	Retail
Linde	Germany	Oil & Gas
ProSiebenSat1	Germany	Telecommunication
Siemens	Germany	Technology
Volkswagen	Germany	Automobiles & parts
TUV SUD AG	Germany	Technology
Telecom Italia	Italy	Telecommunication
Poste Italiane	Italy	Transports & logistics
Enel	Italy	Utilities
FIAT Spa	Italy	Automobiles & parts
UAB Siauliu banko lizingas	Lithuania	Financial services
AmRest Holdings SE	Poland	Food & beverage
ENERGA S.A.	Poland	Utilities
REPSOL	Spain	Oil & gas
Telefonica	Spain	Telecommunication
Inditex	Spain	Retail
Novartis	Switzerland	Health care
Nestlé	Switzerland	Food & beverage