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International Accounting Standards Board
30 Cannon Street
London EC4M6XH
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Dear IASB secretariat

DISCUSSION PAPER DP/2009/1: LEASES - PRELIMINARY VIEWS

CIPFA is pleased to present its comments on the proposals in this discussion paper, which have been reviewed by CIPFA's Accounting and Auditing Standards Panel.

CIPFA is a professional accountancy body in the United Kingdom which specialises in the public services. In this context we are interested in the development of financial reporting standards as they apply to the private sector and as they might be applied in or otherwise affect reporting in the public sector. Because of the substantial interaction between government and the private sector, there are clear benefits for financial reporting in both sectors to be compatible and mutually comprehensible. Reporting using IFRS is mandatory for listed groups in the European Union. IFRS will be used with some adaptation for UK central government and health sector financial reporting from 2009-10, and for all public sector reporting including local government from 2010-11. In the international context, the IFAC International Public Sector Accounting Standards Board also develops its International Public Sector Accounting Standards (IPSASs) having regard to related company sector reporting developed by the IASB.

Overall comments

Recognising a right of use asset and a corresponding liability to pay rentals seems to better capture the economic substance of lease arrangements than current reporting, particularly inasmuch as it does not require very different reporting for some arrangements which are very similar. We would support this approach being the basis for the development of an exposure draft. However

- the benefits of improved reporting are clearly greater for high value leases, and also where the combined value of leases is high. The benefit of more detailed reporting on less significant leases is much less clear.
- Using the lessee interest rate for discounting purposes will provide less relevant and comparable information where it is markedly different from the imputed lessor return. In particular it would result in systematically higher valuations being attached to assets and liabilities for many public sector entities preparing financial statements under IFRS.



INVESTOR IN PEOPLE

- Developing lessee guidance without full consideration of issues for lessor accounting carries a risk that there will be a need for substantial revisions to guidance, at a later stage.

Specific comments on some of the questions in the discussion paper are attached.

I hope this is a helpful contribution to the discussion in this important area.

Kind regards

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Responses to questions in Annex A

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?

If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

CIPFA agrees with the proposed approach.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.

Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

As explained in the covering letter, we consider that the benefits of the approach outlined in Chapter 3 are significant for higher value assets, but may be disproportionate for less significant assets.

We agree with the boards that there are problems in defining non-core assets, and we suggest that further consideration of excluded leases should be primarily in terms of economic effect, and that information on excluded leases should be provided (for example, in line with current disclosures on operating leases) to provide reassurance that the excluded information was not material.

Question 3

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

CIPFA agrees with this approach.

Question 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:

- (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)**
- (b) a liability for its obligation to pay rentals.**

Appendix C describes some possible accounting approaches that were rejected by the boards. Do you support the proposed approach? If you support an alternative approach, please describe the approach and explain why you support it.

CIPFA agrees with this approach.

Question 5

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:

- (a) a single right-of-use asset that includes rights acquired under options**
- (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.**

Do you support this proposed approach? If not, why?

We accept that this is a practical approach chosen for cost-benefit reasons.

Question 6

Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

In our view this decision should be reviewed. We agree with the Discussion Paper that the lessor's imputed return would be a better basis for valuation, and that the DP

proposal to use the lessee's incremental borrowing rate reflects a view that imputed rate information will often not be available, and that adopting a standardised approach will promote comparability.

In our view the decision usefulness of the lessee rate mainly reflects an assumption that it is broadly in line with imputed return, and that it is correspondingly less useful and less comparable when this is not the case. We would also note that the lessee rate will not always be easy to calculate.

A specific issue would arise from public sector application of this approach, given that in many countries the public sector has a much lower incremental borrowing rate than private sector entities.

Question 7

Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

We agree with the boards' tentative decision to initially measure the lessee's asset at an amount equivalent to the obligation to pay rentals.

Question 8

The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach? If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

We accept that this is a practical approach chosen for cost-benefit reasons.

Question 9

Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

We have some sympathy with the view that entities which measure similar assets and liabilities at fair value should be able to adopt comparable approaches to leased assets. However, for arrangements which are, in effect fixed rate borrowing we are not convinced that this would produce the most useful information on financing liabilities.

Question 10

Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons. If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

We do not consider this would be helpful, both because the economic substance may not have changed, and given our concern that incremental borrowing rate may be a poor proxy for the imputed return.

Question 11

In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the boards? If you disagree, please explain why.

We agree with this approach.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.

Would you support this approach? If so, for which leases? Please explain your reasons.

We do not support this approach.

Question 13

The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term. Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We agree with this approach in circumstances where one outcome is substantially more likely than the others, but would have some reservations on its application where circumstances are less clear cut. We wonder if it would be better to concentrate on that part of the potential duration of the lease which is almost certain.

Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

We agree with this approach.

Question 15

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We agree with this approach.

Question 16

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you recommend and why?

We agree with this approach which better captures the value of future economic benefits.

Question 17

The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable.

The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.

Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

In principle we favour the IASB proposal, but in practice we consider that it will often be difficult to obtain objective probabilities.

However, we are also concerned that an approach based upon determination of a single most likely outcome would not provide meaningful information in many cases where there is a large range of outcomes or where the set of outcomes is skewed. It would also be very sensitive to estimation assumptions, and might be vulnerable to manipulation through 'structuring'.

We therefore suggest that any approach based on 'most likely' value should consider the relative likelihood of ranges of outcomes, which will often be easier to assess than for individual outcomes. The boards might for example consider a median estimate of the contingent rental for which it is equally likely that actual variable rent will be higher or lower than the estimate, or a value below this which it is 'most likely' that actual variable rent will exceed.

Question 18

The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Do you support the proposed approach? Please explain your reasons.

We do not agree with this approach, and would favour an approach based on expected rates, where the rate at inception would be an appropriate starting point, to be weighed in the light of other evidence.

Question 19

The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.

We agree with this approach.

Question 20

The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:

- (a) recognise any change in the liability in profit or loss**
- (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.**

Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

We support approach (b), based on a view that this represents a change in the income generating potential or service potential of the right-of-use asset.

Question 21

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

We agree with this approach