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Response of the Accounting Committee of the Institute of Chartered Accountants in Ireland

Discussion paper: Leases Preliminary Views

Dear Sir/Madam,

The Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland welcomes the opportunity to comment on the proposals contained in the above discussion paper (DP). The appendix to this letter provides answers to the detailed questions asked in the document.

AC welcomes the publication of the DP as an important step in improving the accounting for leases. AC considers that the current distinction between finance and operating leases is artificial, is open to manipulation and, by virtue of the notional adjustments which users make to the amounts recognised in the financial statements, does not meet the needs of many users. Accordingly, AC believes that a revised standard on lease accounting should be issued as quickly as possible.

Should you wish to contact us about any of our comments please feel free to do so.

Yours faithfully,

Mark Kenny

Secretary, Accounting Committee

Appendix

CHAPTER TWO: SCOPE OF LEASE ACCOUNTING STANDARD

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.

AC agrees that the scope of the new standard should be based on the scope of existing standards and assumes that such standards comprise both IAS 17 *Leases* and IFRIC 4 *Determining whether an arrangement contains a lease*. Current lease accounting standards are unsatisfactory and need to be rectified as a priority. A complete reassessment of what is a lease would be time consuming and would delay the implementation of necessary reform.

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.

AC believes the new standard should not exclude non-core or short-term asset leases. The acquisition of an asset, whether through lease or purchase, gives rise to a right-of-use regardless of whether that asset is core to the business. The proposals in the DP are predicated on applying a consistent treatment to rights to use an asset. A non-core owned asset will be accounted for like any other owned asset. In AC's view, any distinction between the required accounting for leased core and non-core assets is artificial, would result in a different treatment for owned and leased non-core assets and conflicts with the overall objective of the DP.

CHAPTER THREE: APPROACH TO LESSEE ACCOUNTING

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.

AC agrees with the boards' analysis. However, AC notes that, while the example provides that the lease does not contain any rights to extend, in practice such leases are often extended. The lessee may have built up infrastructure to support the operation of the asset and may require it for its ongoing business, while it may suit the lessor to leave the asset with the current lessee rather than incurring the expense, time and effort in securing a replacement lessor or purchaser for the asset.

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.

AC supports the approach proposed by the boards. There are numerous reasons why entities decide to lease assets rather than buy them outright. These could include an inability to finance a purchase, or a potential breach of covenant if the balance sheet liability effectively equalled the full purchase price of the asset. The whole asset approach ignores the fact that leases and purchases are fundamentally different in a number of respects. In AC's view, it overstates an entity's assets and liabilities and could potentially result in circumstances occurring (such as a breach of covenant) which the selection of a lease arrangement was designed to ensure did not occur. AC also concurs with the reasons for rejecting the executory contract and existing standards approaches.

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?

AC agrees with the approach proposed. However, AC has concerns about the approach to be applied to accounting for extension options (see question 13). As indicated in the response to question 3, there may be little difference in practice between a lease containing an extension option and one which is silent on the issue.

CHAPTER FOUR: INITIAL MEASUREMENT

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.

AC believes that the interest rate implicit in the lease should be used where this can be determined reliably and suggests that the Boards consider including indicators as to when it would be appropriate to use that rate. However, AC also accepts that discounting using the interest rate implicit in the lease is in many cases too subjective and difficult and, where this is the case, the lessee's incremental borrowing rate should be used.

It will be important that a new standard specifies what is meant by 'incremental' borrowing rate and makes it clear that it is the rate the entity would have to pay to draw down additional borrowings on terms similar to the lease obligation and not necessarily what they are currently paying on existing debt.

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.

There are divergent views amongst AC members as to whether there is a significant difference between the rights obtained through the purchase of an asset and those obtained through a lease. However, owned assets are generally recorded at cost and, to ensure comparability, it is AC's view that a similar approach should be applied to leased assets. Accordingly, AC concurs with the board's tentative decision.

AC notes that where the lease is for substantially all of the life of the asset or where title transfers at the end of the lease term, it would expect that if the correct incremental borrowing rate is used, the discounted present value of the lease payments should approximate the fair value of the asset. If this was not the case, the entity should understand the reason for the difference.

CHAPTER FIVE: SUBSEQUENT MEASUREMENT

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.

AC believes that lease liabilities should be measured in the same way as similar non-lease liabilities and, as a result, concurs with the amortised cost approach to subsequent measurement. In relation to assets, AC considers that the options available to owned assets should also be available to leased assets, with the resulting carrying amounts being depreciated accordingly.

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.

AC believes that the same options should apply to lease obligations and other similar liabilities.

Question 10:

(a) Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.

AC does not agree with the proposal to revise the rental obligation amount to reflect changes in the incremental borrowing rate if there has been no change in cash flows or underlying assumptions. As indicated in the response to other questions, AC considers leasing to be akin to purchasing an asset and the accounting for both should be consistent. Take the simple example of two entities wishing to secure the use of an asset with a 10 year life. One can finance the purchase through 10 year fixed rate borrowing, while the other is only able to finance the acquisition of five years of use and must resort to leasing for this. It is difficult to see the justification for requiring the lessee to revise its obligation over the five year period when incremental borrowing rates change while the entity which borrowed the full cost is not required to do so. There was a minority view among AC members that where there is a change in the estimated cash flows as a result of a revision in one of the original estimates used to determine the liability, the retrospective approach noted in paragraph 5.28 should be applied, whereas the majority favoured the prospective method.

AC notes that FASB does not agree with a requirement to reassess the rental obligation to reflect changes in the incremental borrowing rates while IASB does. The logic behind IASB's position is not adequately explained. In paragraph 5.22, there is a reference to IAS 37, perhaps suggesting that lease liabilities should be accounted for as non-financial liabilities, whereas other paragraphs suggest that they be accounted for as financial liabilities. A conclusion needs to be reached on whether lease liabilities should be accounted for in a manner consistent with IAS 37 or IAS 39. Should the boards ultimately decide to require the lessee to revise its lease obligation to reflect changes in the incremental borrowing rate, the basis for such a conclusion and the objectives of such a requirement should be made clear.

(b) 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.

The boards would need to explain the objective they are seeking to accomplish through a revision of the incremental borrowing rate. The use of the lessee's incremental borrowing rate, as noted in Chapter 4, should in most cases provide a reasonable approximation of fair value. Is the objective to maintain the approximation of fair value? As indicated above, AC considers that a conclusion on whether the provisions of IAS 37 or IAS 39 apply is required. If the provisions of IAS 37 apply, annual remeasurement is required. However, if lease liabilities are to be accounted for similarly to IAS 39, AC believes that the remeasurement requirement should apply only when there is a change in the estimated cash flows.

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.

It would appear from paragraph 5.36 that one of the reasons for specifying the required accounting for the obligation to pay rentals is a desire to have consistency in the accounting for lease obligations, in advance of convergence between IFRSs and US GAAP. AC agrees with this approach. AC also assumes that a further reason for the approach proposed is to ensure that the requirements in relation to accounting for embedded derivatives do not apply to leases. Again, AC

concurr with the approach proposed here and therefore supports the preliminary views of the boards that the required accounting for obligations to pay rentals should be specified in the leasing standard.

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.

A lessee is likely to have a range of service potentials available for use, some of which emanate from owned assets and others from leased assets. AC does not believe that the manner in which these rights to use have been financed should influence the recording of the consumption of benefit. Accordingly, AC is of the view that the decrease in value of like items should be described consistently as depreciation or amortisation in the financial statements.

AC believes that depreciation on owned assets should be shown separately from leased assets.

CHAPTER SIX: LEASES WITH OPTIONS

Question 13: The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. 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.

AC concurs with the use of the most likely lease term. However, in AC's view it is unrealistic to exclude consideration of the lessee's intentions and past practice when assessing the lease term. AC accepts that basing the lease term solely on the lessee's intention would be open to abuse. However, AC considers that it is meaningless to require a leased asset to be recorded for a period beyond which the lessee has no intention of holding the asset. Accordingly, AC believes that a combination of contractual, non-contractual, business, past practice and lessee intention factors should be assessed when determining the lease term, with the past practice and lessee intention factors being backed up by supporting evidence.

While the existence of a specific extension option provides the lessee with certainty that it can retain the asset for longer than the initial lease term, it is often the case that negotiations will result in a lease being extended at the end of the term notwithstanding the lack of a specific extension option. For example, a lessor may prefer to leave the asset with the existing lessee if the lease has been satisfactory rather than trying to secure an alternative lessee. The lessee may wish to avoid the disruption of replacing the asset or have made significant improvements that would be lost if the asset is returned. AC is unclear whether a lessee who determines that the most likely lease term is longer than the initial term, albeit that there is no extension option, should account for the lease over the contractual lease term or the longer term.

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.

(a) Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

AC agrees with the requirement to reassess the lease term at each reporting date on the basis of new facts or circumstances. If, for example, the lessee intended to extend the lease term and expended significant sums on improvements, it would be inappropriate if there was not a requirement to reassess the lease term. Seeking to specify the types of events which would trigger a mandatory reassessment of the lease term could lead to loopholes and, accordingly, AC believes that the most practical approach is to require an annual reassessment.

The obligation to pay rentals gives rise to a right to use an asset. A reduction in the liability as a result of a shorter lease term gives rise to a reduction in the right to use the asset, while an increase in the liability gives rise to an enhanced

right-of-use. AC considers that any adjustment to the liability as a result of a reassessment of the lease term should be recognised as an adjustment to the carrying value.

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

AC believes that the financial statements should reflect what is most likely to arise in practice. If events have occurred which make it likely that the actual lease term will differ from that previously used in preparing the financial statements, AC believes that an adjustment to the carrying amounts will result in improved financial information for users.

AC also believes that the standard needs to deal with the accounting for the impact of discounting and whether, consistent with IFRIC 1 *Changes in existing decommissioning, restoration and similar liabilities*, all changes other than the unwinding of the discount should go to the asset value.

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.

AC agrees with the proposal that purchase options should be accounted for in the same way as options to terminate or extend leases. However, as was the case with assessing the lease term, AC does not believe that any assessment of the “most likely” outcome can ignore a lessee’s intention or past practice. In an extreme scenario, the proposals dealing with the most likely outcome could result in an accounting result which differs from that which is virtually certain, forcing the reporting entity to include a clarification in its financial statements. In AC’s opinion, such an approach potentially undermines the credibility of financial reporting to users.

CHAPTER 7: CONTINGENT RENTALS AND RESIDUAL VALUE GUARANTEES

Contingent rentals

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?

AC agrees that the assets and liabilities recognised by the lessee should reflect the obligation to pay contingent rentals. However, AC also accepts the view of some board members that the treatment of the contingent rentals should depend on the nature of the contingency to which the payment is linked.

If the payment is linked to the movement in an index, the recognised amount would reflect the contingent element. AC considers that including contingent rentals that reflect performance or usage levels overstates liabilities and would be potentially misleading for users. At the outset of the lease, the lessee’s only obligation is to pay the minimum lease rentals and, in AC’s view, this is the amount that should be recorded in the balance sheet provided that minimum rental is reasonable. Subsequent economic activity through usage of the asset will generate revenues and costs. It is reasonable to assume that the contingent rentals triggered through such usage will be lower than the net profit generated by that economic activity – otherwise, it is unlikely that it would make economic sense to use the asset at the level that triggers the contingent rentals. Hence, AC regards these contingent rentals as similar to other costs incurred as part the economic activity and should be recognised if or when they arise.

AC notes that this approach could give rise to the potential for abuse. For example, AC does not consider it appropriate that a lease with all rentals contingent on performance should result in no liability being recorded. In AC’s view, ignoring performance related rentals is only appropriate if there is a reasonable minimum lease rental. Hence, AC believes that guidance is necessary on the appropriate treatment of contingent rentals under various contingency scenarios.

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.

To the extent that contingent rentals fall to be recognised under question 16 above, the majority AC view is that IASB's proposal of a probability weighted estimate is appropriate. Such an approach is consistent with how some other liabilities are accounted for. The minority had concerns about the difficulty in applying it and the reliability of such estimates, particularly in a start-up activity, and supported FASB's suggested approach.

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.

AC agrees that the obligation should be determined initially at the index or rate existing at the inception of the lease. Any subsequent changes in that index arise from events after the lease has been entered into and should be recorded if and when they arise. AC is unclear whether FASB is suggesting that the entire effect on the lease obligation of a change in the index should be recognised in the profit and loss account or just the effect on the current year's lease charge. For the avoidance of doubt, AC believes that any adjustment to the liability for future rentals should be reflected in the value of the right to use asset, with the effect on the current year's rental being recorded in the profit and loss account. Any resultant asset carrying value issues would then be reflected in an impairment assessment in the same way as other assets are assessed for impairment.

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.

AC believes that lease liabilities should be treated in the same way as other liabilities and hence considers that remeasurement of the lessee's rental obligations should be required.

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.

In AC's view, the initial recording of the lessee's lease obligation and right-of-use asset represent the best estimates of those amounts at the time. A subsequent change in the lease obligation amount results in an equivalent change in the value of the right-of-use asset. In the event that impairment issues arise as a result of such changes, they are dealt with through impairment assessments in the normal manner. As a result, AC supports IASB's view that changes in estimated contingent rental payments should be recognised as an adjustment to the carrying amount of the right-of-use asset.

AC does not agree that the alternative approach is easier for users to understand. For example, assume that a lessee rents premises where the contingent rental is based on the movement in a rental index for the area where the premises is located. An event occurs (such as a new public transportation system) whereby the demand for premises in that area increases significantly, leading to substantial rental increases. This will give rise to an increase in the lessee's rentals;

however AC has significant doubts that users would understand why this gives rise to a significant expense and no increase in the asset carrying value when it is clear to all concerned that the lessee's premises are in greater demand than previously.

Residual value guarantees

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?

AC agrees that residual value guarantees should not be separated from the lease contract and accounted for as derivatives. AC also agrees that the recognition and measurement requirements for both residual value guarantees and contingent rentals should be consistent.

CHAPTER EIGHT: PRESENTATION

Question 22: Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

AC does not consider that financial statements provide more useful information if lease obligations are shown separately in the statement of financial position as opposed to being disclosed in a note to the financial statements analysing liabilities.

Question 23: This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons. What additional disclosures (if any) do you think are necessary under each of the approaches?

As indicated in paragraph 8.11, a lessee will generally use similar owned and leased assets interchangeably. AC concurs that the right-of-use asset should be presented in the statement of financial position on the basis of the nature of the item. AC was unanimous that owned and leased assets should be separately disclosed but there were differing views on whether such disclosure should be on the face of the statement of financial position or in the notes to the financial statements. Some members argue that the obligation on a lessor to continue to make the asset available to the lessee over the lease term warrants separate disclosure of the right-of-use asset on the face of the statement of financial position. Others believe that the entity has a bundle of assets available for deployment in the business which, from an operating perspective, are similar in nature and used interchangeably and should be so reflected in the statement of financial position. In their view, any benefits from separate disclosure on the face of the statement of financial position are more than offset by the negatives associated with that statement becoming too long or unwieldy.

CHAPTER NINE: OTHER LESSEE ISSUES

Question 24: Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

AC believes that the standard needs to address maintenance accounting in respect of big ticket leases such as aircraft and ships. Unlike the operator of an owned asset, a lessee is likely to have a contractual obligation to carry out specified maintenance, often accompanied by an obligation to pay maintenance deposits to the lessor. The accounting for the obligation, the ultimate expenditure and any maintenance deposits should be specified. In addition, AC believes that the standard should address dilapidation provisions for buildings and accounting for sale and leaseback transactions.

CHAPTER TEN: LESSOR ACCOUNTING

Question 25: Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

AC agrees that the lessor's right to receive rentals constitutes an asset.

Question 26: This chapter describes two possible approaches to lessor accounting under a right-of-use model:

- (a) derecognition of the leased item by the lessor or***
- (b) recognition of a performance obligation by the lessor.***

Which of these two approaches do you support? Please explain your reasons.

There were differing views among committee members on whether a portion of the original asset should be derecognised. Some believe that the lessor has exchanged the right to use a portion of the asset for a receivable and accordingly part of the asset should be derecognised. In their view, recording a new lease receivable, without derecognising a portion of the original asset, results in a misleading total asset amount in the statement of financial position. Others believe that the lessor still controls the original asset in full and that, therefore, the original asset should not be derecognised and a separate lease receivable asset should be recorded together with the obligation to continue to make the asset available to the lessee over time. These members argue that while the lessor has incurred an obligation for the duration of the lease on delivery of the asset, the obligation is only discharged over the term of the lease. While these members are uncomfortable with the effect that this approach has on total assets, they believe that the alternative, which results in up front revenue recognition, is inappropriate.

Question 27: Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

AC believes that the issue of when a lessor should recognise income at the inception of the lease should be considered. The boards should also consider the issue of revenue recognition where a manufacturer leases the asset.

Question 28: Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

AC believes that accounting for investment properties should be included within the scope of a new standard on lessor accounting. AC has not formed a view on whether changes need to be made to investment property accounting, however, at a minimum, there is a need to reconcile the accounting approaches for leases and investment property.

Question 29: Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

AC suggests that the boards consider the accounting for initial direct costs incurred by a lessor in respect of a lease.