27 September 2013

Hans Hoogervorst
IFRS Foundation
30 Cannon Street,
London
EC4M 6XH

Dear Hans

IASB ED/2013/6: LEASES

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £4.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, IMA members manage holdings amounting to just over 30% of the domestic equity market.

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, they have an interest in the standards governing how such companies prepare their financial statements and the information disclosed to them as users.

We welcome the opportunity to respond to the ED and as commented in our response to ED/2010/9 Leases (the 2010 ED), we support the development of a new approach to lease accounting and in respect of operating leases, proposals to recognise the appropriate assets and liabilities on the balance sheet. These changes will help address users’ concerns with a number of the requirements in IAS 17 which impaired transparency and comparability in accounts and resulted in many users making their own adjustments to the reported amounts. We do not believe disclosure on its own would be sufficient these concerns.

Whilst we recognize that many of the issues with the 2010 ED have now been addressed, we still have reservations about certain of the proposals in this ED which we set out below. Our answers to the specific questions are in the attached annex.

- We agree that not all leases are the same and that there should be different recognition, measurement and presentation models for different leases. However, the proposals
introduce new “bright lines” and three categories of lease: Type A; Type B; and short-term leases. Whilst we understand the rationale differentiating Type A or Type B being whether there is insignificant consumption, the term “insignificant” is not defined and is vague. As such it could lead to restructuring opportunities particularly as with a Type A lease expenses are to be front loaded.

- Moreover, we question whether the type of the underlying asset and the presumption that all property leases are Type B leases will necessarily reflect the economic reality of the lease in question. For example, leases of land through which pipelines run or on which cell towers are located are likely to be treated as equipment and not property. We believe each of these should be assessed on its own merits and yet the proposals do not allow for this.

- In this context, the differentiation between finance and operating leases is well understood and our preference is that this is carried forward with Type A leases being finance leases, where all the risk and rewards are transferred, and Type B, operating leases. In particular, the IASB is looking at the definition of assets and liabilities as part of its conceptual framework project and could revisit lease accounting as the project progresses. The accounting treatment proposed should be retained meantime but we consider that better terminology should be used than Type A and Type B as these could cause confusion.

- Whilst we support some form of exemption for short-term leases, we do not support lessees and lessors being able to opt for the accounting treatment on a lease-basis by class of underlying assets. If the reporting entity opts for a particular treatment then the same treatment should be applied to all short-term leases and the policy should be clearly disclosed.

Please contact me if you would like clarification on any of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
Director, Corporate Governance and Reporting
IMA’s ANSWERS TO THE DETAILED QUESTIONS RAISED

IMA’s answers to the detailed questions raised are set out below.

1. Identifying a lease

This revised Exposure Draft defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration”. An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and
(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We consider it important to distinguish a leasing contract from a sale or a service contract. We note that the IASB seeks to address the potential confusion over such classification in BC 20 to 23 in that one of the distinguishing features of a service contract is that it does not typically require the delivery of an identified asset in that the supplier has a right of substitution. However, we consider that as proposed, there is a risk that substitution clauses could be introduced into contracts which, although unlikely to be ever exercised, would mean that what in substance is a leasing contract would be treated as a service contract and not be recognised on the balance sheet. We consider additional guidance is needed to address this.

2. Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We agree that the recognition, measurement and presentation of expenses and cash flows should be different for different leases. However, the proposals introduce new “bright lines” and three categories of leases: Type A; Type B; and short-term leases.

In distinguishing between Type A and B complexity is added by proposing that the lessee amortise the asset and recognise interest on the liability separately in the income statement for leases where “the lessee is expected to consume more than an insignificant portion of the economic benefits” (Type A lease) as opposed to recognising a single lease expense that comprises both amortisation and interest for those leases where the lease term is for an insignificant part of the total economic life (Type B lease).
IMA’s ANSWERS TO THE DETAILED QUESTIONS RAISED

The term “insignificant” is not defined and is vague. As such it could lead to restructuring opportunities particularly as with a Type A lease expenses are to be front loaded.

Finally, as noted in our response to the 2010 ED we support some form of exemption for the third model and the option for short-term leases to recognise lease payments on a straight-line basis in profit or loss over the lease term. However, we did not support both lessees and lessors being able to opt for the accounting treatment on a lease-by-lease basis in that this could impair comparability. We note that paragraph 120 of the ED seeks to address this by requiring that the policy election should be “by class of underlying asset to which the right of use relates”. Nevertheless, we are concerned that this could still afford the opportunity for leasing transactions to be structured to achieve this simplified accounting. If the reporting entity opts for a particular treatment then the same treatment should be applied to all short-term leases and the policy should be clearly disclosed.

3. Lessor accounting
Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We acknowledge that on commencement of the lease there are two assets to be recognised by lessors - the residual asset and the lease receivable. Income from the lease takes the form of interest for Type A and a lease payment for Type B. We accept that this pattern is not dissimilar to that of IAS 17 in relation to income allocation for finance and operating leases.

Albeit a complex calculation, we agree that profit should be recognised at the commencement of the lease when it relates to the portion of the asset that is the subject of the lease agreement. In addition, the residual asset should be measured initially on a cost basis and any profit associated with it should not be recognised until the residual asset is sold or re-leased at the end of the term.

4. Classification of leases
Do you agree that the principle on the lessee’s expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

In the proposals there is a presumption that going forward lease classification would depend on the nature of the underlying asset, for example, equipment or vehicles would usually be Type A leases and property Type B leases. We question whether the type of the underlying asset and the presumption that all property leases are Type B leases will necessarily reflect the economic reality of the lease in question. For example, leases of land through which pipelines run or on which cell towers are located are likely to be treated as equipment and not property. We believe each of these should be assessed on its own merits and yet the proposals do not allow for this.

In this context, the differentiation between finance and operating leases is well understood and our preference is that this is carried forward with Type A leases being finance leases, where all the risk and rewards are transferred, and Type B, operating leases. In particular,
IMA’s ANSWERS TO THE DETAILED QUESTIONS RAISED

the IASB is looking at the definition of assets and liabilities as part of its conceptual framework project and could revisit lease accounting as the project progresses. The accounting treatment proposed should be retained meantime but we consider that better terminology should be used than Type A and Type B as these could cause confusion.

5. Lease term
Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We agree with the proposals on lease term and would expect the lease term to include options to extend the period when the lessee has a significant economic incentive to exercise that option and to curtail the period when it is unlikely to be exercised for the same reason. We agree that reassessment of the lease term should be rare and only when the lessee’s likelihood of exercise or not in relation to the options changes.

6. Variable lease payments
Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

In principle, we support the measurement of variable lease payments including those that are in substance fixed and a reassessment if there is a change in an index or a rate used to determine them. However, we consider that more guidance is needed on what is meant by “in substance” fixed payments in that as it stands it is not clear.

7. Transition
Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

IMA’s preference is that there should be retrospective application for all new IFRSs. Users want to be able to compare previous and current year information based on the same accounting treatment. Nevertheless, as commented in our response to the 2010 Exposure Draft, we acknowledge that mandatory full retrospective application could be onerous for some entities and that it is, therefore, necessary to allow a simplified approach. In which case, on first applying the new standard the entity should disclose its approach on transition.

8. Disclosure
Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?
IMA’s ANSWERS TO THE DETAILED QUESTIONS RAISED

We agree with the disclosure proposals particularly paragraphs 59 and 99 which require the lessee and the lessor to consider the level of detail necessary to achieve the objective and how much emphasis to place on the each of the requirements. We note that the requirements are specific and this should go some way to avoid boiler-plate reporting.

Questions 9, 10, and 11 have not been answered as they are for FASB only

IAS 40 Investment Properties

12. Consequential amendments to IAS 40
The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

We agree with the proposed amendments to IAS 40 in this respect.