The Corporate Reporting Users' Forum

September 30, 2013

CRUF's comments on the Exposure Draft "Leases"

The CRUF welcomes the opportunity to respond to the IASB's Exposure Draft on leases. The CRUF recognises that accounting for leases has always been complicated by the fact that contracts like this are at the centre of the conflict between accounting for economic substance and legal form. We understand the inherent compromise that the standard has to take in order to balance this conflict and satisfy a number of stakeholders. Overall we are pleased that the IASB has sought to address the failings of current accounting and, in particular, welcome the move to ensure the majority of contractual lease obligations are recognised. We do not believe that improved disclosure alone would be adequate.

We welcome the revised Exposure Draft that, like the last Exposure Draft, proposes to bring lease liabilities onto the balance sheet in the case of most lease contracts, including operating leases, and thereby contributes to significantly improving financial statements' usefulness for their users in calculating financial ratios to analyze profitability, efficiency and financial soundness without adjusting balance sheets to include lease assets and liabilities. We also basically agree with the issues raised by the questions below and therefore want the proposals that are mostly the same in content as in the revised Exposure Draft to be adopted as accounting standards as soon as possible, albeit with some future modifications.

Question 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) fulfillment 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.

Yes, we 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.

The criteria for identifying a lease are now specified more clearly, with the two requirements of IFRIC 4 being maintained. When determining whether a contract contains a lease, the key is whether a service is separable. This point is conveniently illustrated with examples, helping to identify a lease.

According to the proposed requirements in paragraphs 6–19, a contract does not contain a lease but is regarded as a service arrangement (1) when it does not convey the right to use an identified asset, (2) when a supplier has the right to substitute an identified asset, or (3) when a customer does not have the ability to derive the benefits from use of an asset, that is, the customer can obtain the benefits from use of the asset only in conjunction with particular goods or services that are not provided by other suppliers. Checking these points helps to easily distinguish a lease from a service arrangement.

The Exposure Draft's proposed requirements encourage an entity to properly record lease liability. This also reduces the risk of overstating lease liability based on the view that even a contract which is bundled and inseparable with a service contains a lease.

That said, preparers of financial statements could face practical difficulties when determining whether a contract contains a lease. In order to dispel these concerns, it would be advisable to provide additional guidance or clarification of the principle.

An example of a fact pattern where we believe diversity of application might emerge is best seen for the marine transportation industry. Time charter contracts are commonly used in the shipping industry and we believe it may be difficult to determine whether the chartering of a ship, crew included, (1) is wholly composed of non-lease components, as the lessee does not have the ability to derive the benefits from use of the ship in the absence of crew, (2) is a lease in that the lessee has the ability to derive the benefits from use of the ship even in the absence of crew, and is wholly composed of lease components as a service component(crew) is inseparable, or (3) should be divided into service and non-service components that are separately identified, as the lessee has the ability to derive the benefits from use of the ship even in the absence of crew and a service component (crew) is separable. Users of financial statements in Japan are keenly interested in whether or not time charter contracts in the shipping industry contain a lease, and they fear that divided opinions could lead to substantial incomparability of financial statements given the likely financial statement impact.

(Note)
Under a time charter contract, a lessor（shipowner）mans a vessel she/he owns and leases it to a charterer for an agreed duration, and also puts a captain and crew under the charter's command. The charterer pays contracted charter rates to the shipowner responsible for managing the vessel, including the manning and repair of the vessel and the procurement of supplies. Charter rates are calculated on a hire basis.（Excerpt and translated from the website of the Japanese Shipowners' Association）

Question 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.

We support the revised Exposure Draft that, like the last Exposure Draft, proposes to bring operating leases, previously carried off balance sheet, onto the balance sheet. We think this revision brings big benefits to users of financial statements in that they can calculate financial ratios to analyze profitability, efficiency and financial soundness without adjusting their balance sheets to include lease assets and liabilities.

We like the accounting model that classifies a lease as either a Type A lease applied to most of equipment and vehicles, or a Type B lease applied to most of property and then applies two different approaches to accounting for a lease, as the model is not excessively complicated but highly understandable for users of financial statements.

We are comfortable with the idea of classifying a lease based on the extent that the lessee is expected to consume the economic benefits embedded in the underlying asset. The expression "determining on the basis of whether the lessee is expected to consume more than an insignificant portion of the economic benefits" seems abstract, but in practice, this essentially means determining whether the underlying asset is property or not, and thus is not so hard to understand.

This is also consistent with the accounting used when acquiring other nonfinancial assets through financing, thus making financial statements more useful.

Question 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 agree.

We support the proposal, as lessor accounting is easier to understand if consistent with lessee accounting.

As for Type A leases, gains/losses are recognized at the time of contract formation if there is a difference between the book value and market value of a leased asset. This transaction is accounted for in accordance with finance lease accounting, which has been long used in practice. However, the coverage of Type A leases may be wider than that of finance leases. Thus, when it is hard to gain market value data, we think it is worth considering a safe harbor rule under which book value is used as a proxy of market value.

Some people may think it is a bit cumbersome that lease receivables and residual assets are required to be classified and accounted for separately. We think, however, this provides useful information to understand changes of lease receivables and residual assets during the lease term.

Question 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?

We agree.

Property is a typical asset that meets the following two criteria: (a) the lease term is for an insignificant part of the total economic life of the underlying asset, and (b) the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date. We therefore see it reasonable to apply the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset, depending on whether the underlying asset is property, when classifying a lease.

As for classification of leases, no examples are provided for a lease classified as a Type B lease when the underlying asset is not property, and a lease classified as a Type A lease when the underlying asset is property. We are concerned that this could lead to practical confusion in these cases.

Question 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.

On the subject of determining the lease term, we appreciate improvements in terms of reduced costs and complexity shown in the revised Exposure Draft, compared to the 2010 Exposure

Draft.

When determining the lease term, an entity assesses whether the lessee has a significant economic incentive to exercise, or not to exercise, an option to extend the lease term. This helps avoid balance sheet manipulation aimed at shortening the contract term to unduly understate right-of-use assets and lease liabilities. At the same time, this helps avoid forcing to record right-of-use assets and lease liabilities on the balance sheet beyond the intended period of use only because the contract has an option to extend.

An entity shall consider contract-based, asset-based, entity-based and market-based factors together when assessing whether a lessee has a significant economic incentive either to exercise an option to extend a lease, or not to exercise an option to terminate a lease. This helps avoid assessing whether a lessee has a significant economic incentive simply on the basis of violating or bypassing formal criteria.

Question 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?

We agree.

(1)Recording the estimable portion of variable lease payments as liabilities, or (2) recording variable lease payments that are in-substance fixed payments as liabilities on the lessee's balance sheet is reasonable in that this helps to avoid overstating the non-estimable portion of variable lease payments and also to clarify the lessee’s future cost burden.

A change in an index or a rate used to determine lease payments necessarily leads to a change in lease payments. Thus, in depicting economic reality as faithfully as possible, we think it necessary to review estimates relating to variable lease payments in order for a lessee to reassess the measurement of the lease liability and for a lessor to reassess the measurement of the lease receivable.

As for variable lease payments linked to future performance or use, we are concerned that the carrying amount of the lease liability could be understated by using lower criteria for performance or use to reduce the fixed portion and increase the variable portion. Regarding variable lease payments linked to future performance or use that is almost certainly achievable, they should be understood as "variable lease payments that are in-substance fixed payments" shown in paragraph 39(c).

Question 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?

We agree.

We welcome efforts to secure comparability over time while considering whether these approaches are applicable in practice.

Although a full retrospective approach is desirable, it is not realistic to require all companies to adopt it. We think the realistic solution is that companies which can use a full retrospective approach should use it and that other companies are allowed to use a modified retrospective approach.

Question 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?

We agree

We would like to see a 'total lease expense' table that also specifies those leases that were not capitalised:

- the lease consumption expense from leases (i.e. relates to capitalised leases)
- interest expense from leases (i.e. relates to capitalised leases)
- variable lease expenses, insofar not included in the above (not capitalised)
- lease expenses relating to leases <1 year, insofar not included in the above (therefore not capitalised)
- any other lease expenses

The table should explicitly exclude those expenses that do not meet the overall definition of a lease, i.e. excluding services, take-or-pay contracts, tolling agreements.

We are highly encouraged by the disclosure requirements that cover almost all necessary disclosures.

Reconciliations shown in paragraphs 61 and 64 include items that are useful in understanding the change in the carrying amount of right-of-use assets. Information on the change in the carrying amount of right-of-use assets in the latest fiscal year can be useful in forecasting that in the future, and accordingly we think it is valuable for financial analysis. The information is also decision-useful, as it is disclosed by class of underlying asset separately for leases and right-of-use assets measured at revalued amounts.

We think it natural that (1) the restrictions or covenants imposed by leases and (2) a maturity analysis of the lease liability should be disclosed in comparison with the disclosure of other liabilities.

Lease assets and lease liabilities are determined on the basis of: (1) the basis, and terms and conditions, on which variable lease payments are determined, (2) information about options to extend or terminate the lease, (3) the existence, and terms and conditions, of residual value guarantees, (4) information about significant assumptions and judgments made in applying the draft Standard, etc. We therefore think these items are useful in forecasting the change in the carrying amount of lease assets and liabilities.

Question 12 (IASB-only): 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.

We support this in light of the consistency of the accounting treatment for investment property.

Other comments

Analysts will continue to make adjustments to the accounting numbers for businesses where leases are very material to ensure that the underlying economics are comparable between similar businesses, but the proposed disclosure will improve the ability for the analysts to make the necessary adjustments. We would still not support simply a better data package, whilst retaining current accounting, as for the majority of businesses we believe analysts will no longer need to make as many adjustments to leverage ratios as is currently needed today.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organisations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

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Appendix - an alternative view from one CRUF participant on questions 2 and 3

Question 2: lessee accounting

The notion of "significant consumption of economic resources" is likely to be a sticking point. We understand the boards' desire to enunciate a principle and leaving it open for interpretation and implementation. It may become difficult for users to understand the variability in preparers' decisions in implementing this rule, since we are concerned about the level of detail preparers will provide about their decision making. We feel that preparers are used to a bright line, and may need more guidance.

Question 3: lessor accounting

When the market value is hard to determine, we would prefer a fair value to be provided (using the fair value principles already established by the boards). Additionally, they should provide information on how the fair value is estimated and the difference between the fair value and book value