Financial Reporting Council

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Dear Hans

Results of leases outreach

At the December 2013 ASAF meeting we indicated that we would undertake further leases outreach with UK preparers to obtain their views on the costs and benefits of possible simplifications to the leases proposals. We sought input from UK preparers on a one-to-one basis and discussed the ideas for simplifications for lessees that the IASB discussed at its January 2014 meeting and other simplifications set out in ASAF Agenda Paper 4A. We focussed on possible simplifications that will reduce the burden on preparers in order to achieve an acceptable cost-benefit balance. This letter provides a summary of this input and our conclusions. Appendix A lists the organisations we met.

We received largely consistent feedback with most participants supporting significant simplifications to the proposals. The main points that arose were:

- **Lessee accounting model**—general support for a single approach where a lessee accounts for all leases as Type A. A minority support a dual approach with the distinction between leases being based upon the distinction between a finance lease and operating lease in IAS 17.
- **Distinction between a lease and a service**—most participants consider that this distinction needs to be clarified. In particular, that more arrangements should be considered to be services and therefore outwith the scope of the proposals. In addition, arrangements that include a significant service component should be accounted for as a service contract and the lease component should not be accounted for separately.
- **Other suggested simplifications—**most participants consider that some of the suggested simplifications would help, with the type of simplification dependent on the specific circumstances of the entity, but these would only make a small difference to the costs of applying the proposals.
- **Cost of implementing the proposals**—a majority of participants consider that the implementation of the leases proposals will be a very significant and costly undertaking for preparers. Consequently, they are unsure whether the benefits of the leases proposals in their current form outweigh the costs.

Appendix B expands on these points.

We hope that our findings are useful in the IASB's and the FASB's redeliberations on the leases Exposure Draft. I should, of course, be very happy to expand on these or any other matters relating to the leases proposals with you.

Yours sincerely

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Appendix A: Organisations

The 100 Group

BP plc

BT Group plc

easyJet plc

Finance and Leasing Association

Flybe Group plc

Rolls-Royce plc

Vodafone Group plc

Appendix B: Detailed feedback

Lessee accounting model

At their January 2014 meeting the IASB and the FASB discussed three possible approaches to the lessee accounting model:

- *Approach 1 proposes a single approach where a lessee accounts for all leases as Type A and recognises amortisation of the right of use asset separately from interest on the liability.*
- *Approach 2 retains a dual approach similar to that in the 2013 ED, but with simplifications and improvements to the lease classification test. This would mean that most property leases would be Type B and all other leases would be Type A.*
- *Approach 3 is another dual approach, with the lease classification principle based on the current IFRS or US GAAP guidance. This would mean that most finance leases would be Type A and operating leases would be Type B.*

1. The lessee accounting model was an area of concern. A majority of participants preferred a single model where all leases are accounted for as type A leases (Approach 1). The reasons given included that a single approach to lessee accounting is the most conceptually pure model, it is simpler to apply and having a distinction between type A and type B leases is not worth the additional complexity.
2. A minority of participants supported Approach 3 whereby the distinction would be based on the current finance and operating lease distinction in IAS 17.
3. If the IASB decides there must be a distinction, then participants who supported a single model had differing views as to which approach would be the least burdensome. One participant considers that Approach 2 would be the clearest distinction whilst another participant prefers Approach 3 because the distinction in IAS 17 is well understood and easier to apply.
4. However, the greatest concern raised was the distinction between a lease and a service. A majority of participants considered that the proposals were not clear on how to determine whether or not a contract is a lease or a service.
5. These participants also considered that if a contract included a significant service component, then the contract should be accounted for as a service contract and the lease component should not be accounted for separately. This would simplify the proposals and effectively reduce the number of contracts to which the leases proposals would apply.
6. We believe that further consideration could be given to explicitly scoping out contracts whereby services are a significant and integral or essential part of the contract. We acknowledge that this idea would need development in order to prevent abuse.

Small-ticket leases

ASAF agenda paper 4A discusses possible simplifications for small-ticket leases:

a. *Simplification 1: to extend the recognition and measurement exemption for short-term leases either by:*
   i. *increasing the short-term threshold beyond 12 months; or*
   ii. *changing the definition of a short-term lease to be consistent with the proposed definition of lease term.*

b. *Simplification 2: to clarify that lessees can apply the guidance at a portfolio level.*

c. *Simplification 3: to introduce a scope exclusion for small-ticket leases, i.e. leases of assets that are neither 'core' to a lessees operations nor individually significant*.

Small-ticket leases are described as leases of assets that have both of the following characteristics:

a. *The value of the asset is individually small.*

b. *The asset is a non-specialised asset that would be used, without modification, by entities across industry sectors.*

Examples include leases of some classes of IT and office equipment, such as laptops, desktops, water dispensers, mobile phones, office furniture. Small-ticket leases would not include leases of cars, trucks, real estate.

7. Some participants consider that changing the definition of a short-term lease to be consistent with the proposed definition of lease term would be a logical amendment. One participant does not consider that this exemption will provide much relief and notes that effort will still be required to identify the contract as a lease and determine whether or not it meets the short-term lease exemption.
8. One participant considers that explicitly permitting a portfolio approach would be helpful, but that approach needs to be simple. Conversely, another participant considers it will be difficult to apply a portfolio approach because the entity applies IFRS in its subsidiaries. They consider that it is unlikely for individual subsidiaries to have a sufficient number of homogenous leases to make applying a portfolio approach worthwhile.
9. Participants held differing views as to whether or not a scope exemption for small-ticket leases would be the most effective way to reduce the costs of applying the proposals. One participant considers that a distinction between core and non-core assets would be helpful. But another participant does not consider this distinction could be operationalised. And another participant does not consider that any scope exclusion for small-ticket leases could be operationalised.
10. Another participant considers that any scope exemption for small-ticket leases would need to be clear that it does not reduce the level of materiality an entity applies.
11. Another participant considers that the pressure for a small-ticket leases exemption arises because of the requirement to discount the lease liability for type B leases. They consider that type B leases should not be discounted and then this exemption would not be necessary.
12. One participant does not consider that a scope exclusion for small-ticket leases is necessary.

Lease term

ASAF agenda paper 4A discusses possible simplifications to the lease term:

a. *to remove the reassessment requirements (i.e. reassess only when a renewal or termination option is exercised or not exercised); or*

b. *to require reassessment only upon the occurrence of one or more "triggering events" that would indicate a significant change in relevant factors relating to the exercise of renewal or termination options.*

13. Most participants support a reduction in the requirements to reassess the lease liability. Some participants hold the view that whenever an entity reports, including

quarterly or interim reporting, reassessments will be required and this task would be onerous. To address this, one participant considers that the standard should be explicit that the reassessment requirements are considered only at each financial year-end. They noted that paragraph 51 of IAS 16 limits the reassessment of the residual value and the useful life of an asset to the financial year-end.

Variable lease payments

ASAF agenda paper 4A discusses possible simplifications relating to the subsequent measurement of variable lease payments that depend on an index or a rate:

a. to remove the reassessment requirements; or

b. to require reassessment only when there is evidence that remeasuring the liability would lead to a significant change in that measurement.

14. Most participants have lease arrangements with variable payments based on LIBOR. They consider that it would reduce the burden of applying the leases proposals if the reassessment requirements were removed.

Lessee's incremental borrowing rate

ASAF agenda paper 4A discusses a possible simplification to the calculation of the lessee's incremental borrowing rate is to include practical expedients, for example, by permitting the use of a lessee's secured borrowing rate or an estimate of that rate or permitting the use of a credit-adjusted risk free rate.

15. One participant commented that its incremental borrowing rate for the group is different than for individual subsidiaries within the group. They consider that being able to use the group rate in the individual subsidiaries' financial statements would lessen the burden of having to calculate an incremental borrowing rate for each subsidiary that has leases.

Separation of lease and non-lease components

ASAF agenda paper 4A discusses two possible simplifications relating to the separation of lease and non-lease components:

a. Simplification 1: to permit, by class of underlying asset, a lessee to account for lease and non-lease components together as a single lease component rather than separating the components.

b. Simplification 2: to permit a lessee to estimate the payments relating to lease and non-lease components in the absence of observable stand-alone prices, similar to the requirements in IFRIC 4.

16. One participant considers that permitting a lessee to estimate the payments relating to lease and non-lease components in the absence of observable stand-alone prices, similar to the requirements in IFRIC 4, would be helpful. They would like to be able to use industry benchmarks to determine the lease and non-lease components of an arrangement.

17. We note that if contracts with significant service components were outwith the scope, this would reduce the burden of separating lease and non-lease components.

Cost of implementing the proposals

18. Most participants consider that they will incur significant costs to implement the leases proposals. For example, one participant considers that the implementation of the leases proposals will be the biggest change to their accounting system since the first-time adoption of IFRS. Most of these participants are unsure whether the leases proposals in their current form will result in a sufficient enhancement of the usefulness of financial information for the users of the financial statements to justify the costs of implementing the proposals as well as the ongoing costs. Consequently, these participants welcome simplifications that reduce costs.