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International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom
Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON *DISCUSSION PAPER ON LEASES – PRELIMINARY VIEWS*

In response to your request for comments on the IASB's discussion paper on *Leases – Preliminary Views,* attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

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SAICA SUBMISSION ON *DISCUSSION PAPER ON LEASES – PRELIMINARY VIEWS*

GENERAL COMMENTS

We welcome the Boards' discussion paper on their preliminary views on a proposed new standard for leases. Whilst we acknowledge the impact that the proposals are likely to have on the leases that are currently classified as operating leases, we are of the view that the proposals lay a critical foundation for a future lease standard and such an approach is likely to curb any possible structuring opportunities between finance and operating leases.

A concern we have is that the proposed lease approach is based on the current definitions of assets and liabilities and these are likely to be revised in the conceptual framework project and might result in consequential amendments to the proposed new lease standard.

A second concern we have is that whilst we acknowledge that the discussion paper has provided reasons for excluding lessor accounting in this project, we are of the view that the proposed lease standard should be addressing lessor accounting, in order to have a complete picture of lease accounting. This is because there is an expectation that lessor and lessee accounting should have common principles and thus lessor accounting could have an impact on lessee accounting.

We are also concerned with the number of IASB projects that could be impacted by the conceptual framework project. These include financial statement presentation, revenue recognition and leasing, which are being considered before the conceptual framework project is complete. The concern is that accounting standards dealing with these areas could be produced that may not be fully compliant with the conceptual framework when finalised, and which may need to be reconsidered. A particular example that could have a significant affect on accounting for leases is whether the lease obligation meets the definition of a liability. This is because the liability could include cancellable amounts that are neither contractual obligations nor constructive obligations.

For these reasons we believe caution needs to be exercised in determining the extent of change required to accounting standards and the timing of those changes.

It also needs to be appreciated that the proposals could have a major impact on many entities. This impact could be on the statement of financial position as well as the time and effort needed to prepare financial statements. This is due to the possible need to change accounting systems to obtain information necessary to apply the proposals, the need to use judgmental estimates that are not presently required and the need to reassess previously recorded amounts. Accordingly, care needs to taken in requiring entities to deal with these issues, which could have a significant impact on entities, if some of the principles could be changed not long after the proposed standard is issued.

We believe the approach to leases should have a consistent approach for options and contingent rentals. While the boards agreed on a most likely lease term in the case of a lease with an option to extend, the boards tentatively supported different approaches for contingent rentals. The FASB favoured using the most likely amount, but the IASB supported the use of the probability-weighted estimate. We support the use of the most likely amount in both cases as we believe it is difficult to justify the use of different approaches for areas that are considered similar.

As many lease arrangements can have a long term effect on entities, we believe the focus should be on a long term solution rather than a short term solution that could be impacted by other projects of the boards. If the boards were wanting to have a quick solution to some of the perceived problems with the accounting for leases they could, for example, have required all operating leases to be accounted for as finance leases in terms of the existing IAS 17 - *Leases.*

SPECIFIC COMMENTS

Chapter 2: 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.

Whilst the proposed approach to base the scope of the proposed new lease standard on the scope of the existing standards is supported, we are of the view that the proposed scope should be as broad as possible. For example, the discussion paper acknowledges that the scope of IAS 17 is wider than that of SFAS 13 and, while these differences need to be reconciled, we do not believe that the scope of IAS 17 should be made narrower than it presently is. In addition, the boards should reconsider whether other agreements such as executory contracts and service agreements should be included in the proposed scope as a result of any changes to definitions. This would necessitate a review of the scope exemptions contained in the current lease standards. In incorporating IFRIC 4 – *Determining whether an Arrangement contains a Lease,* we suggest that the criteria to identify what a lease is should be clearly spelt out in the scope paragraph. Furthermore, we also recommend that the proposed scope should be extended to include lessor accounting. The reason for this is that some leases can have a long lease term and so it would be undesirable if the far reaching proposals in the discussion paper were to be implemented, followed shortly by further major changes as a result of lessor accounting, subsequently resulting in lessee accounting being reconsidered.

Accordingly, if the proposed approach is seen as a long term solution to lease accounting, then the boards should undertake a full reconsideration of what constitutes a lease.

In addition we suggest that a right-of-use asset should be defined. For example, this could comprise the contractual right to use property, plant and equipment, investment properties and intangibles. Such a definition could assist in ensuring that transactions of similar economic substance are not accounted for differently.

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.

No, the proposed new standard should not exclude non-core or short-term leases. We believe that the fundamental principle of the 'right of use' should be applied equally and consistently for all types of leases. If this is not done, we are of the view that this could potentially lead to structuring opportunities.

Chapter 3: 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.

Yes, we agree in principle with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract. This analysis is appropriate for a single element contract. However, we believe that entities might encounter practical difficulties in applying the proposed measurement requirements to many typical types of lease arrangements. These have been highlighted in our responses to the measurement questions below.

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.

Yes, we agree in principle with the proposed approach. We believe that this approach to recognising an asset and a corresponding liability is a fundamental foundation to the recognition requirements under the new lease standard. This proposed approach is likely to scope in all the leases currently accounted for under the existing leases standards.

Our understanding of the term 'liability' in this discussion paper appears to imply that the liability for the obligation to pay rentals is far broader than the definition of liability as contained in IAS 37 – *Provisions, Contingent Liabilities, and Contingent Assets* and IAS 39 – *Financial Instruments: Recognition and Measurement*. This is because lease payments during possible extensions of leases are probably not a contractual obligation nor a constructive obligation until it is decided to renew a lease. However, we are of the view that this has not been clearly articulated in the discussion paper. We propose that this be clearly articulated in the exposure draft. We also believe that the proposed approach will bring about practical issues where additional elements such as renewal options are introduced in a simple lease arrangement.

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?

Most commentators supported the proposed approach as they believe that it is simpler to apply than a components approach, particularly when other lease components, such as renewal options, are directly linked to the lease. Whilst they acknowledge that the proposed lease model will introduce some practical measurement difficulties, they are of the view that this approach would eliminate, to some extent, the complexities that could arise under the components approach, such as measuring components for which there is no ready market and other components that are dependent on each other.

Chapter 4: 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.

We 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. This proposed method of calculating the present value is not seen to differ significantly from the current accounting, where the incremental rate is the default rate in the case where the implicit rate cannot be determined by the lessee in a finance lease. We also believe that this will be simpler to apply as in many cases it is difficult to determine the interest rate implicit in the lease, particularly in the case of existing operating leases.

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 right-of-use asset at cost. We are of the view that this proposed approach is consistent with the initial measurement requirements of other standards and is a more practical approach as it avoids day one gains and losses.

With the cost of the asset being equal to the initial lease obligation, it is important to ensure that the liability only comprises payments for the right-of-use. This is another reason why we believe it would be beneficial to define a right-of-use asset. As paragraph 9.25 acknowledges, it may not always be easy to separate payments for services from other lease payments.

Chapter 5: 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.

We support an amortised cost-based approach to subsequent measurement as the impact on profit or loss is the same as if the entity had purchased the asset.

However, as noted below in our other comments on the discussion paper, we question whether the revaluation model should not be allowed to be applied to the right-of-use asset.

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.

A new lease accounting standard should not permit a lessee to elect to measure its obligation to pay rentals at fair value, because this is not likely to provide useful information to users regarding future cash flows. This is because this liability is similar to a fixed rate borrowing and so would not be expected to be held for trading and the liability would be settled by payment rather than being sold.

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.

No, the lessee should not be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate. We are of the view that if the borrowing rate is treated as a fixed rate, then a change in this rate subsequently would not result in a change in the liability, which is also in line with the amortised cost principles in IAS 39.

If the boards were to decide to adjust for changes in incremental borrowing rates, we believe the most correct approach would be to make revisions when there is a change in estimated cash flows. However, we believe that this could result in the accounting becoming onerous, particularly where there are numerous leases. Accordingly we believe a more practical approach would be to make the revisions at each reporting date.

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 the proposed approach, even though the liability recognised in respect of the obligation to pay rentals seems to be broader than the definition of financial liabilities. In addition, the measurement requirements for a lease liability differ from those of financial liabilities and this obligation is treated as a fixed interest rate borrowing, which we consider as appropriate.

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 as we believe that the accounting descriptions for all leases should be consistently applied.

Chapter 6: Leases with options

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 support the proposed approach on the basis that it is consistent with the assessment that lessees are likely to make at inception and is in line with the embedded derivatives approach.

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.

Yes, we support the proposed approach to require reassessment of the lease term at each reporting date as this is necessary if you recognise the lease based on the most likely term as per question 13 and this will be more useful to users. The reassessment exercise is more relevant where, for example, an obligation to pay rentals has been raised in respect of renewal options, and the facts and circumstances that existed at initial recognition date might have significantly changed to those that exist at a specific reporting date.

It needs to be appreciated that this approach could however result in entities having to spend a significant amount of time and effort in applying this approach, particularly where they have a large number of leases.

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 support the boards' tentative decision that purchase options be accounted for in the same way as options to extend or terminate the lease. We believe that if a distinction is made between purchase options and options to extend or terminate the lease, which are in substance similar, this could potentially create structuring opportunities.

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?

We agree in principle with the boards' proposal that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. We, however, envisage that the proposed accounting will cause practical difficulties for preparers which would necessitate educating the users in order to explain the impact of contingent rentals on a year on year basis.

Again, as noted above, it needs to be appreciated that this approach could however result in entities having to spend a significant amount of time and effort in applying this approach, particularly as the amounts involved are likely to require a significant amount of judgement. The extent of efforts needed to determine the appropriate amount would be compounded further where entities have a large number of leases.

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.

Whilst we take cognisance of the fact that the probability-weighted estimate method takes into account the uncertainties, which is consistent with IAS 37 and IFRS 3 (revised in 2008) – *Business Combinations,* measurement requirements, we are of the view that determining the most likely amount is less complex because management will probably find it easier to use the necessary information to determine the most likely outcome than to estimate probabilities for possible outcomes. In addition, this will be aligned with the method for establishing the lease term, which includes renewal options.

We also believe the approach to leases should have a consistent approach for options and contingent rentals. While the boards agreed on a most likely lease term in the case of a lease with an option to extend, the boards tentatively supported different approaches for contingent rentals as noted above. We support the use of the most likely amount in both cases as we believe it is difficult to justify the use of different approaches for areas that are considered similar.

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 support the proposed approach as this is not consistent with the determination of the expected future cash flows approach and it also does not reflect what is expected to occur. This approach, in our view, would result in a rule based approach and not a principle based approach.

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.

Yes, we support the proposed approach. Contingent rentals are based on assumptions which might change significantly at each reporting date and would necessitate a remeasurement of the lessee's obligation to pay rentals.

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.

Most commentators supported recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments in profit or loss. This approach is consistent with the IAS 37, IFRS 3 and IAS 21 recognition requirements, which require that changes in estimates be accounted for in profit or loss in the period in which they occur. It is noted that this approach is not consistent with the approach adopted in IFRIC 1 – *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, but it is believed that after initial recognition the asset and liability should no longer be linked and therefore subsequent adjustments to the liability should not be linked to the asset that gave rise to the liability.

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?

We agree with the proposed approach.

Chapter 8: 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?

Our preferred approach is not to require the lessee's obligation to be presented separately in the statement of financial position. We believe that presenting this obligation as part of other financial liabilities (based on nature), with the necessary disclosures being made in the notes to the financial statements, would suffice.

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?

We support the view that the right-of-use asset should be presented by nature of the underlying asset in the statement of financial position for the same reasons as listed in the advantages 8.11 in the discussion paper.

Chapter 9: 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.

Yes, we believe that the following issue should be addressed:

- SIC 15 – *Operating leases: Incentives.* We believe that these impact the total lease rental payments and so should be included in the scope of the proposed standard.

Chapter 10: 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.

Yes, in our view the lessor's right to receive rentals under the lease meets the definition of an asset. At the same time as the lessee's obligation to pay rentals is regarded as an obligation, it is believed that this creates an asset for the lessor. It is also believed that the definition of an asset in terms of the framework is met.

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.

We support the approach of derecognition of the asset as the right to income streams from the asset has been transferred to the lessee. As a result of entering into a lease agreement, the lessor has given up a right it has to use the asset and in exchange has required a right to receive cash or other assets and the accounting should reflect this.

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.

Yes. We believe that the IASB's discussion paper on revenue recognition could have an impact on lessor accounting and therefore when and how to recognise income could be impacted by this project.

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

Yes. We believe that investment properties should be included within the scope of any proposed new standard on lessor accounting as there does not appear to be any conceptual reason to distinguish between the types of asset being leased.

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

In lessor accounting it might not be clear whether an asset is sold or leased. For example, a property company might have given various parties the right to use the property for the remaining useful life of the property in return for an upfront payment. It could be argued that there is no residual value in the property and that therefore the proceeds are for the sale of the property; alternatively that ownership does not transfer and therefore no sale has occurred. This decision could impact on the accounting for the property company. If the various parties contribute to the running costs of the property, and if the property is regarded as being sold, then it is argued that the property company is operating as an agent for the owners and the only revenue would be the fee earned for providing a property management service. Alternatively, if the property is regarded as being leased, then the revenue would be amounts charged to the various parties for operating expenses. Accordingly guidance could be provided on determining the differences between an asset being sold and a leased asset.

OTHER COMMENTS

Revaluation of right-of-use assets

We question whether the revaluation model of the underlying asset should not be allowed to be applied to the right-of-use asset, particularly where the lease arrangement includes the purchase option that gives the lessee the right to use the asset for the whole of the economic useful life of the underlying asset.

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