

September 23, 2013

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

Re: Comments on IASB's Exposure Draft on Leases

I am pleased to provide comments on the International Accounting Standards Board (IASB)'s May 2013 Exposure Draft *Leases* (ED). These comments have been developed by the International Auditing and Assurance Standards Board (IAASB)'s IASB Liaison Working Group (the Working Group), with a particular focus on auditability or verifiability, and reviewed by the IAASB Steering Committee.

The Working Group suggests that the IASB consider whether the proposed standard and its application would be improved if:

- (a) The proposed standard were to provide more explanations about key concepts and related terms underlying significant judgments, and include a requirement to document such judgements;
- (b) Educational initiatives were to be undertaken to assist preparers and auditors in appropriately applying concepts particular to this standard; and
- (c) More in-depth guidance was to be provided for application of the concept of materiality to the IFRSs, including the proposed standard.

These matters are discussed briefly below. Further detailed comments on various matters are provided in the Appendix of this letter.

Explanations of Key Concepts Underlying Significant Judgments, and a Requirement to Document Such Judgements

The proposed standard would require management and auditors to exercise many significant and quite difficult judgments using key concepts and related terms particular to this standard. The Working Group understands the principles-based nature of IFRSs, but in its view, this proposed standard should provide more explanations of these concepts to help preparers and auditors consistently make sound professional judgments. The concepts and related terms include, for example, "substantive change" when considering contract modifications, "insignificant part" and "major part" used for classification of leases (as discussed further in the Appendix).

The Working Group has, in the past, emphasized the importance from an auditability perspective of management's documentation of important judgements in preparing the financial statements. Given the many significant judgments that would be required under this proposed standard, it is particularly important for the IASB to consider providing an explicit requirement for management to document its judgment process, including the rationale for important judgments made.

Need for Educational Initiatives

The Working Group also believes that significant educational initiatives would be needed to enable preparers and auditors to properly understand and implement the requirements of this proposed standard. This is because the proposed standard is quite complex and would apply to many transactions of different entities. The Basis for Conclusions of the ED explains why the IASB concluded to require particular approaches, but preparers and auditors may not fully understand what is intended. Therefore, educational initiatives would be paramount to ensure consistent application of the proposed standard.

Need for More In-depth Guidance on Applying the Concept of Materiality

This proposed standard presents a number of significant issues that are affected by how the concept of materiality is applied. For example, because of the complexity and wide scope of application of this proposed standard, many entities would likely first consider whether the right-of-use assets of their lease contracts are deemed immaterial to justify the use of simplified accounting treatments. Therefore, additional discussion about materiality would be valuable from a practical perspective.

At the same time, the Working Group recognizes that it may not be feasible for the IASB to provide additional guidance on applying the concept of materiality in this particular standard, without first more broadly considering materiality issues. The concept of “materiality” is not unique to the ED; IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* already provide a general explanation about the concept of materiality. It is our understanding that while no significant changes are envisioned to Conceptual Framework, IAS 1 or IAS 8 regarding materiality, the IASB plans to develop educational material relating to materiality in parallel with its initiative to update its Conceptual Framework.

In the context of developing the educational material, a matter that might be worth exploring is the concept of “clearly trivial”, which is not currently discussed in IASB’s Conceptual Framework, IAS 1 or IAS 8. The International Standards on Auditing¹ (ISAs) require the auditor to accumulate misstatements identified during the audit, other than those that are “clearly trivial”. “Clearly trivial” is explained as not being another expression for “not material.” Matters that are clearly trivial are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances.

In addition, one useful change that could be made to the proposed standard is to incorporate, with appropriate changes, the material currently located in paragraph BC 405. This would result in giving the concept of materiality a higher profile and thereby help ensure consistent understanding by auditors and preparers.

BC405. In addition, the IASB expects lessees to apply a similar materiality threshold to leases as it does to items of property, plant and equipment. This would result in a lessee not applying the proposals to leases considered to be immaterial on a basis similar to that applied to items of property, plant and equipment, whereby an entity does not capitalise the costs of purchasing items of property, plant and equipment when that cost is less than a particular amount.

¹ Paragraphs 5 and A2 of ISA 450, *Evaluation of Misstatements Identified During the Audit*

I hope that you will find the comments helpful. If you require any clarification or would like to discuss this letter further, please do not hesitate to contact me or Mr. Tomokazu Sekiguchi, the Chair of the Working Group (t.sekiguchi@asb.or.jp).

Yours sincerely,

Prof. Arnold Schilder

A handwritten signature in blue ink, appearing to read "Arnold Schilder".

Chairman, IAASB

Cc. Mr. Prabhakar Kalavacherla, Member and Liaison Representative, IASB

IASB EXPOSURE DRAFT - LEASES

Comments of the IAASB's Working Group

I. COMMENTS ON SPECIFIC QUESTIONS IN THE ED

QUESTION 2 and 3: LESSEE AND LESSOR ACCOUNTING MODEL

Issues Description

Paragraph 28 of the ED proposes to require an entity to classify a lease as either a Type A lease or Type B lease at the commencement date. In relation to the classification, paragraphs 29 and 30 of the ED set out the following requirements:

29.If the underlying asset is not property, an entity shall classify a lease as a Type A lease unless one of the following two criteria is met:

- (a) the lease term is for an *insignificant part* of the total economic life of the underlying asset; or
- (b) the present value of the lease payments is *insignificant* relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease.

30.If the underlying asset is property, an entity shall classify a lease as a Type B lease unless one of the following two criteria is met:

- (a) the lease term is for the *major part* of the remaining economic life of the underlying asset; or
- (b) the present value of the lease payments accounts for *substantially all* of the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type A lease. [Emphasis added in the paragraphs.]

Depending on whether the lease is classified as Type A or Type B, the resulting accounting requirements would differ significantly. Taking into account the significant implications of the requirements, the Working Group believes that key terms (such as “insignificant part” and “major part”) should be explained more thoroughly to help to improve the consistency of these significant judgments by preparers and auditors.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group recommends that the IASB provide more explanation of key terms (such as “insignificant part” and “major part”) either in the requirements or application guidance.

QUESTION 5: LEASE TERM

Issues Description

Paragraph 25 of the ED requires an entity to consider whether an option to extend or terminate the lease has a *significant economic incentive* for an entity to exercise [emphasis added]. Paragraph 26 of the ED requires an entity to consider contract-based, asset-based, entity-based and market-based factors when assessing whether a lessee has a significant economic incentive. Although paragraph B5 in part explains the concept of “significant economic incentive”, the Working Group believes that significant judgment will still be required to determine whether options embedded in the lease contract are considered to provide a significant economic incentive because various options are embedded in many lease contracts. The

Working Group has the view that incorporating the related explanation provided in the Basis for Conclusions of the ED would be helpful.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group recommends that the IASB consider incorporating the following explanation provided in the Basis for Conclusions of the ED into authoritative guidance.

BC140 [...]The boards note that applying the concept of “significant economic incentive” would provide a threshold that is similar to the concepts of “reasonably assured” and “reasonably certain” in existing US GAAP and IFRS, which the boards understand work well in practice.

II. OTHER COMMENTS

ALLOCATION OF CONSIDERATION IN A LEASE CONTRACT

Issues Description

Paragraph 23 of the ED requires lessees to allocate the consideration in a lease contract if there are observable stand-alone prices for one or more of the components of the contract. Different from financial instruments, leased items do not usually have established markets from which objective prices are obtainable. Without additional guidance, therefore, the Working Group feels that such a requirement may be onerous to implement, because it may effectively imply that management and auditors need to search for observable prices of components of lease contracts, which would be impracticable and unproductive.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group recommends that the IASB consider providing additional guidance about what efforts would be expected for preparers in meeting the requirement.