



European Federation of Accountants and Auditors for SMEs

European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
B-1000 BRUSSELS
Attn. Filippo Poli
Brussels, 26 November 2010

Dear Mr Poli

Reaction to EFRAG's draft comment letter on the IASB's Exposure Draft - Leases

The European Federation of Accountants and Auditors for SMEs ("EFAA") represents accountants and auditors providing professional services primarily to small and medium-sized entities ("SMEs") both within the European Union and Europe as a whole. Constituents are mainly small practitioners ("SMPs"), including a significant number of sole practitioners. EFAA's members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, and tax and business advice) to SMEs.

EFAA appreciates the opportunity to comment on the Exposure Draft - Leases. Our comments are made in relation to the areas outlined below.

General comments

The issue of lease accounting has been much debated with many commentators believing that it has resulted in significant accounting misuse. The IASB's exposure draft ("ED") seeks to address this alleged misuse and we fully support the focus of this ED.

We firmly believe that whilst the current lease accounting principles deserve review, the ED serves to make lease accounting much more complex. Our support is therefore in principle for the changes to be made to IFRS for listed companies where accounting misuse under the existing standard may well be more prevalent and the effect of such misuse may be more significant.

We do not believe that the changes required under the ED should be incorporated into IFRS for SMEs whose remit is to simplify accounting for SMEs and to disclose information in SME financial statements that better reflects the users' needs in respect to those financial statements. This ED does not do that. The accounting principles for leases under IFRS for SMEs focus on the economic owner and we believe that this is sufficient. We therefore urge the IASB not to transpose the proposed changes in the ED into IFRS for SMEs.



European Federation of Accountants and Auditors for SMEs

Why not in IFRS for SMEs?

Whilst lease accounting is clearly important in the SME sector with many SMEs involved as both lessee and lessor we feel that the adoption of the accounting practise in the ED would not improve the information presented in SME financial statements. A summary of our observations is given below:

- **Cost v Benefit.** More information is required to be collated by the preparer of the financial statements but who actually benefits from this? As the IASB has stated "because full IFRSs were designed to meet the needs of equity investors in companies in public capital markets, they cover a wide range of issues, contain a sizeable amount of implementation guidance and include disclosures appropriate for public companies. Users of the financial statements of SMEs do not have those needs, but, rather are more focused on assessing shorter-term cash flows, liquidity and solvency. Also, many SMEs say that full IFRSs impose a burden on them — a burden that has been growing as IFRSs have become more detailed and more countries have begun to use them. Thus, in developing the proposed IFRS for SMEs, IASB's twin goals were to meet user needs while balancing costs and benefits from a preparer perspective."
- It is our contention that the quality of information provided in the financial statements in respect of operating leases is the fundamental issue. Many users of financial statements use the information disclosed in respect of operating leases to project future cash flows. They are less concerned with whose balance sheet the asset and liability sits on as long as they can estimate the cash flow impact on the business that they are currently assessing. This is particularly relevant to SMEs. Accounting for the lease of the office photocopier under the ED adds little to the veracity of the SME accounts.
- The definition of assets and liabilities within the ED is at odds with the general definition of assets and liabilities in IFRS. Why should rent be recognised as an asset? Moreover, misuse is always possible by the rebuttable presumption that the relative contract is a finance lease, unless clearly demonstrated otherwise.
- There are clear issues over asset valuation once the lease has been accounted for. What does this actually mean for readers of financial statements? We believe that this would add little to the readers of accounts.
- The ED accounting principle artificially alters asset ratios whilst leaving the net worth position unchanged. Would this be an improvement when the actual position is unchanged?

Other comments

We make the following comments on the ED in an attempt to suggest improvements to the ED and to support the objective of improving the current lease standard.

1. Exclusion from the exposure draft of intangible and biological assets

It is the IASB's contention that the above assets should be dealt with as a separate project. In our opinion such exclusion is unwise. We believe that the current distinction between both tangible and intangible assets and the distinction between intangible and biological assets is unclear.

The subjectivity of whether an asset is tangible or intangible in nature is well known and accepted. For example, software in one country is considered tangible, in another country it is considered intangible



European Federation of Accountants and Auditors for SMEs

and in a further the distinction has to be made on the type of software in question. Generally, almost all fixed assets have a tangible and an intangible component and under the proposed standard it matters which component you interpret as being dominant, thus increasing subjectivity.

The distinction is again unclear with respect to intangible or biological assets where, for example, the right to produce specific seeds can be furnished by providing the seeds or the knowledge of how to do it. Our opinion is that the IASB may be able to avoid these complications by including intangible and biological assets within the revised leasing standard.

2. Inclusion of short-term leases

We believe that the inclusion of short-term leases in the vast majority of instances does not satisfy the cost/benefit argument where the benefit of incorporating this information in the financial statements is to provide useful information to users of the accounts.

Our suggestion would be that in circumstances where the remaining terms of lease contracts are less than 6 months and the leases that are not substantial (e.g. because of a large final payment) then they should be excluded from the standard. We do not believe that a detrimental effect to the financial statements would result.

3. Extension of lease contracts and contingent lease contracts

The ED includes options to extend lease terms as liabilities in the case where it is more likely than not that the option will be taken up and the extension will occur. This conceptual approach, whilst reflecting economic reality, is in sharp contrast to other IFRS. Other IFRS dealing with the accounting treatment of liabilities exhibit different principles. Some examples are detailed below:

- IAS 37 requires a legal or constructive liability at the balance sheet date, not of an economic cause. Unavoidability is not relevant for a reorganisation provision, but communication to relevant staff is (and therefore management can choose the communication to be happen before or after a specified date).
- In IAS 19, expected future salary increases have to be taken into account when determining the required provision. This is regardless of whether the increases are at the discretion of the entity and as such does not reflect the economic reality of the provision.

We believe that the IASB should review its current accounting principles with respect to the treatment and recognition of liabilities and adopt an approach that is consistent.



European Federation of Accountants and Auditors for SMEs

4. Purchase options

Purchase options are not included as a liability, even if the option is below market price. We do not believe that this reflects economic reality.

I trust that the above is comprehensive but should you have any questions on our comments, please do not hesitate to contact me.

Yours sincerely,

Federico Diomeda
Chief Executive Officer

This paper has been prepared by the EFAA Accounting Expert Group, chaired by Mr. Jan Achten.