



Exposure Draft *Leases* – EFRAG’s draft comment letter

Comments should be submitted by 26 November 2010 to Commentletters@efrag.org

[XX Month 2010]

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Dear Sir / Madam

Re: Exposure Draft *Leases*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft, *Leases* (‘the ED’). This letter is intended to contribute to IASB’s due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

Leases are a very important class of transactions and source of financing for entities. However, accounting for leases has been criticised over the years, not least by users. Therefore, we support the decision to develop an accounting model to replace the existing IAS 17, provided that the proposals offer an effective improvement over the existing requirements. While there are conceptual merits in some of the proposals included in the Exposure Draft, we are not persuaded that the proposals offer an effective improvement for a number of reasons, summarised below and explained in detail in Appendix 1 and 2 to this letter:

- the boundary between leases (particularly those currently categorised as operating leases) and service contracts is difficult to determine. We are not convinced that the proposed criteria carried over from IFRIC 4 provide the necessary robust and operational distinction required to determine which (very different) accounting treatment is appropriate and most meaningful for the specific transaction;
- the conceptual premise of the right-of-use approach – that an asset is a bundle of rights – is not reflected throughout the standard consistently:

- the hybrid model for lessors replicates in substance the existing model in IAS 17; the justification for the performance obligation model contradicts the rationale for having lessees apply the right of use approach to all leases. EFRAG supports the right of use approach for lessees and a single partial derecognition model for lessors;
- the analysis of a sale and leaseback transaction as a sale of the asset followed by a lease contradicts also the analysis of an asset as a bundle of rights. EFRAG believes that in such a contract the lessee sells all the rights to the asset except for the right-of-use that is retained in the lease;
- there is no real relief provided for short-term leases. EFRAG believes that lessees should apply to short-term leases the accounting of operating leases in the existing IAS 17; and
- amounts due under options and contingent rentals should not be included in the measurement of the lease assets and liabilities. We believe that these components are distinct from the contractually unavoidable rental payments and should be subject to separate recognition and measurement criteria.

As a result, EFRAG does not believe that the proposals are effective in addressing the concerns about the complexity of lease accounting and comparability of information. Furthermore, EFRAG is not convinced that the proposals result in information that is relevant to users of financial statements.

Since leases are so widespread, we believe that the IASB should further develop and field-test its thinking and, subsequently to:

- better define what information users really need;
- clearly distinguish between what should be recognised in the financial statements and what should be disclosed, the distinction being based on the definition of assets and liabilities;
- articulate supplementary criteria to support a robust distinction between leases and service contracts. Provided such criteria are identified, the IASB should pursue the project and make the requirements for lessee and lessor accounting consistent with the right of use approach to lessees; and
- make a thorough assessment of the costs involved.

We acknowledge that our recommendations may not be compatible with the June 2011 deadline that the Board has set for itself in this project. However, we believe that supplementary time required to make the final standard robust and worthwhile is a matter of months and not years.

If you wish to discuss our comments further, please do not hesitate to contact Filippo Poli or me.

Yours sincerely,

Françoise Flores
EFRAG, Chairman

Appendix 1 – General observations

- 1 The introduction to the Exposure Draft states that the current lease accounting model should be improved to provide better financial reporting for the following reasons:
 - (a) existing models lead to a lack of comparability and undue complexity because of the bright line distinction between finance leases and operating leases;
 - (b) existing models omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the Framework; and
 - (c) Existing models have been criticised for failing to meet the needs of users.

- 2 As explained in detail below, EFRAG is not convinced that the ED has addressed these concerns sufficiently.

Comparability and complexity

- 3 The different accounting requirements for finance and operating leases have created significant application issues. Entities are required to make complex judgements and slightly different contractual terms may trigger a very different accounting treatment. However, in addressing the issue, it appears, the Board has replaced that distinction with a new set of classification requirements for lease transactions:

- (a) *Lessees* – The proposed approach for lessees emphasises the need to distinguish clearly between service contracts and leases. We believe that this distinction is hard to make in practice and we are not persuaded that the Board has yet achieved a robust and operational definition of a lease. For example, asset-intensive contracts for easily interchangeable generic assets – such as back office IT hardware, telecommunications equipment or pipeline capacity – may or may not fall within the definition of a lease. We further explore these issues in our replies to Questions 4 and 6 below; and
- (b) *Lessors* – The proposed approach for lessor relies on a complex distinction between four categories of transactions:
 - (i) leases that meet the definition of sales and are accounted for under the revenue recognition standard;
 - (ii) transactions accounted for under the derecognition model;
 - (iii) transactions accounted for under the performance obligation model; and
 - (iv) short-term leases.

As noted in our responses to Questions 2, 3 and 4, we have concerns about the delineation of each of these four categories of transactions. Furthermore, we note that the definitions of a sale in the Revenue Recognition proposals and the Leases proposals (paragraph 8(a) of the ED) are not entirely symmetrical which, if unaddressed, might result in a fifth category of transactions (see our response to Question 4).

- 4 EFRAG does not believe that the proposed approach is very effective in addressing the concerns about comparability.

Definition of assets and liabilities

- 5 Paragraph BC7 of the ED states that when an entity enters into a lease:
- (a) It obtains a valuable right that meets the definition of an asset; and
 - (b) It incurs in an unavoidable obligation that meets the definition of a liability.
- At present if a lease is classified as an operating lease, IAS 17 fails to require recognition of these assets and liabilities and in the IASB's view this is its fundamental conceptual flaw. However, as explained in the paragraphs below, we do not think that the IASB has clearly illustrated the rationale for the new proposals.
- 6 We believe that the Basis for Conclusions does not fully describe the conceptual premise of the proposed model. Paragraph BC7 of the ED seems to be based on the assumption that an item of PPE is the sum of its rights of use over its economic life and can be separated into the rights of use in different periods, each of them being a separate asset. Under this view entering into a lease transaction (or actually, providing access to the underlying item of PPE at commencement date) is a transfer of an asset from the lessor to the lessee.
- 7 In paragraph BC7 of the ED the IASB states that a simple lease ceases to be an executory contract after the date of commencement of the lease. So the IASB seems to require a distinction between a right to the performance of the counterparty (which arises at inception of the contract, but should not be separately recognised) and a right to the use of an item (which arises at commencement of the contract, and should be recognised). The distinguishing features between commitments and rights/obligations to be recognised seem to be the existence of a specific underlying item and the provision of access to the item. However, we think that the IASB has not yet explained why it is relevant to recognise one type of commitment but not the other.
- 8 An alternative view would be that an underlying item is not separable into different components and that entering into a lease transaction does not entail the relinquishment of control of the underlying item. Under this view, the lessee can be seen as receiving a service (the use of the asset) and the lessor can be seen as providing a service over the term of the lease. The fact that the IASB has chosen a right-of-use model implies the rejection of this view.

Optional lease periods and contingent rentals

- 9 The model, as proposed in the ED, fails to deal appropriately with payments for optional lease periods and contingent rentals that depend on the use of an asset. Requiring the recognition of a liability for lease payments that are expected to be made rather than unavoidable raises a number of concerns:
- (a) As observed by Mr. Cooper in paragraph AV7 of the ED, the resulting liability does not appear to meet the definition of a liability in the current Conceptual Framework, as it takes account of payments:
 - (i) that are still at the discretion of the entity (i.e. the obligation to pay results from a future event – the exercise of the option – rather than a past event); and
 - (ii) that will only occur under conditions that are favourable to the entity (i.e. the entity will not to exercise an option to extend a lease under conditions that are potentially unfavourable); and

- (b) This approach creates an inconsistency, as IFRSs would not require the recognition of liabilities for unavoidable firm commitments to acquire services, while at the same time requiring the recognition of possible liabilities for lease payments that are likely but not certain.
- 10 Lessors face similar conceptual issues in respect of lease receivables. In particular, lease extensions that are at the option of the lessee (i.e. the lessor has a written call option over the leased asset) give rise to lease receivables in the books of the lessor. This despite the fact that:
- (a) the lease receivable will only arise as a result of a future action by another party (i.e. the future exercise by the lessee of the option to extend the lease); and
 - (b) written options are generally considered to result in liabilities rather than assets.
- 11 As explained in further detail in our response to Question 8, EFRAG is not convinced that the proposals result in the recognition of assets and liabilities that meet the definitions in the Board's Conceptual Framework. In addition, as explained below, we remain to be convinced that the resulting information is relevant to the users of financial statements.

Needs of users

- 12 IAS 17 has been often criticised as failing to meet the needs of users. In particular, it is difficult for users to compare entities that lease assets, with their peers who own similar assets or peers that outsource the activities in which such assets are used.
- 13 In respect of the financial statements of lessees, it has not become clear as a result of the Board's project what information users are primarily interested in:
- (a) The volume of assets used in the operations of the entity;
 - (b) The entity's exposure to asset related risks;
 - (c) The amount of unavoidable lease payments;
 - (d) The amount of unavoidable payments under leases and executory contracts;
 - (e) The amount of expected lease payments; or
 - (f) The leverage in an entity's financing structure.
- 14 The Board acknowledges that many users of the financial statements of lessees adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases. A common way of doing this in practice has been to recognise an asset and a corresponding liability based on a multiple of the minimum lease payments as defined under IAS 17, but not necessarily to make the corresponding adjustments to the statement of comprehensive income. This suggests that users are most interested in the amount of highly likely lease payments. However, this is something that we suggest the Board confirm in its outreach and field-testing activities.
- 15 Although users may be interested in this information, it does not provide a solid basis for concluding that recognition in the statement of financial position of highly likely lease payments is to be preferred in all cases over a more disclosure-focused approach.

- 16 Similarly, it has not become clear in the course of the Board's project whether the proposals in the ED result in information that is useful to users of the financial statements of lessors. We would suggest that the Board confirm this as part of its outreach and field-testing activities.

Cost-benefit considerations

- 17 We note that the Board has considered the costs and benefits of the proposals in paragraphs BC200 to BC205 of the ED. However, as noted in paragraphs 10 and 11 above, considerable uncertainties remain regarding the benefits of the proposals to users. In addition, there are potentially significant costs of implementation and ongoing application of the rather complex proposals in the ED. We would recommend that the Board perform additional work to confirm the existence and magnitude of the benefits and assess in more detail the costs associated with the proposals.

Appendix 2 – Response to questions in the Exposure Draft

The accounting model

Question 1: Lessees

Do you agree that a lessee should recognise a right-of-use asset and a liability for its obligation to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on its liability for lease payments? Why or why not? If not, what alternative model would you propose and why?

Notes for constituents

- 1 *The proposals require lessees to apply the following :*
 - (a) *It uses the criteria in paragraphs B1 and following to distinguish a lease arrangement from a service arrangement. A lease is an arrangement whose fulfilment depends from providing a specified asset and the lessee obtains the right to control the use of the asset. A service arrangement is accounted for as an executory contract;*
 - (b) *If the arrangement contains both lease and service components, the lessee separates services that are distinct. Services are separated when they meet the definition of a separate performance obligation in accordance with the proposals in the ED Revenue from Contracts with Customers ('the Revenue Recognition ED'). If services do not meet the definition, the lessee shall treat the entire contract as a lease arrangement;*
 - (c) *If the lease qualifies as a purchase, it is accounted for as such. An arrangement qualifies as a purchase of an asset when it transfers the control of the asset and all but a trivial amount of the risks and benefits associated with the underlying asset.*
 - (d) *If the lease does not qualify as a purchase, the lessee recognises a right-of-use asset and a liability. The lessee recognises the net position from inception date to commencement date; and the asset and liability separately from commencement date.*
- 2 *It should be noted that the lessee shall recognise the right-of-use and the lease liability at inception of the lease (which will normally be the date when the parties enter into the agreement) but shall present a net contract position until the date it obtains access to the asset (the date of commencement). From that moment, the lessee shall present the right-of-use and the liability separately in its statement of financial position.*
- 3 *The conceptual assumption behind the right-of-use model is that an asset is a bundle of rights that can be divided and separately transferred. Other views are possible – in the DP the IASB explored the whole asset approach that is based on the assumption that during the lease term the lessee has the control of the asset (and not of the right to control its use) and it should therefore recognise the whole asset. The IASB rejected this approach.*

EFRAG's response

EFRAG acknowledges that the model has conceptual merits and can be supported, subject to the development of robust criteria for distinguishing between leases and service contracts.

- 4 EFRAG agrees that the existing model in IAS 17 has limits and application issues. Therefore, we appreciate the IASB's efforts to develop a new approach to address these issues.
- 5 As explained in Appendix 1, EFRAG believes that the IASB has not provided a robust rationale to support the right-of-use model. We also have a number of concerns about some specific aspects of the model that are addressed in our responses to Questions 6 to 10 below. However, on balance we believe that a right-of-use model provides useful information and satisfies users' needs about recognition of assets and liabilities arising from leases. Therefore, EFRAG has concluded that it can support the right-of-use model.
- 6 As further explored in our response to Question 4 below, under the proposals the accounting treatment of lease transactions and service arrangements is significantly different. Therefore, it is crucial that the definition of a lease be further improved to distinguish clearly leases from services.
- 7 We agree that if the right-of-use model is applied, a lessee should recognise amortisation of the right-of-use and interest on the lease liability. We agree that neither the right-of-use nor the lease liabilities are required to be measured at fair value.

Question 2: Lessors

Do you agree that a lessor should apply the performance obligation approach when the lease exposes the lessor to significant risks and benefits associated with the underlying asset, and a derecognition approach otherwise? Why or why not? If not, what alternative model would you propose and why?

Do you agree with the boards' proposals for recognition of assets and liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Notes for constituents

- 8 *The proposals require a lessor to apply the following :*
 - (a) *It uses the criteria in paragraphs B1 and following to distinguish a lease arrangement from a service arrangement. A lease is an arrangement whose fulfilment depends from providing a specified asset and the lessee obtains the right to control the use of the asset. A service arrangement is accounted for as an executory contract;*
 - (b) *If the arrangement contains both lease and service components, the lessor separates services that are distinct. Services are distinct when they meet the definition of a separate performance obligation in accordance with the proposals in the Revenue Recognition ED. Separated services are accounted for as executory contracts;*
 - (c) *If the arrangement includes non-distinct services and the lessor applies a derecognition approach, the lessor shall also separate non-distinct services;*

- (d) *If the lease qualifies as a sale of an asset, it is accounted for as such. An arrangement qualifies as a sale when it transfers the control of the asset and all but a trivial amount of the risks and benefits associated with the assets;*
 - (e) *If a lease does not qualify as a sale, the lessor shall consider if it is still exposed to significant risks and benefits associated with the underlying asset. If this is the case, the lessor accounts for the arrangement using the performance obligation approach; if not the lessor applies the derecognition approach.*
 - (f) *When a lessor uses a performance obligation approach, there is no requirement to separate services that are non-distinct. When a lessor uses a derecognition approach, it has to separate also non-distinct services.*
- 9 *The derecognition approach as proposed is a partial derecognition approach rather than a full derecognition approach. The lessor recognises a lease receivable, derecognises only a portion of the carrying amount of the leased asset and maintains the residual portion in its statement of financial position.*
- 10 *The lessor determines the portion to be derecognised based on the proportion between the relative fair values of the rights transferred and the rights retained by the lessor.*

EFRAG's response

EFRAG supports a single partial derecognition model for lessors.

- 11 The current proposals require lessors to use a hybrid model based on exposure to the risks associated with the underlying asset. If the IASB is persuaded that there are valid arguments to support a hybrid model for lessors (which EFRAG does not believe) but not for lessees it should provide a clear rationale for why it is the case.
- 12 Paragraph BC25 of the ED states that one approach to lessor accounting would not be appropriate for all leases due to the differences in the economics of the transactions (or business models for different transactions). We are not convinced by this argument as the same can be said about lessees. Some lease arrangements are entered into by lessees as an alternative way to finance the acquisition of the underlying asset while in other cases they merely intend to obtain the use of an asset for a limited time.
- 13 As mentioned in Appendix 1 to this letter, the IASB seems to have adopted a conceptual premise based on the view that an asset is a bundle of rights. The performance obligation model does not appear to be consistent with this premise. The requirement to recognise a right-of-use asset and a liability by the lessee implies that a transfer has been executed by the lessor – and therefore the lessor should be able to derecognise an asset or part of it.
- 14 Paragraph BC7 of the ED states that in the IASB's view a lease ceases to be an executory contract after the date of commencement of the lease, When the lessor provides access to the underlying asset, the lessee has an unconditional right to use it and the lessor cannot prevent the lessee from using the asset. If the lessee has an obligation for the full term when it obtains initial access to the asset then it follows that from that moment the lessor has completed the execution of its part of the transaction.

- 15 Paragraph BC18 of the ED explains the rationale for the performance obligation approach and states that lessors should recognise revenue when their performance obligation is performed, as required in the proposals of the Revenue Recognition ED. The IASB's view is that the performance obligation of the lessor is to permit the lessee to use the underlying asset over the lease term, and that this obligation is satisfied continuously during the lease term.
- 16 EFRAG believes that there is a contradiction between the view in paragraph BC18 and that in paragraph BC7, under which the lessee has an unconditional obligation to pay for the right-of-use over the full lease term as soon as the lessor has provided access.
- 17 Another weakness of the performance obligation approach is that the lessor continues recognising the whole asset but also recognises a lease receivable. The lease receivable embodies part of the future cashflows that the underlying asset will generate for the lessor, therefore recognising it without derecognising part of the underlying in our view results in a double counting of the same asset.
- 18 For the reasons above, EFRAG supports a single derecognition model for all leases. We also believe that the IASB should try to avoid a hybrid model that would closely duplicate the distinction in the existing IAS 17 between finance and operating leases. As indicated in Chapter 1 of the Discussion Paper, many criticise the current model because distinction is difficult to operate and leads to accounting arbitrage.
- 19 Some argue that it is more appropriate to differentiate between lease transactions based on the nature of the risk the lessor is exposed to: when a lease is in substance a secured sale, the lessor is only exposed to credit risk, while in other cases the lessor maintains a degree of exposure to the asset risk.
- 20 However, EFRAG notes that the proposed approach is a partial derecognition approach under which the lessor is required to maintain the residual asset in its books. Therefore, the derecognition approach does not fail to represent that the lessor may still be exposed to some asset risk.
- 21 Those who oppose the derecognition model seem mainly concerned that the lessor could recognise revenue for services that have not yet been delivered to the lessee; and the lessor would recognise a Day-1 gain for all lease transactions.
- 22 EFRAG notes that the first concern is addressed by the requirement that a lessor applying a derecognition model shall separate service components even when they are non-distinct.
- 23 EFRAG believes that the recognition of a gain is conceptually consistent with a derecognition model. We also note that such a Day-1 gain would only arise if the lessor is in an economic position similar to a that of a manufacturer/dealer. Both under the current proposals and under the existing IAS 17, Day-1 manufacturer/dealer gains would be recognised immediately.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor should apply simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term is twelve months or less:

- (a) At the date of inception of a lease a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit and loss over the lease term (paragraph 64).
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from short-term leases in the statement of financial position, nor derecognise any portion of the right to use the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit and loss over the lease term (paragraph 65). (See also paragraphs BC41-BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Notes for constituents

- 24 *Under the existing IAS 17, most short-term leases meet the definition of an operating lease. Operating leases are accounted for in a straightforward manner and require relatively little disclosure.*
- 25 *Some constituents had expressed concern that the cost of applying the right-of-use model to short-term leases may exceed the benefit. Paragraph BC44 of the ED explains that the IASB proposes to mitigate the cost-benefit concerns by allowing simplified requirements.*

EFRAG's response

EFRAG believes that the IASB should propose a more meaningful relief for lessees.

- 26 EFRAG believes that the main burden for lessees of applying the proposed model to short-term leases is the cost of identifying and tracking a large number of expected lease payments, rather than the cost of discounting those lease payments. Also, the application of the accounting model for lessees may prove complex, especially when the contract includes contingent rentals. Therefore, we are not persuaded that the simplification proposed for lessees offers much relief in practice.
- 27 Paragraph BC43 of the ED states that a scope exemption for short-term leases would introduce an artificial distinction between leases that are recognised and leases that are not.
- 28 EFRAG agrees that short-term leases are not inherently different from other leases. However, EFRAG notes that users mainly criticise the existing model in relation to long-term arrangements that involve core operating assets. In other words, users do not seem to be concerned about short-term leases of non-core assets such as cars or hotels room not being recognised in the statement of financial position.
- 29 For this reason, EFRAG supports an exception to the general model on practical grounds and proposes that lessees apply to short-term leases the treatment of operating leases in the existing IAS 17.

- 30 EFRAG does not believe it is appropriate to extend a similar exception to other leases. Therefore, a robust definition of short-term leases is needed to prevent extending this exception. We suggest specifying that entities should consider the economic substance of clauses to determine if contracts include any options to extend the term beyond 12 months.
- 31 Paragraphs 64 and 65 of the ED allow lessors and lessees to choose on a lease-by-lease basis whether to use the simplified requirements or not. EFRAG is concerned that this option affects comparability and believes that lessors and lessees that decide to use the simplified requirements (or the exemption proposed by EFRAG) should apply them to all short-term leases.

Definition of a lease

Question 4

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- (b) Do you agree with the criteria for distinguishing a lease from a purchase or sale in paragraphs B9 and B10? Why or why not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance provided for distinguishing leases from service contracts in paragraphs B1-B4 is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Notes for constituents

- 32 *The IASB proposes that an arrangement qualifies as a lease when it conveys the right to use an asset for a period of time in exchange for consideration. To qualify as a lease the following conditions should be met:*
- (a) *The fulfilment of the arrangement depends on providing a specified asset; and*
- (b) *The arrangement conveys the right to control the use of the specified asset.*
- 33 *The table below compares how certain contract clauses or economic terms may affect the classification of a lease in IAS 17 as opposed to the new proposals.*

Situation	Existing IAS 17
<i>The title is transferred at the end of the lease term.</i>	<i>The presence of these situations, individually or on combination, normally results in a lease being classified as a finance lease.</i>
<i>The lessee has a bargain purchase option that is reasonably certain to be exercised.</i>	
<i>The lease is for the major part of the economic life of the asset.</i>	
<i>The present value of minimum lease payment is substantially equal to the fair value of the asset.</i>	

<i>The asset is so specific that only the lessee can use it in its current state.</i>	
<i>If the lessee can cancel the lease, it has to bear the lessor's losses due to cancellation.</i>	
<i>Changes in the fair value of the residual accrue to the lessee.</i>	
<i>The lessee has an option to extend the lease at substantially favourable terms.</i>	
Situation	Proposals
<i>The title is transferred at the end of the lease term.</i>	<i>These situations, normally results in the arrangement being classified as a purchase/sale.</i>
<i>The lessee has a bargain purchase option that is reasonably certain to be exercised.</i>	
<i>There are material non-distinct services provided during the lease term.</i>	<i>In these situations the lessor may not be exposed to significant risks and benefits and shall apply a derecognition model.</i>
<i>The lease covers a major part of the economic life of the asset.</i>	
<i>There are options to extend or terminate the lease.</i>	
<i>The value of the underlying asset at the end of the lease term may be subject to significant change.</i>	
<i>There are significant contingent rentals based on the usage or performance.</i>	<i>In this situation the lessor is exposed to significant risks and benefits and shall apply the performance obligation approach.</i>

EFRAG's response

EFRAG believes that the criteria to identify a lease put excessive weight on the physical delivery or access to the underlying physical asset rather than the benefit or the right-of-use that is actually transferred with the lease itself.

EFRAG believes that the criteria for distinguishing leases and sales/purchases are inconsistent with those set in the Revenue Recognition ED.

Is the lease defined appropriately?

- 34 EFRAG notes that the boundary between leases and service contracts will be difficult to determine. We are not convinced that the criteria indicated in IFRIC 4 *Determining whether an Arrangement contains a Lease* (that have been in substance carried forward to the Exposure Draft) will provide the necessary robust and operational distinction required to determine which (very different) accounting treatment is appropriate and most meaningful for each specific transaction. We believe that the criteria give excessive weight to physical delivery or access to the asset, while it should be important to identify the business purpose of the transaction. In other words, when the lessee is mainly interested in receiving a service – and is indifferent as to the specific asset used – the transaction should be treated as a service arrangement.
- 35 EFRAG thinks that the IASB should further clarify and improve the criteria in paragraphs B2 to B4. We disagree with the way the proposals define the notion of specific. We think that a key feature is whether the asset used is easily exchangeable or replaceable by another that can provide substantially the same goods or services. When transactions involve non-specialised assets or assets that are not strictly related to the activity of the entity, those transactions are more likely to be entered into to obtain a service rather than the right to use the underlying asset. For example, a broadband customer will usually receive a modem or router that meets specifications set by its internet provider, such an asset is an unavoidable necessity rather than something the customer set out to acquire.
- 36 We also believe that the ability of the supplier to replace the assets and continue providing the required goods or services is a key indicator of whether the customer is interested in the asset as such or whether the asset is merely a ‘vehicle’ for receiving a service. In this context it is irrelevant that the supplier does not have a practice to replace the assets.

Do you agree with the criteria for distinguishing leases and sales/purchases?

- 37 We note that the IASB identifies purchases/sales in those arrangements that transfer the control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying assets. The wording indicates that both conditions have to be satisfied. However, we note that the two criteria indicated in paragraph B10 (automatic transfer of title and existence of a bargain purchase option) only deal with the transfer of control and not the exposure to risks and benefits.
- 38 A lessor may retain an exposure to the risks and benefits of an asset when the lease payments are adjusted to reflect the fair value at the end of lease term. We agree that an entity should consider all relevant facts and circumstances, but it may be useful to include additional indicators in paragraph B10.
- 39 We are concerned that the proposal is not fully consistent with the Revenue Recognition ED which only requires the transfer of control as a condition to recognise a sale. We believe that in some circumstances (for instance, when contingent payments exist) a transaction would not qualify for as a sale under the Leases proposals but may qualify as such in the Revenue Recognition ED.
- 40 To avoid any inconsistency we would recommend that the scope exemption for sale/purchases in the Leases proposals would be defined by reference to the scope criteria in paragraphs 25 and applicable guidance in the Revenue Recognition ED.

41 Do constituents believe that a distinction between leases and sales/purchases is required? If so, do they believe that the criteria are appropriate?

Scope

Question 5: Scope and scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33-BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

Notes for constituents

- 42 *The proposed scope in the Exposure Draft is similar to existing IAS 17 and to the Discussion Paper.*
- 43 *The main differences between IAS 17 and the lease guidance in US GAAP is that SFAS 13 Accounting for Leases only applies to tangible assets, including investment property. IAS 17 excludes licensing of specified intangible assets.*
- 44 *Although the definition of lease relates to rights to use assets in general, the proposed scope excludes intangible assets so at least part of the divergence has been eliminated.*
- 45 *The new proposals have specific requirements for investment property:*
- (a) *lessees are allowed to measure the right-of-use of an investment property at fair value in accordance with IAS 40;*
 - (b) *lessors are allowed to apply IAS 40 (rather than the lease standard) to investment property carried at fair value.*

EFRAG's response

EFRAG believes that there is no conceptual basis for excluding intangible assets from the scope of the proposals.

- 46 EFRAG notes the following implications of the decision to exclude intangible assets from the scope of the Lease proposals:
- (a) Lessors of intangible assets shall use the guidance in the Revenue Recognition ED that provides criteria to decide if a contract should be treated as a sale or a license of an intangible asset, and how to account for these transactions. However, there will be no accounting guidance for lessees of intangible assets;
 - (b) In some circumstances, the recognition of revenue on license of exclusive rights to intangible assets may be different in the Revenue Recognition ED from what it would be under the Leases proposals; and
 - (c) Options to purchase or extend the term of the license are treated differently in the Revenue Recognition ED and in the Leases proposals therefore the measurement of the revenue and receivable will differ.

- 47 Also, EFRAG notes that contracts may include both tangible and intangible assets, as is the case in the IT industry where many lease solutions include both equipment and software. Entities will have to segment those contracts and apply different requirements to each component. We believe that this creates additional complexity that does not benefit user.
- 48 The exclusion of all intangible assets from the Leases proposals represents a backward step from IAS 17, which excludes only some intangible assets from its scope. EFRAG agrees with the IASB's statement in paragraph BC36 of the ED that there is no conceptual reason to exclude lease of intangible assets and we think that this exclusion may lead to a different accounting treatment of transactions that have similar economic substance.
- 49 While recognising the complexities involved in applying the notion of date of commencement to intangible assets, EFRAG encourages the IASB to do further work on the issue and explore the possibility to include intangible assets in the proposals.
- 50 EFRAG supports the proposed specific requirements for investment property valued at fair value in accordance with IAS 40 *Investment Property*. We agree that measuring these assets at fair value provides relevant information to users so it is appropriate to maintain this option.
- 51 We note that both the definition of investment property in IAS 40 and some of the examples in paragraphs 8 and 9 in that Standard are based on the distinction between finance and operating leases. Since the proposals remove this distinction, consequential amendments to IAS 40 should be made to clarify when a property held under a lease is considered an investment property.

Question 6: Contracts that contain both service and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B6-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not distinct:

The FASB proposes that the lessee and lessor should apply the lease accounting requirements to the combined contract.

The IASB proposes that (i) a lessee should apply the lease accounting requirements to the combined contract; (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract; (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements and the service component in accordance with the proposals in *Revenue from Contracts with Customers*.

Do you agree with either approach to accounting for leases that contain service and lease components appropriate? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Notes for constituents

52 *In the Revenue Recognition ED, a service is distinct when:*

- (a) *the entity, or another entity, sells an identical or similar good or service separately; or*

- (b) *the entity could sell the good or service separately because the good or service meets both the following conditions:*
- (i) *it has a distinct function – a good or service has a distinct function if it has utility either on its own or together with other goods or services that the customer has acquired from the entity or are sold separately by the entity or another entity;*
 - (ii) *it has a distinct profit margin – a good or service has a distinct profit margin if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service.*

EFRAG's response

EFRAG believes that when a contract includes both lease and non-distinct services, a lessee should identify the predominant component and treat the whole contract accordingly.

EFRAG believes that the lessor should always be required to account for the services and lease components of a contract separately.

- 53 EFRAG has concerns about the proposals for the treatment of arrangements that have both service and lease components.
- 54 We agree that entities should assess if services are distinct using the criteria in the Revenue Recognition ED. However, we have a concern about these criteria that we expressed in our comment letter on the Revenue Recognition ED.
- 55 EFRAG believes that an entity should consider its *own* business practices in determining how to unbundle performance obligations. The wording of paragraph 23 (a) of the Revenue Recognition ED suggests that an entity should also consider what other entities do. We disagree with this and believe that unbundling should be based solely on an entity's own business practices.
- 56 EFRAG in general supports symmetry of treatment between lessors and lessees; this is especially useful when the same entity is a lessee in a head lease and a lessor in a sub-lease of the same asset (or portion of the same asset). However, when an arrangement includes a lease and non-distinct services, EFRAG accepts that there may be different requirements for lessors and lessees because the two parties are unlikely to have access to the same information when non-distinct services are included. When services cannot be purchased separately, lessees are unlikely to have information to allocate payments reliably. Therefore, we agree that it would not be appropriate to force a lessee always to separate the contract into the different components.
- 57 EFRAG disagrees with the rule to apply lease accounting to the whole contract if it includes both service and non-distinct service components. We believe that entities should rather picture the economic substance of the transaction. To do so the lessee should assess what the predominant component is, then treat the whole contract accordingly. Identifying the predominant company requires a lesser degree of precision than identifying the relative fair values of each component, and lessees should be able to achieve it in most cases.

- 58 On the other hand, EFRAG believes that lessors are generally able to determine this information even when there is no market for these services because they *need* the information on the cost of all service components to price their contracts and handle a much larger volume of transactions than lessees. We think that this holds true regardless of the accounting model that the lessor applies.
- 59 Having a different requirement based on the accounting model creates an inconsistency in the presentation of the financial position: when lessors apply the derecognition approach, the receivable will not include the amounts for undelivered non-distinct services, while when they apply the performance obligation approach it will. EFRAG believes that the lessor should always be required to separate lease and service components, whether they are distinct or not.
- 60 EFRAG notes however that an entity that acts simultaneously as lessee and lessor of the same asset (or portion of it) has the information to separate the contract also in its capacity as a lessee.

61 Do constituents agree with EFRAG's suggestion on the lessee's treatment of a contract that includes non-distinct services? If not, what other approach do you support?

Question 7: Purchase options

The exposure draft proposes that a contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus a contract is accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraph 8 and BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options when they are exercised? Why or why not? If not, when do you think that a lessee or a lessor should account for a purchase option and why?

Notes for constituents

- 62 *IAS 17 requires that if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date when the option becomes exercisable (a so-called "bargain purchase option"), the minimum lease payments include the minimum payments receivable until the option becomes exercisable and the payment required to exercise it.*
- 63 *The existence of a bargain purchase option is one of the indicators that the lease agreement is a finance lease. Like renewal options, purchase options may affect both the classification of the lease and its initial measurement.*

EFRAG's response

EFRAG does not see a conceptual reason to treat options to purchase and options to extend a lease differently.

EFRAG believes that options should be recognised and measured separately.

- 64 As explained below in the response to Question 8, EFRAG believes that options should be recognised separately and measured based on their value.

- 65 EFRAG does not see a conceptual reason to treat options to purchase and options to extend a lease differently. We do not agree with the argument presented in paragraph BC64 of the Exposure Draft that the exercise price of an option is not a lease payment. We think that if the IASB adopts a “single asset and single liability” approach as opposed to a component approach, a purchase option is as integral to the agreement as an option to renew.
- 66 EFRAG is concerned that the proposals regarding purchase options result in very different accounting for scenarios that are similar. Under the proposals, the presence of a bargain purchase option results in treating the arrangement as a purchase; but when the option is not considered a bargain purchase option, then it is to be ignored until it is exercised. This difference in treatment is likely to give rise to application issues. Also, if the purpose is to assist users in predicting future cashflows, exclusion of options that are likely to be exercised decreases the relevance of the information.
- 67 We also note that if a lease arrangement includes both options to extend and options to purchase, a difference in accounting treatment has confusing consequences. For example, assume a lease arrangement that at the end of its contractual duration of 5 years has either an option to extend for another 5 years or an option to purchase:
- (a) If the lease is expected to be extended, the lessee recognises a right-of-use asset and a liability amounting to the rentals due over the 10 years;
 - (b) If the lessee is expected to exercise the purchase option, the lessee will only recognise a right-of-use asset and a liability amounting to the rentals due over the 5 years contractual term without considering the purchase price.
- A lessee that is expected to use the purchase option ends up with a lower liability, although the payment under the purchase option may be higher than the rentals for a 5-year extension.
- 68 Also, it is possible to change the initial assessment of the likelihood of the two scenarios and this reassessment would result in a significant change of accounting for the transaction.
- 69 Based on the above, we disagree with the proposal that options to purchase should be ignored until they are exercised. We believe that they should be separately recognised and measured and we suggest doing the same with options to extend as explained in our answer to Question 8.

Measurement

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

Notes for constituents

- 70 *The methods for including amounts due under renewal options in the lease payable and receivable could be based on:*
- (a) *a weighted-average approach;*

- (b) *the most likely term of the lease (that is, the term that has the highest probability to occur); or*
- (c) *the longest term that is more likely than not to occur.*

For example, assume that a lease arrangement has a fixed term of 5 years and the lessee has an option to extend for two additional 5-years periods. The lessee estimates that there is an 80% probability that it will exercise the first option; and after exercising it, there is a 60% probability that it will exercise the second option. The following table summarises the probability of each scenario:

<i>Term</i>	<i>Probability associated with the term</i>	<i>Probability that the lease will cover the term</i>
<i>5 years</i>	<i>20%</i>	<i>100%</i>
<i>10 years</i>	<i>80% * 40% = 32%</i>	<i>80%</i>
<i>15 years</i>	<i>80% * 60% = 48%</i>	<i>48%</i>

- 71 *Under the three different approaches above, the lessee's right-of-use and liability and the lessor's receivable (and performance obligation when applicable) are the rentals payable over:*
- (a) *11.4 years (5*20% + 10*32% + 15*48%)*
- (b) *15 years. This is the term to which the single highest probability is associated;*
- (c) *10 years. The probability that the lease term will be at least 15 years is less than 50%.*
- 72 *Paragraph BC118 of the ED states that the IASB wished to clarify that the most likely lease term should reflect the entity's reasonable expectation of what the term will be. The IASB did not mean to require the use of the term that has the highest probability to occur, but the longest possible lease term that is more likely than not to occur.*

EFRAG's response

EFRAG does not support the proposal that amounts due under renewal options should be included in the lease receivable or lease payable.

EFRAG believes that options should be accounted for, but their measurement should reflect their values rather than the gross cash flows resulting from the exercise.

- 73 *EFRAG believes that the proposal to include amounts due under renewal options in the measurement of lease payable and receivable is inconsistent with the Conceptual Framework and does not provide relevant information to users of the financial statements.*

- 74 EFRAG shares the concern expressed by Stephen Cooper in paragraph AV2 and following of the ED. We agree that options to extend or cancel a lease provide the lessee with the flexibility to react to changing business circumstances and consequently these features reduce risks. If these amounts are included in the measurement of the lease liability, a 10-year lease would be accounted for in the same way as a 5-year lease with a 5-year extension period (assuming the lessee is likely to extend the lease). In our view, this fails to provide useful information about the different economic position of the lessee in each of these transactions. Furthermore, we consider that:
- (a) rentals payable in an extension period do not meet the definition of a liability based on the Conceptual Framework. The lessee does not have an unconditional obligation to pay as long as it does not exercise the option;
 - (b) rentals receivable in an extension period do not meet the definition of an asset based on the Conceptual Framework. The lessor has neither an unconditional right to receive nor control over these amounts as long as the lessee does not exercise the option;
 - (c) including amounts payable and receivable in extension periods requires the lessee and the lessor to assess the likelihood of the exercise of the option. This is complex and judgemental for both parties because:
 - (i) The lessee may not have reliable information at every reporting date about future market rentals for the asset and therefore be unable to assess if the option is favourable or not;
 - (ii) The lessor may not be aware of lessee's decisions that may impact the likelihood of the renewals (e.g., a decision to relocate); and
 - (d) Including these amounts increases volatility because they are likely to be reassessed; and may reduce comparability because entities in similar situations with similar leases may end up accounting for them quite differently.
- 75 On the other side, we do not propose that the parties should ignore the existence of the options because of the following reasons:
- (a) The accounting treatment of a 5-year lease with a 5-year extension period should be different from the treatment of a 5-year lease. A lessee that has a favourable extension option has a more valuable asset than a lessee that does not have an extension option or one that is unfavourable ; and
 - (b) If the measurement excludes amounts payable in extension periods, this may create structuring opportunities. Entities may structure agreements with a short initial period and multiple short with renewal options only to achieve a certain accounting treatment. Therefore, EFRAG believes that options should be accounted for, but their measurement should reflect their values and not the gross cashflows resulting from the exercise.
- 76 EFRAG notes that in the Revenue Recognition ED an entity that grants an option to a customer recognises a separate performance obligation only if the option provides a material right to the customers that they would not receive without entering into that contract. The portion of the consideration that the entity allocates to the option reflects its intrinsic value.

- 77 EFRAG acknowledges that the IASB rejected treating options as derivatives because it believed that it might prove too complex to determine the fair value of this type of option. However, we encourage the IASB to develop an approach similar to that in the Revenue Recognition ED.
- 78 As mentioned in Appendix 1 of the present letter the IASB acknowledges that many users of the financial statements of lessees adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases. A common way of doing this in practice has been to recognise an assets and a corresponding liability based on a multiple of the minimum lease payments as defined under IAS 17. This may suggest that users are interested in the expected cash outflows arising from the lease contract.
- 79 Although users may be interested in this information, it does not provide a solid basis for concluding that recognition in the statement of financial position of highly likely lease payments is to be preferred in all cases over a more disclosure-focused approach.
- 80 Moreover EFRAG believes that the appropriate measurement is the one that helps users to predict future cashflows. If the IASB were to proceed with its proposal to include these amounts in the lease assets and the liability, which we disagree with, EFRAG's view is that the measurement should be based on the term that has the highest probability to occur. This term is not more difficult to determine than the longest term that is more likely than not to occur.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease contract should be included in the measurement of lease assets and lease liabilities using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors can only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the lease receivable if they can be measured reliably? Why or why not?

Notes for constituents

- 81 *IAS 17 does not explicitly prescribe an accounting treatment for contingent rentals. However, the definition of minimum lease payments explicitly excludes contingent rentals.*
- 82 *In July 2006 the IFRIC considered whether an estimate of contingent rentals payable (receivable) under an operating lease should be included in the total lease payments (receipts) to be recognised on a straight-line basis over the lease term. The IFRIC noted that, although IAS 17 is unclear on this issue, this has not, in general, led to contingent rentals being included in the amount to be recognised on a straight-line basis over the lease term.*
- 83 *Under IAS 17, the lessee includes in the minimum lease payments any amount guaranteed to the lessor by the lessee or a lessee's related party.*

- 84 *The lessor includes in the minimum lease payments any residual value guarantee extended by the lessee, a lessee's related party or a third party that is financially capable to discharge the obligation.*
- 85 *Therefore, like renewal options and purchase options, residual value guarantees may impact both the classification and the initial measurement of the lease.*

EFRAG's response

EFRAG believes that rentals that are under the control of the lessee, such as rentals contingent on usage or performance of the asset, should not be included in the measurement of lease assets and liabilities.

EFRAG supports a measurement based on a most likely outcome approach for components included in the measurement of lease assets and liabilities.

- 86 EFRAG believes that there are two different issues to address regarding contingent rentals and residual value guarantees:
- (a) Should all contingent rentals receive the same accounting treatment?
 - (b) If some of these components are included, how should they be measured?
- 87 EFRAG notes that there are different categories of contingent rentals. Contingent rentals that are linked to the use of an asset (such as mileage) are under the control of the lessee and similar to an extension option – the lessee has the right to acquire more of the right-of-use of the asset.
- 88 Lease payments that are contingent on the performance of the asset are less under the control of the lessee. It may be argued that the lessee could reduce or avoid the liability (because it has the ability to affect the performance) but at the same time the lessee is interested in obtaining benefits from the asset. This type of rental is similar to a profit-sharing agreement.
- 89 Finally, lease payments that are contingent on a price index are totally outside the control of the parties and unrelated to the proportion of the right-of-use that is controlled by the lessor or the lessee.
- 90 Therefore, the arguments presented above in the reply to Question 8 apply differently to the different categories of contingent rentals. It may be argued that contingent rentals linked to use of an asset do not meet the definition of current obligation because the obligation results from a future decision of the lessee. Rentals that are contingent on a future price index meet the definition of an unconditional obligation where the uncertainty only relates to the measurement of the amount to be paid (see also paragraph 25 of IAS 32).
- 91 EFRAG supports the alternative view expressed by Stephen Cooper, that contingent rental agreements that vary upon usage or performance of the asset provide the lessee with additional flexibility and reflecting them in the measure of the lessee's liability does not provide relevant information about the underlying economics of the agreement.
- 92 However, EFRAG acknowledges that when an agreement includes different types of contingent rentals applying a different treatment to each component may increase complexity.

- 93 Residual value guarantees can be viewed as unconditional rights and obligations – only their amounts is contingent on future events, but not their existence. To treat residual value guarantees as assets and liabilities is consistent with the treatment of obligations to stand ready to perform in the ED *Liabilities*.
- 94 With reference to the measurement basis, EFRAG favours a consistent approach for all variable lease payments. As explained above, we believe that a measurement based on a most likely outcome is more relevant for users as it is more helpful to predict future cashflows. EFRAG also notes that the argument in Paragraph BC120 of the ED – that a weighted average approach to assess the lease term might be difficult to be measured reliably and may result in a lease term that do not reflect a possible outcome – can be offered for contingent rentals and residual value guarantees.
- 95 Paragraphs 35(b) and 52(b) of the ED require lessors to include in the measurement of the lease payments an estimate of the amounts receivable by the lessee under residual value guarantees that the lessor can measure reliably. Residual value guarantees that are provided by an unrelated third party are not lease payments.
- 96 Based on the above, it is seems that residual value guarantees are included when they are provided by a lessor's related party are lease payments. The current definition in Appendix A of the ED however includes guarantees extended by the lessor only. To avoid misunderstanding, we suggest that the definition in Appendix A is amended to explicitly include guarantees extended by a lessor's related party.

97 Do constituents believe that separating different categories of contingent rentals might be too complex?

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the obligation or receivable arising from changes in the lease term or contingent payments since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Notes for constituents

- 98 *When reassessing the lease term:*
- (a) *The lessee shall adjust both the right-of-use and the liability;*
 - (b) *The lessor in a performance obligation model shall adjust both the receivable and the performance obligation;*
 - (c) *The lessor in a derecognition model should adjust the receivable and derecognise/reinstate a portion of the residual as follows:*
 - (i) *If the new expected lease term is longer than previously expected, the lessor shall derecognise an additional portion of the asset;*
 - (ii) *If the new expected lease term is shorter than previously expected, the lessor shall reinstate part of the asset that had been derecognised.*
- 99 *When reassessing contingent rentals or amounts due under residual value guarantees:*

- (a) *The lessee shall adjust:*
 - (i) *both the right-of-use and the liability for changes related to future periods;*
 - (ii) *the liability and credit or debit the result of the period for changes related to current or past periods.*
- (b) *Under a performance obligation model the lessor shall allocate the adjustment between unsatisfied performance obligation and satisfied performance obligation;*
- (c) *Under a derecognition model the lessor shall credit or debit the result of the period.*

100 *Under the proposals, lessees and lessors shall reassess the lease term and/or contingent rentals and amounts due under a residual value guarantee only if any new facts or circumstances indicate that there is a material change since the previous reporting date.*

EFRAG's response

EFRAG agrees that it would be onerous to require a periodic reassessment of changes in the obligation or receivable arising from changes in the lease term or contingent payments.

- 101 As mentioned in the replies to Question 8 and 9 above, EFRAG does not support the proposal that options to extend the lease term and contingent rentals based on performance or usage are included in the measurement of lease receivables and payables as proposed by the IASB.
- 102 However, if the IASB were to proceed with their proposal then EFRAG would agree that requiring a periodic reassessment could be very onerous. We also believe that this requirement is more compatible with a most likely outcome approach and less compatible with a weighted-average approach.
- 103 Under a weighted-average approach, a probability is allocated to each possible outcome. Any change in the likelihood of possible outcomes changes the weighted-average result. Therefore, if an entity does not adjust the measurement for each and every change, it actually moves away from a weighted-average approach. On the other side, an immaterial change is unlikely to affect a measurement based on the most likely outcome.
- 104 EFRAG does not agree with the proposal that when the lessor is in a derecognition model, any subsequent remeasurement of contingent rentals should be recognised as part of the result of the period. We believe that a reassessment of certain contingent rentals requires a remeasurement of the residual asset.
- 105 When contingent rentals are based on usage, a remeasurement arises when it is expected that the lessee will acquire more or less of the right-of-use. This is not different from a reassessment of the lease term that is treated as a new recognition (derecognition) event.

- 106 It may be argued that when the lessor expects a future increase in the use of the asset, this may lead to the need to recognise an impairment charge on the residual asset. Therefore, the lessor may need to recognise an impairment charge that offsets the additional revenue recognised. However, as the recoverable amount of the residual is affected by other factors, the lessor could recognise no impairment at all, or an impairment different from the adjustment of the contingent rentals,

Sale and lease back

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or not? If not, what alternative criteria would you propose and why?

Notes for constituents

- 107 *The proposals require that the seller/lessee and the buyer/lessor in a sale and leaseback transaction assess if the transfer meets the definition of a sale.*
- 108 *If the transfer meets the definition of a sale:*
- (a) *The seller/lessee will derecognise the asset and will recognise the lease based on the proposals in the ED; and*
 - (b) *The buyer/lessor will recognise the asset and will apply the performance obligation model to the lease.*
- 109 *If the transfer does not meet the definition of a sale, the seller/lessee will not derecognise the asset and will recognise a financial liability; the buyer/lessor will not recognise the asset and will recognise a financial receivable.*
- 110 *When the consideration for the transfer is not at fair value, the parties will adjust the measurement of the right-of-use and the underlying asset to reflect current market rates.*
- 111 *The parties shall consider the following conditions and contract terms when assessing if the transfer meets the definition of a sale:*
- (a) *The seller/lessee has an obligation or an option to repurchase the asset at an amount that is not fair value at the time of the repurchase; or the buyer/lessor can compel the lessee to repurchase the asset;*
 - (b) *The seller/lessee provides the buyer/lessor non-recourse financing or guarantees the debt of the buyer/lessor or is still obligated to service any debt related to the asset;*
 - (c) *The seller/lessee guarantees the buyer/lessor's investment or return on the investment;*
 - (d) *The buyer/lessor is obliged to share a significant portion of the asset appreciation, or the seller/lessee is allowed to participate in the appreciation of the asset or in the future profits of the buyer/lessor;*
 - (e) *The rental payment is contingent on some predetermined or determinable level of future operation of the buyer/lessor;*
 - (f) *The seller/lessee enters into a sale and leaseback transaction involving asset enhancements without leasing the transferred asset from the buyer/lessor.*

EFRAG's response

EFRAG supports an alternative accounting model for sale and leaseback transaction based on a “partial asset” approach.

EFRAG disagrees with the requirement that a lessor in a sale and leaseback transaction shall use a performance obligation approach because EFRAG supports a partial derecognition approach for lessors.

Link between the sale and the leaseback

112 If the IASB were to continue with its approach to sale and leaseback transactions, EFRAG would suggest including a general statement that the parties should look at the commercial substance of the arrangements to determine if it is a linked transaction or not. This would be similar to the approach taken in IAS 16, IAS 38 and IAS 40 regarding asset exchanges.

Identification of a sale

113 Paragraph BC162 of the ED states that the IASB proposes to use the same criteria for a sale as those used to distinguish between sales/purchases and leases. However, IASB has added in paragraph B31 examples of conditions that the parties must assess to reach a conclusion on whether the transfer is a sale.

114 EFRAG notes that the additional conditions in paragraph B31 of the ED imply that sale and leaseback transactions have to satisfy a higher threshold to qualify as sales than separate lease transaction that are subject to paragraphs B9 and B10 of the ED. If this is not the IASB’s intention, EFRAG suggests moving all examples of conditions to paragraph B9. This would clarify that there are no additional criteria to be met for sale and leaseback transactions to qualify as sales.

Accounting treatment of sale and leaseback transactions

115 EFRAG believes that the treatment of sales and leaseback that are linked should reflect the conceptual premise that an asset is a bundle of rights, which can be separately negotiated or exchanged.

116 In this view, in a linked sale and leaseback transaction the seller/lessee has actually:

- (a) Transferred the residual asset; and
- (b) Financed the portion of the asset that the seller/lessee is still entitled to use.¹

EFRAG believes that this view is consistent with the partial derecognition approach that we support for all lease transactions.

117 In this alternative model the accounting treatment of a linked sale and leaseback transaction (when the first transfer meets the definition of a sale) is as follows:

- (a) the seller/lessee should derecognise the portion of asset transferred and recognise a financial liability for the obligation to pay rentals over the lease term; and
- (b) the buyer/lessor should recognise the asset purchased, and a financial receivable.

¹ “Portion of the asset” does not refer to a physical portion but to the right of use for the period of the leaseback term.

- 118 EFRAG notes that the IASB had considered this “partial asset” approach (see paragraph BC161 of the ED) and rejected it because it believed that it was too complex. EFRAG notes that this approach relies on an allocation of the consideration paid between the purchase/sale of the residual asset and the financing of the right-of-use; a similar allocation process is required in paragraph 50 of the ED when a lessor applies the derecognition approach. We do not see why applying a “partial asset” approach in a linked sale and leaseback transaction should prove to be more complex.

Additional comments on the proposals

- 119 Paragraph B31 of the Application Guidance in the Exposure Draft includes examples of conditions that normally preclude the recognition of a sale/purchase and require treating the whole transaction as a financing transaction. We agree with most of them, but we are concerned about the criterion listed in B31 j)

*Any other provision of circumstance exist that allow the seller/lessee to participate in **any future profits** of the buyer/lessor or the appreciation of the transferred asset, eg **a situation in which the seller/lessee owns** or has an option to acquire **a significant interest in the buyer/lessor***

- 120 Based on the above, any sale and leaseback transaction where the seller/lessee is a parent company or an investor, and the buyer/lessor is a subsidiary or an associate would always be treated as a financing transaction in the separate accounts of the seller/lessee.
- 121 We agree that when the seller/lessee has the right to a significant portion of the appreciation of the transferred asset the transaction normally would not qualify as a real sale. However, we are not persuaded that it is appropriate to conclude that any transaction between a parent and a subsidiary is a financing transaction. This will be the case when the subsidiary is a vehicle and its only activity is to manage the transferred asset, but it is not necessarily true when the subsidiary is an operating entity.
- 122 EFRAG believes that this requirement may have an anti-abuse purpose and be meant to prevent structuring. We do not support including anti-abuse rules in principles-based Standards. Also, we think that this is part of a more general issue of how to treat intra-group transactions in separate accounts of participating entities and this should be addressed in a separate project and not on a case-by-case basis.

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| 123 Do constituents agree with the analysis and EFRAG’s proposals for the treatment of sale and leaseback transactions? |
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Presentation

Question 12: Statement of financial position

- (a) Do you agree that a lessee should present its liability to make lease payments separately from other financial liabilities and present right-of-use assets as if they were tangible assets within property, plant and equipment, or investment property as appropriate, but separately from other assets that the lessee does not lease (paragraphs 25-27, 42-45, 60-63 and BC142-159)? Why or why not? What alternative presentation do you propose and why?
- (b) Do you agree that a lessor applying the performance obligation approach should present its underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease

liability (paragraphs 42, BC148 and BC149)? Why or why not? What alternative presentation do you propose and why?

- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? What alternative presentation do you propose and why?
- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease separately (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

EFRAG's response

EFRAG agrees with the proposals for lessees.

EFRAG agrees with the proposal that a lessor using leases as an alternative way to realise an asset should disclose separately the lease income and expenses.

EFRAG is not persuaded by the presentation requirements for lessors applying a performance obligation approach.

Lessees

- 124 EFRAG agrees with the proposals for lessees and with the arguments in paragraph BC143 of the ED. We believe that there are differences between owned assets and assets held under a lease and between lease liabilities and other borrowings that justify a separate presentation.

Lessors

- 125 With reference to the presentation requirements for lessors applying derecognition approach, we note that paragraph 6 of IAS 16 *Property, plant and equipment* defines property, plant and equipment as tangible items that:

- (a) Are held for use in the production or supply of goods or services, for rental to others or for administrative purposes; and
- (b) Are expected to be used during more than one period.

Paragraph 6 of IAS 2 *Inventories* defines inventories as assets:

- (a) Held for sale in the ordinary course of business;
- (b) In the process of production for such sale.

- 126 The proposals for lessors applying the derecognition approach require a different presentation in the statement of comprehensive income based on the business model. EFRAG agrees with this proposal but believes that a similar distinction should be also made in the statement of financial position. If the lessor has to separately the lease income and expenses, in our view this implies the underlying assets are more akin to inventories than to items of property, plant and equipment and should be classified as such.

- 127 EFRAG is not persuaded by the presentation requirements for lessors applying a performance obligation approach. We think that the proposals reflect the ambiguity of the approach. Paragraph BC148 of the ED explains that the linked presentation is required because of the interdependency of the assets and liabilities originated by the lease transaction and because it alleviates the concern that under the approach both assets and liabilities are overstated in the statement of financial position.
- 128 We agree with these points, but we think that they are a consequence of the approach. As mentioned in our response to Question 2 we do not support the performance obligation approach and we do not think that adding a subtotal addresses the underlying issues.
- 129 If the IASB retains the performance obligation approach and believes that some form of aggregation is advisable, EFRAG would suggest requiring a net presentation of the underlying asset and performance obligation. The lease receivable should not be included in the net total, because it is subject to a different type of risk (e.g., the lessor could transfer the receivable without terminating the lease arrangement). On the other hand, the underlying asset is strictly linked to the obligation to provide access.
- 130 EFRAG believes that presenting a net balance on the face of the statement of financial position (and providing a breakdown in the notes) would be a more effective way to mitigate the concerns about the “grossing up” effect of the performance approach rather than inserting an additional sub total line.
- 131 However, entities should always consider the general requirements in paragraph 57 of IAS 1 *Presentation of Financial Statements* to include line items in the statement of financial position when separate presentation is relevant to an understanding of an entity’s financial position.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and expense separately from other income and expenses in the statement of comprehensive income (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Notes for constituents

- 132 *The lessor’s presentation in the statement of comprehensive income changes according to the approach used and its business model:*
- (a) *a lessor using the performance obligation approach presents separately revenue from its satisfying the performance obligation, depreciation expense and interest income in the lease receivable;*
 - (b) *a lessor that uses leases as an alternative way to realise the asset and applies derecognition approach presents separately lease income, lease expenses and interest income;*
 - (c) *a lessor that uses leases as a way to provide finance and applies derecognition approach presents a net gain (or loss) and interest income.*

EFRAG’s response

- 133 EFRAG supports the presentation requirements in the Exposure Draft and believes that it provides useful information.

Question 14: Statement of cash flows

Do you think that cash flows arising from lease contracts should be presented on the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

EFRAG's response

134 EFRAG agrees with the proposals and believes that it provides useful information.

135 Paragraph 44 of IAS 7 *Statement of Cash Flows* requires treating the acquisition of an asset by means of a finance lease as a non-cash transaction. The proposals do not change the requirement. Do constituents agree with the treatment? Or do constituents believe that a lease is essentially a financing transaction and therefore should be presented in the statement of cash flows in the same way an entity presents the purchase of an asset financed by way of a bank loan?

Disclosures

Question 15

Do you agree that lessee and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from lease contracts; and
- (b) describes how lease contracts may affect the amount, timing, and uncertainty of the entity's future cash flows?

(paragraphs 70-86 and BC168-BC183) Why or why not? If not, how would you amend the objectives and why?

Notes for TEG constituents

136 *The disclosure requirements include the following:*

- (a) *the nature of an entity's lease arrangements, including:*
 - (i) *a general description of those lease arrangements.*
 - (ii) *the basis and terms on which contingent rentals are determined.*
 - (iii) *the existence and terms of options, including for renewal and termination. A lessee shall provide narrative disclosure on the options that were recognised as part of the right-of-use asset and those that were not.*
 - (iv) *the existence and principal terms of any options for the lessee to purchase the underlying asset.*
 - (v) *information about assumptions and judgements relating to amortisation methods and changes to those assumptions and judgements.*
 - (vi) *the existence and terms of residual value guarantees.*
 - (vii) *initial direct costs incurred during and included in the measurement of the right-of-use asset or right to receive lease payments .*
 - (viii) *the restrictions imposed by lease arrangements, such as those relating to dividends, additional debt and further leasing.*

- (b) *information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations for the entity.*
- (c) *the nature and amount of significant subleases included in the disclosure provided in accordance with paragraph 73.*
- (d) *If an entity applies the simplified requirements allowed for short-term leases, disclosure of the fact and of the amount recognised in the financial statements for such short-term leases.*
- (e) *If an entity enters into a sale and leaseback transaction, disclosure of that fact, and of any gains or losses arising from sale and leaseback transactions separately from gains or losses on other disposals of assets. The lessee shall also disclose terms and conditions for the sale and leaseback transaction.*
- (f) *A reconciliation between opening and closing balances of right-of-use assets and liabilities to make lease payments, disaggregated by class of underlying asset. The reconciliation shall show separately the total cash lease payments paid during the period.*
- (g) *Information about the entity's exposure to the risks or benefits associated with the underlying asset that it used in determining whether to apply the performance obligation or derecognition accounting models.*
- (h) *Impairment losses arising from leases to which the lessor applies the performance obligation approach separately from those to which it applies derecognition approach.*
- (i) *A reconciliation between opening and closing balances for*
 - (i) *its rights to receive lease payments;*
 - (ii) *lease liabilities arising from leases to which it applies the performance obligation approach;*
 - (iii) *residual assets arising from leases to which it applies the derecognition approach*
- (j) *Information about the nature of significant service obligations related to its leasing activities.*
- (k) *Information about significant assumptions and judgements and changes in assumptions and judgements relating to options, contingent rentals, residual value guarantees and the discount rate used when determining the present value of lease payments.*
- (l) *In place of the maturity analyses required by paragraph 39(a) and (b) of IFRS 7 Financial Instruments: Disclosures, a maturity analysis of the liabilities to make lease payments showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years. Those liabilities shall include expected contingent rentals. The maturity analysis shall compare the potential differences in cash flows attributable to the minimum contractual obligations and the amounts recognised in the statement of financial position.*
- (m) *In place of the maturity analyses required by paragraph 37(a) of IFRS 7, a maturity analysis of the right to receive lease payments showing the undiscounted cash flows on an annual basis for the first five years and a total of the amounts for the remaining years. The maturity analysis shall compare the potential differences in cash flows attributable to the minimum contractual receivable and the amounts recognised in the statement of financial position.*
- (n) *Any other information relating to risks arising from a lease required in accordance with IFRS 7.*

EFRAG's response

- 137 EFRAG welcomes the requirement in paragraph 71 of the Exposure Draft that an entity should consider the level of disclosures appropriate to satisfy the objectives in paragraph 70. The list of disclosure requirements is extensive and we believe that the IASB should state even more clearly that they should not be regarded as mandatory in all situations.
- 138 Some of the disclosure requirements are reflect the existence of a hybrid model for lessors or diverging recognition requirements for different options. As mentioned above, EFRAG does not support a hybrid model or a different treatment of options.

Transition

Question 16

The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

Do you think that full retrospective application of lease accounting should be permitted? Why or why not?

Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Notes to constituents

- 139 *The main impacts of the simplified approach in the proposals compared to a full retrospective application are as follows:*
- (a) *As illustrated in paragraph 92 of the ED, the carrying amount of leases that do not have options, contingent rentals or residual value guarantees and that had been treated as finance leases will be carried over;*
 - (b) *Lessees will measure the right-of-use at the same amount of the financial liability. Under existing IAS 17 and the proposals, assets and liabilities have the same initial measurement but at subsequent dates their measurement differs.*

EFRAG's response

- 140 We agree that mandatory full retrospective application would be onerous for long-term leases, and welcome the relief given to preparers.
- 141 Paragraph 91 of the Exposure Draft requires that when lease payments are uneven over the lease term, a lessee shall adjust the right-of-use asset recognised at the date of initial application by the amount of any recognised prepaid or accrued lease payments. Paragraph BC190 of the ED explains that this occurs when lease payments include relatively large amounts at the beginning or the end of the lease term. We understand that the requirement in paragraph 91 should apply only to unavoidable lease payments; however "lease payments that are uneven over the lease terms" may be read to also include contingent rentals. We suggest amending the definition in order to clarify that this is not the case.

- 142 In general terms, EFRAG is in favour of full retrospective application. We appreciate the reasons why the IASB is not mandating it, but we do not think that there are conceptual reasons to prohibit it when entities have the relevant information.
- 143 However, if the IASB decided to allow an option for transition rules, we recommend that entities should treat it as an accounting policy option in accordance with paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Therefore, an entity that decides to adopt full retrospective application should do that for all arrangements for which the entity has the relevant information.
- 144 Paragraph 29 of the Exposure Draft requires a lessor to assess its exposure to significant risks and benefits associated with the underlying asset at inception of the lease. This assessment shall not be reassessed subsequently.
- 145 We note that the transition requirements in paragraphs 94 and following do not specify at what date lessors should assess their exposure to risks and benefits when first applying the new rules. EFRAG recommends that it is specified that this assessment should be made at the transition date based on the information available at that time.

Benefits and costs

Question 17

Paragraphs BC200-BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals outweigh the cost? Why or why not?

EFRAG's response

We encourage the IASB to expand its outreach activities to collect additional information on the costs associated with the implementation of the proposals and their potential effects.

- 146 In paragraph BC203 of the ED, the IASB states that the following costs will be incurred by preparers to implement the new proposals:
- (a) The cost to determine an appropriate discount rate on a contract-by-contract basis;
 - (b) The cost to reassess contingent rentals and options on a contract-by-contract basis;
 - (c) The cost of gathering and compiling lease information that might be distributed all over the world and associated with leases that have different contract terms.
- The IASB is confident that they have adequately addressed these concerns by allowing simplified requirements for short-term leases and requiring remeasurements of contingent rentals and options only when there is an indication of material changes.
- 147 EFRAG has not conducted a cost-benefit analysis. However, we are aware that material from other sources supports the view that other costs are likely to be incurred. These additional costs include for instance education (for preparers and analysts), robust upgrades of accounting systems and implementation of new processes and controls.
- 148 The proposals are also likely to impact financial ratios and debt covenants of entities. This may affect capital requirements based on local regulation and possibly increase the cost of capital for some entities.

- 149 Based on the above, we are uncertain that the analysis presented in the Basis for Conclusions is conclusive. We believe that the IASB should expand its outreach activities and do further work to ensure that the benefits of the proposals do not outweigh costs. For this reason, EFRAG welcomes the publication of a questionnaire for users by the IASB.

Other comments

Question 18

Do you have any other comments on the proposals?

EFRAG's response

Initial direct costs

- 150 Paragraph 12 of the Exposure Draft requires a lessee to measure the right-of-use asset initially at the amount of the liability to make lease payments plus any *initial direct costs* incurred by the lessee. Initial direct costs are defined as recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.
- 151 The accounting treatment for costs incurred in the context of a transaction is not unique to leases. The recently issued Exposure Draft *Insurance Contracts* requires including *incremental acquisition costs* in the present value of the fulfilment cash flows; and exclude all other acquisition costs. The Revenue Recognition Exposure Draft allows capitalising contract costs only if certain conditions are met, and require expensing the cost of obtaining a contract (for example, the cost of selling, marketing, advertising, bid and proposals, and negotiations).
- 152 It is unclear if the capitalisation requirements under the different proposals are meant to be equivalent or not. We believe that equivalent requirements should apply and advise to use consistent concepts and wording across the different proposals.

Impairment of the underlying asset in the performance obligation approach

- 153 Paragraph 41 of the Exposure Draft requires lessor to apply IAS 39 to assess whether the right to receive lease payment is impaired. There is no indication about how to assess impairment of the underlying asset but IAS 36 *Impairment of Assets* should apply.
- 154 IAS 36 requires the entity to assess the recoverable amount of the asset being the higher of fair value less cost to sell and its value in use. However, the lessor cannot include the cashflows arising from the lease payments in the value in use if the asset, because they already support the recoverable amount of the lease receivable. It is therefore likely that the value in use will result lower than the carrying amount of the asset.
- 155 One possible solution is to aggregate the underlying asset and the lease liability arising from the performance obligation for the purpose of impairment testing. Paragraph 67 of IAS 36 states that the recoverable amount of an individual asset cannot be determined only if the asset does not generate cash inflows that are largely independent of those from other assets; paragraph 78 of IAS 36 states that it may be necessary to include liabilities in a cash-generating unit when disposal of a cash-generating unit would require the buyer to assume the liability.

156 EFRAG is unsure that under the existing requirements in IAS 36 a performance obligation qualifies for the inclusion in a cash-generating unit for impairment testing purposes. Therefore, we would recommend the IASB to specify in the proposals that a performance obligation meets the conditions in paragraph 78 of IAS 36.