

## Exposure Draft Leases EFRAG's draft comment letter

Comments should be submitted by 6 September 2013 to [Commentletters@efrag.org](mailto:Commentletters@efrag.org)

8 July 2013

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH  
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 revised Exposure Draft *Leases* ('the ED'), published on 16 May. 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.

EFRAG agrees with the IASB that more lease arrangements than today's finance leases are in-substance purchase of assets, albeit for a term that is less than the useful life of the asset. For this reason, EFRAG remains supportive of the IASB Lease project. In particular EFRAG believes that the right-of-use model if applied to the right population of leases has the potential to bring useful information to users of those financing arrangements which are kept off balance sheet today. EFRAG also notes that the ED incorporates a number of our previous recommendations, reflects significant improvements in the accounting for leases in accordance with the right-of-use model (both for lessee and lessor) and includes a better approach to the distinction between lease and service arrangements.

However, not all lease transactions have the same characteristics (for example, consumption of the underlying asset may vary as the IASB recognises) and in our view there are some leases for which the right-of-use model is not appropriate and that might rightly be not presented on the balance sheet.

The IASB has emphasised in its communications that the project was intended to recognise financial liabilities that are currently left off balance sheet. Focussing on this objective seems to have been the primary driver behind the development of the right-of-use model. This model is based on a notion that an asset is a bundle of rights, one of them being the right-of-use; this is a new approach, which has never been debated on a conceptual level and we are not convinced that the focus on liability recognition has led to capturing the right population to which the right-of-use model should be applied. This is in our view illustrated by the inconsistencies in the proposed application, in particular the use of two measurement bases and different accounting for lessors and lessees which will add to the perception of complexity.

In our answers to both the Discussion Paper published in 2009 and the first Exposure Draft published in 2010, as well as in other communications such as our regular EFRAG-IASB meetings, we have emphasised the need to ensure that constituents have a good understanding of the objectives of the project and what economic phenomena the IASB intended to depict in the primary financial statements. We do not think that this understanding exists today and we do not think that it is adequately explained in the Basis for Conclusions.

EFRAG is therefore concerned that without a proper debate on the underlying concepts and the related transactions, the right-of-use model will not be understandable for constituents and this will add to the feeling that this proposed IFRS is unduly complex.

Based on these observations, EFRAG recommends that the IASB proceeds to finalise its project in steps:

- 1- To require without delay relevant disclosure on lease arrangements to ensure that users have access to the information they need;
- 2- To take advantage of the discussion on the conceptual framework to refine the definition of the right-of-use, distinguish this right from the other rights which are bundled in the asset, investigate whether the consumption of economic benefits of the underlying asset has a role to play, and refine the guidance to identify what activities convey the ability to direct the use of an asset and how this links with the business models of lessors (providing finance or managing assets). Such discussion could in our view be concluded before completion of the conceptual framework project itself;
- 3- Finalise the accounting for leases, with the benefit of clarified objectives and a carefully identified lease population and the results of the current consultation.

We include in the letter further comments and recommendations, with the objective to achieve greater internal consistency, reduced complexity and inherent costs. If you wish to discuss our comments further, please do not hesitate to contact Filippo Poli, Robert Stojek or me.

Yours faithfully,

Françoise Flores  
**EFRAG, Chairman**

## The right-of-use model

- 1 EFRAG agrees that leasing is important for many entities and hence that users of financial statements should obtain a complete and understandable picture of an entity's leasing activities. There has been criticism of the existing accounting model, mostly for lessees, and EFRAG agrees that there is room for improvement in reporting for leases.
- 2 At the beginning of the project there was a concern that existing lease accounting allows significant financial liabilities to stay off balance, and this was what the IASB should have fixed. The IASB has however assumed that all lease arrangements provide asset financing to the lessee, but EFRAG is not convinced that this is the case.
- 3 The proposals represent a significant change from existing requirements. IAS 17 *Leases* was aimed only at those transactions that are substantially identical to purchase financing. Now the IASB proposes recognition of a right to use an identified tangible asset, which is based on a notion that an asset is a bundle of rights. This notion has never been debated at a conceptual level.
- 4 In our answers to both the Discussion Paper and the first Exposure Draft, as well as in other communications such as our regular EFRAG-IASB meetings, we have outlined the need to fully explain the project from a conceptual perspective, so that constituents would have a good understanding of what economic phenomena the IASB intended to depict in the primary financial statements. The Basis for Conclusions makes a considerable effort to explain that the right of use meets the definition of an asset, and that users adjust today the balance sheet to get a better picture of the actual leverage of the entity, but it does not explain when their recognition would result in useful information.
- 5 EFRAG believes that the right-of-use model has potential to bring useful information to users of those financing arrangements which are kept off balance sheet today, if constituents will be able to understand what information results from the application of the model. It is important that preparers and users understand what rights are brought onto the balance sheet (and what rights are not) and when recognition is the most appropriate way to provide information that is relevant and decision-useful.
- 6 EFRAG commends the Board's significant efforts to reach out to constituents and respond to the many views expressed. However, the decision to introduce a dual measurement approach and to adopt asymmetrical accounting treatments for lessors and lessees has increased the complexity of the proposals as well as the likely costs associated with their implementation and does not help to understand the right-of-use model.
- 7 Having a dual measurement approach and optional requirements (such as the option to apply fair value in certain circumstances, or an exemption for short-term leases) may affect users' ability to understand which rights are and which are not recognised and how they are measured. The inclusion of a dual measurement approach indicates that the right-of-use model may not fit all the arrangements in scope of the proposals. The IASB should address these questions at a conceptual level rather than trying to achieve consensus through a compromise solution.
- 8 We are also concerned that the proposals still leave room for structuring opportunities, for instance through the use of options to extend or terminate a contract; and maintain classifications based on bright lines. This can be seen as a shortcoming, given that one stated goal was to eliminate the bright-line distinction between operating and finance leases.

- 9 We are aware that the IASB is reluctant to significantly delay the completion of the project, because the information on leases required by IAS 17 is not satisfactory. In the short term, the Board should bring improvement to the existing limitations with relevant disclosure of leases. These disclosures should provide users with information on minimum commitments and maximum potential future cash flows disaggregated by category of underlying asset.
- 10 Many users have expressed support for the project and would be disappointed to see no improvement in the short term. Relevant and meaningful disclosure would address their request for better information, whilst recognising that not all users are in favour of the same measurement requirements.
- 11 Simultaneously, the on-going Conceptual Framework project provides the best context to refine the definition of the right of use, distinguish this right from the other rights which are bundled in the asset, investigate whether the consumption of economic benefits of the underlying asset has a role to play and refine the guidance to identify what activities convey the ability to direct the use of an asset and how this links with the business models of lessors (providing finance or managing assets).

## Response to questions in the Exposure Draft Leases

### Question 1: identifying a lease

This revised Exposure Draft defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration”. An entity would determine whether a contract contains a lease by assessing whether:

- (a) fulfilment of the contract depends on the use of an identified asset; and
- (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

### Notes to constituents

- 12 *The ED proposes a definition and criteria to identify a lease that are very similar to the ones in IFRIC 4 Determining whether an Arrangement contains a Lease. However, it has added some clarifications.*
- 13 *Specification in the contract is neither a sufficient nor a necessary condition for an asset to be an identified asset.*
- 14 *If the supplier has a legal right to replace the asset, and there are no economic barriers that would prevent replacement, then the arrangement does not contain a lease. However, an obligation to replace an asset that is not operating properly does not preclude the existence of a lease.*
- 15 *A capacity portion of an asset cannot be an identified asset.*
- 16 *A contract contains a lease only if the customer has both the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract; and obtain substantially all of the potential economic benefits from the use of the asset throughout the term of the contract.*
- 17 *The customer’s right to specify the output of an asset is not sufficient in isolation to grant the right to control the use of an identified asset.*
- 18 *A contract may include clauses that restrict the use of the asset; these protective rights do not in isolation preclude the customer’s ability to direct the use.*
- 19 *Paragraph 19 of the ED states that a customer does not have the ability to derive the benefits from the use of the asset when the customer can obtain the benefits only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers; and the asset is incidental to the delivery of services because it has been designed to function only with the additional goods or services provided by the supplier.*

20 Paragraph 20 of the ED states that the right to use an asset is a separate lease component if both the following conditions are met:

(a) the lessee can benefit from its use either on its own or together with other resources that are readily available to the lessee (goods or services that are leased or sold separately by the supplier or other suppliers); and

(b) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

*These requirements are also applied to identify separate performance obligations in the future Revenue Recognition Standard.*

### **EFRAG's response**

21 The following replies and comments are provided on the assumption that the IASB proceeds to issue a Lease Standard based on the proposals in the Exposure Draft. They are not intended to express unconditional support for the right-of-use model as explained above.

#### Identification of a lease

22 If all leases are recognised on the balance sheet, EFRAG believes that the definition of a lease must capture only those contracts that are not in-substance service arrangements. This is difficult to achieve because the provision of services often involves some use of assets, and a 'service' is not a defined term in IFRSs.

23 We believe that applying the proposed criteria will require significant judgment, which may result in application issues. It may be difficult to assess 'control' when the asset is not in the physical possession of and is not directly managed by the lessee. The IASB should consider adding more guidance on the assessment of control, which could be developed from other projects such as:

(a) The difference between substantive and protective rights in IFRS 10 *Consolidated Financial Statements*; and

(b) The considerations in the ED on revenue recognition on whether an entity is a principal or an agent of another party.

24 A criterion that could be added to identify a lease is the existence of observable prices for the underlying asset. The lack of observable prices should give rise to a rebuttable presumption that the asset is of no use to the client without additional goods or services provided by the supplier, and therefore the agreement is not a lease. See also below in paragraph 35.

#### Interaction between definition of a lease and separation of components

25 EFRAG agrees that a contract does not include a lease when the underlying asset is only a vehicle to benefit from consumables (such as the coffee consumables in Illustrative Example 2) or services provided only by the supplier. In this case, the essential component is the consumable or service, which does not qualify as an identified asset in a lease.

- 26 EFRAG believes that paragraphs 19 and 20 of the ED may confuse preparers, as the condition in paragraph 20a (the asset being dependent from other resources that are readily available to the lessee) appears to be very similar to the condition in paragraph 19a. However, we understand that the two conditions are used to assess two very different issues: paragraph 19 to assess if the contract includes a lease and paragraph 20 to assess whether the lease contract (already identified in accordance with paragraph 19) includes only one or more lease components.
- 27 EFRAG believes that the IASB should reconsider the wording of paragraphs 19 and 20 to make sure that they are relevant only to the specified issue that they are intended to solve.

**Question to constituents**

- 28 Do you agree that a better distinction is needed between the conditions in paragraph 19 and 20 of the ED?

**Accounting for contracts that contain service components and lease components**

**Notes to constituents**

- 29 *An arrangement may include both lease and non-lease components. Non-lease components are services or other costs, such as property taxes, included in the total contract payments.*
- 30 *If an arrangement includes lease and non-lease components, a lessee shall account for them separately and allocate the total contract payments between the components as follows:*
- (a) If there are observable standalone prices for each component, the lessee would allocate the payments on the basis of the standalone prices;*
  - (b) If the standalone price of one or more, but not all, of the components is observable, the lessee would allocate the payments on the basis of a residual method; or*
  - (c) If there are no standalone observable prices, the lessee would account for all the payments required by the contract as a lease.*
- 31 *A lessor allocates the total payments in accordance with the guidance in the ED on revenue recognition.*

**EFRAG's response**

- 32 The following reply and comments are provided on the assumption that the IASB proceeds to issue a Lease Standard based on the proposals in the Exposure Draft. They are not meant to express unconditional support for the right-of-use model as explained above.
- 33 EFRAG agrees with the requirement to identify and account separately for lease and non-lease components. We think that it is consistent with the principles in the ED on revenue recognition and with the right-of-use model.
- 34 With reference to the guidance, EFRAG agrees that observable prices should normally be used when they are available for all components. Some adjustment may however be needed when observable stand-alone selling prices are not fully meaningful in the context of a lease transaction, because for example of different tax effects.

- 35 EFRAG has concerns about paragraph 23(c) which states that if there are no observable stand-alone prices for any components of the contract, a lessee shall treat the components as a single lease component. As mentioned above, the absence of an observable price for an asset should be an indication that the asset is not a lease component. We believe that when an asset could be used without additional goods or services that only the supplier can provide, a separate price for the asset will be observable.
- 36 Assuming that there are exceptions, EFRAG suggests that an entity should allocate on some reasonable estimate based on available information, rather than allocate all payments to the lease component. This would be consistent with the guidance in the ED on revenue recognition.

**Question to constituents**

- 37 Do you agree that observable prices for separate components may on occasions be not fully relevant in allocating the total payments to different components? If so, what types of adjustments should be made?
- 38 Do you agree that lessees should be allowed to use reasonable estimates to allocate the price to lease and non-lease components in the absence of observable stand-alone prices?

**Question 2: Lessee accounting**

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

**Notes to constituents**

- 39 *The original Exposure Draft Leases published in August 2010 ('the 2010 ED') proposed that lessees apply a single approach for subsequent accounting of right-of-use assets and liabilities to make lease payments. A lessee would measure the liability at amortised cost, and the right-of-use asset at cost less depreciation in accordance with IAS 16 Property, plant and equipment and IAS 38 Intangible assets.*
- 40 *Many constituents expressed concern about this approach, which leads to recognising a higher cost in the early periods of the lease (so called front loading of cost). The Board discussed several alternatives and organised extensive outreach to constituents. Finally the boards reached a tentative agreement on a dual approach right-of-use model for lessees.*
- 41 *The ED requires an entity to assess if a lease is a Type-A or Type-B based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. The assessment would usually depend on the nature of the underlying item (real estate or other assets).*

- 42 *For Type-A leases, the lessee carries the liability at amortised cost and the right-of-use asset at cost less amortisation in accordance with IAS 16. For Type-B leases – the ‘Single Lease Expense’ approach – the liability is measured at amortised cost, and the right-of-use asset is adjusted so that the total lease cost is recognised on a straight line over the lease term. Total cost shall be presented as one item in the statement of income.*
- 43 *A lessee has the option to measure the right-of-use asset at fair value in accordance with IAS 40 (if the underlying asset qualifies as investment property) or at revalued cost in accordance with IAS 16, if the lessee applies revalued cost to owned assets in that category of property, plant and equipment. In that case, the lessee does not have to classify the lease as Type-A or Type-B.*

#### **EFRAG’s response**

- 44 The following reply and comments are provided on the assumption that the IASB proceeds to issue a Lease Standard based on the proposals in the Exposure Draft. They are not intended to express unconditional support for the right-of-use model as explained above.
- 45 We concur with paragraph 73 of the Basis for Conclusions, that when the lessee is expected to consume very little of the economic benefits embedded in the underlying asset, the lease does not represent a transfer of a significant portion of the underlying asset. We also agree with paragraph 44 of the Basis for Conclusions that in these cases the lessee is only providing the lessor with a return on its investment in the underlying asset in exchange for the access to it.
- 46 However, EFRAG questions the conclusion drawn. Having chosen a full right-of-use model, the IASB was necessarily led to conclude that these cases should still result in lease recognition but under an alternative measurement approach. This leads to an approach – the Single Lease Expense – based on a linked measurement notion that we do not believe to be consistent with a right-of-use model.
- 47 Specifically in the Single Lease Expense approach the carrying amount of the right-of-use asset depends on the interest charge calculated on the lease liability and is in fact a balancing figure. EFRAG does not think that the subsequent measurement of the right-of-use asset under Type-B reflects the pattern of its consumption, or that it provides relevant information. For example, it is not clear how users will be able to calculate meaningful ratios based on carrying amounts of such right-of-use assets.
- 48 EFRAG therefore believes that the analysis set out in the Basis for Conclusions leads to a different conclusion, i.e. that the right-of-use model does not provide an appropriate accounting basis for transactions where the lessee is only providing the lessor with a return on its investment in the underlying asset in exchange for the access to it.
- 49 We also have practical concerns about the Single Lease Expense approach. We think it creates issues when assessing impairment of the right-of-use asset or when the lease term is reassessed. Also, this approach will likely require changes in systems because amortisation of the right-of-use asset must be calculated as the complement of the interest charge.

**Question to constituents**

50 Do you agree that the proposed distinction between Type-A and Type-B leases should lead to different recognition, and not just different measurement?

**Question 3: lessor accounting**

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

**Notes to constituents**

51 *For Type-A leases, a lessor shall:*

- (a) Derecognise the underlying asset at commencement;*
- (b) Recognise:*
  - (i) A lease receivable, initially measured at the present value of the future lease payments discounted at the rate the lessor charges the lessee;*
  - (ii) A residual asset at an allocation of the carrying amount of the underlying asset.*

52 *At subsequent dates, a lessor shall measure:*

- (a) The lease receivable at amortised cost;*
- (b) The residual asset at its initial amount plus unwind of the discount.*

53 *For Type-B leases, a lessor shall recognise lease payments as income over the lease term.*

**EFRAG's response**

54 The following reply and comments are provided on the assumption that the IASB proceeds to issue a Lease Standard based on the proposals in the Exposure Draft. They are not intended to express unconditional support for the right-of-use model as explained above.

55 As explained in Question 2 EFRAG could support an approach under which a lessee recognises assets and liabilities only for Type-A leases. Under this assumption, we would also agree with the proposed dual approach for lessors – indeed EFRAG thinks that the fact that the IASB is proposing this treatment for lessors provides support for the view that the right-of-use model is not appropriate for Type-B leases for lessees either.

56 If the IASB confirmed recognition of Type-B leases by the lessee, EFRAG would question the proposed Type-B accounting for lessors. While recognition and derecognition requirements are not always symmetrical in IFRSs, by choosing a right-of-use model for Type-B leases, the Board would take the view that the unit of account is the right to use the underlying asset and that it is transferred to the lessee at the commencement date. In this model, the logical implication is that the lessor should reflect this transfer and derecognise a portion of the asset.

Back-to-back leases

- 57 EFRAG is particularly concerned by the application of the proposed Type-B accounting in the context of back-to-back leases. If the entity is a lessee in a main lease of Type-B and it leases out the same asset, the sub-lease shall be also a Type-B. The entity shall therefore recognise and maintain a right-of-use asset in its statement of financial position.
- 58 The outcome would be different if both the main lease and the sub-lease were Type-A – in that case (assuming the same terms of the two leases) the entity would not present a right-of-use asset, but only a receivable and a payable. We think that this is a more faithful representation of a back-to-back lease.
- 59 Assuming that the IASB confirmed the proposed treatment of Type-B leases for both the lessor and the lessee, we would recommend an exception for back-to-back leases of the same underlying asset when the main lease is of Type-B. The entity should be required to use the ‘receivable and residual approach’ to the sub-lease.

**Question to constituents**

- 60 If the IASB confirmed Type-B accounting for lessees, do you agree that lessors should also de-recognise part of the underlying asset?
- 61 If the IASB confirmed Type-B accounting for lessors and lessees, do you support an exception for back-to-back leases?

**Question 4: classification of leases**

Do you agree that the principle on the lessee’s expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

**Notes to constituents**

- 62 *The proposals include rebuttable presumptions to identify Type-A and Type-B leases:*
- (a) *leases of underlying assets other than property (i.e. equipment leases) are Type-A, unless:*
    - (i) *the lease term is for an insignificant portion of the economic life of the underlying asset; or*
    - (ii) *the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset;*
  - (b) *leases of property (land or a building—or part of a building) are Type-B unless:*
    - (i) *the lease term is for the major part of the remaining economic life of the underlying asset; or*
    - (ii) *the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.*

**EFRAG's response**

*View A- accept the proposed criteria and presumptions for the classification of leases*

- 63 The following reply and comments are provided on the assumption that the IASB proceeds to issue a Lease Standard based on the proposals in the Exposure Draft. They are not intended to express unconditional support for the right-of-use model as explained above.
- 64 EFRAG agrees with the guidance of classifying leases in Type-A and Type-B and the presumption based on the nature of the underlying asset. The presumption is useful in reflecting the fact that for most leases of equipment the consumption of the underlying asset's economic benefits is significant, while this is not the case for real estate.
- 65 As acknowledged in paragraph 50 of the Basis for Conclusions, the presumptions may not always result in conclusions that are consistent with the principle. However we think that the presumptions are understandable by users and will result in a substantial simplification and cost saving for preparers in applying the principle.

*View B – reject the proposed criteria and presumptions for the classification of leases*

- 66 The following reply and comments are provided on the assumption that the IASB proceeds to issue a Lease Standard based on the proposals in the Exposure Draft. They are not intended to express unconditional support for the right-of-use model as explained above.
- 67 While EFRAG could support different recognition requirements for Type-A and Type-B leases, the way a lease is classified should be the same for all underlying assets, regardless of their nature.
- 68 Paragraph 42 of the Basis for Conclusions states that a single lease expense would provide better information about leases for which the lessee pays only for the use of the underlying asset and is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset. The distinction is based on the expected level of consumption, not on the nature of the underlying asset. We do not see why this should be introduced in the Standard.
- 69 As acknowledged in paragraph 50 of the Basis for Conclusions, the presumptions may not always result in conclusions that are consistent with the principle, and we do not think that this is appropriate.
- 70 We are also not persuaded that a lessee consumes more than an insignificant portion of the economic benefits of a real estate only if the duration of the lease term is for most of the economic life of the asset.

**Question to constituents**

- 71 Which view (A or B) on the classification criteria for leases do you support?

**Question 5: lease term**

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

**Notes to constituents**

- 72 *The ED proposes that the lease term is the non-cancellable period for which the lessee has the right to use an underlying asset, together with:*
- (a) *periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; and*
  - (b) *periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.*
- 73 *If a contract does not have a determined period and each of the parties can cancel it at any time, the non-cancellable period is the period of notice that each party is required to give when it terminates the contract.*
- 74 *The ED requires that an entity should include the present value of any options to extend or to terminate the lease, if lessee has a significant economic incentive to exercise or not to exercise that option. The IASB decided that purchase options and term penalty options should be accounted for in the same manner. As a reminder, IAS 17 also requires recognition of payments due under options, when at inception of the lease it is reasonably certain that the lessee will exercise the option.*
- 75 *An entity should consider contract-based, asset-based, entity-based and market-based factors in assessing the significance of the economic incentive for lessee.*
- 76 *An entity shall reassess the lease term when:*
- (a) *there is a change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise any options to extend or terminate the lease;*
  - (b) *lessee elects to exercise an option even if it has a significant economic incentive not to do so, or elects not to exercise an option even if it has a significant economic incentive to do so.*
- 77 *The thresholds for evaluating a lessee's economic incentive to exercise or not to exercise an option should be the same for both initial and subsequent evaluation, however changes in market-based factors after lease commencement should not in isolation trigger reassessment of the lease term.*
- 78 *An entity has the option not to apply lease requirements to short-term lease contract. A contract qualifies for the exemption only when the maximum duration is 12 months or less including any option to extend.*

**EFRAG's response**

*View A – accept to include in the lease liability payments under options in certain circumstances*

- 79 EFRAG's initial position had been to support a component approach under which options are recognised and measured separately. EFRAG then concluded that this was not feasible for these types of options. Neither would it have been acceptable to use intrinsic values; this assessment would still be too complex since it requires projecting future market rates for the underlying asset during the optional periods, and would create an exception to measurement requirements in the other Standards.
- 80 Therefore EFRAG now supports that lease payments due under options should be recognised under certain circumstances. Not recognising options most likely to be exercised distorts the depiction of performance of the entity. When the terms are advantageous to the holder, the value of the option is likely to have been incorporated in the payments for the initial term, which will then be more expensive than the payments for the optional period. Excluding the payments for the optional periods then results in recognising a higher cost of the lease in the first non-cancellable period.
- 81 Similarly, excluding these payments from the measurement of the lease receivable by the lessor may result in overstating the carrying amount of the residual asset. If exercising the option is highly likely, the payments that the lessor will obtain in the optional period may be lower than the corresponding portion of the underlying asset's cost allocated to the residual.
- 82 We welcome that the Board has accepted EFRAG's recommendation that the lease term should not be based on the longest term more likely than not to occur, as was suggested in the 2010 ED. However, we recommend maintaining the current notion of 'reasonably certain' in IAS 17.
- 83 EFRAG believes that the current practice of accounting for lease options works well. In paragraph 140 of the Basis for Conclusions, the Board agrees with this assessment and notes that applying the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably certain' in existing IFRS.
- 84 We therefore think would be advisable to maintain the current definition, which is well understood by preparers and users. Replacing it with 'significant economic incentive' may lead to a view that the Board is introducing a completely new threshold, which is not the case. The analysis of economic factors developed by the Board in paragraph B5 is indeed useful, but we recommend presenting it as application guidance to help assess when the exercise is reasonably certain.
- 85 It is important to emphasize that an entity needs to consider all economic factors relevant to that assessment. The fact that an option is in the money should not be conclusive in isolation. For this reason, we recommend revising Illustrative Example 16 which as it stands may suggest that an entity has a significant incentive to exercise a purchase option only because the exercise price is lower than the current market value of the underlying asset. The example should remind constituents that all relevant factors need to be considered to reach that conclusion.

*View B – reject recognition of payments due under options*

- 86 EFRAG does not agree with the Board proposal to recognise a liability for an option that grants a significant economic incentive. The Board proposal implies that an entity that has an incentive to extend a 5-years lease for another 5 years is in the same economic position as an entity that has a fixed 10-years lease. We do not think that this is the case and believe that the obligating event that gives rise to a liability is the lessee's decision to exercise the option.
- 87 The IASB proposal leads to recognition of a liability based on economic compulsion and expectations of future behaviour. We believe that this is in conflict with other Standards. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that an entity has a present obligation before requiring a liability - it is only those obligations arising from past events independently of an entity's future actions (i.e., the future conduct of its business) that are recognised as provisions.
- 88 Likewise, the inclusion of payments due under options in the measurement of the lessor's receivable appears even more inappropriate because the lessor does not have the ability to control the lessee's future decisions, or even predict them reliably.
- 89 Our view does not imply separate recognition and measurement of the options. There is consensus that current option pricing models and techniques are inadequate for lease options, as the exercise of these options generally depends on entity-specific considerations rather than observable external facts. Lessees should provide sufficient disclosure of options so that users may adjust the reported numbers as they deem fit for their purposes.
- 90 We understand that the Board may be concerned about structuring opportunities, were options never to be included in the assessment of the lease term. EFRAG is usually not supportive of including anti-abuse provisions in accounting Standards. However, the IASB could introduce a notion of 'in-substance fixed term' (mirroring in-substance fixed payments) to capture periods that are options only formally.

**Question to constituents**

- 91 Do you support view A or view B in relation to the recognition of payments due under optional periods?

*Exemption for short-term leases*

- 92 EFRAG welcomes the fact that the IASB has accepted the recommendation from EFRAG and other constituents to extend the exemption for short-term leases to lessees. The cost of recognising these leases would outweigh the benefit. However, we believe that the exemption should still be improved.
- 93 Under the proposals the significant economic incentive affects differently the assessment of a lease term and the use of the short-term option. If a contract has a fixed term of less than 1 year and an option to extend it for another year, and the entity concludes that the option does not offer a significant economic incentive, the entity accounts for a lease term of less than one year but is not able to use the exemption. If the contract cannot be treated as a short-term lease it may seem illogical to measure it as one.

- 94 This different application seems to be mostly driven by the concern of abuse. If the assessment of the significant economic incentive was also relevant to apply the exemption, an entity could try to achieve non-recognition by having a fixed term of less than 12 months and multiple 1-year extensions, and then arguing that the options do not provide incentive. While we acknowledge that this is a possibility, EFRAG usually does not support mere anti-abuse provisions in accounting Standards.

**Question to constituents**

- 95 Do you support the definition of short-term leases in the ED? Or do you think that the exemption should be applicable also when the possible duration of the contract is more than 12 months but the lessee has no significant economic incentive to stay in the contract for 12 months or more?

**Question 6: variable lease payments**

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

**Notes to constituents**

- 96 *Variable lease payments should not be included in the measurement of lease assets and liabilities with the exception of:*

- (a) variable lease payments are linked to an index or rate;*
- (b) lease payments that are in-substance fixed payments, but are structured as variable lease payments.*

*Variable lease payments are defined as lease payments that arise under the contractual terms of a lease because of changes in facts or circumstances occurring after the date of inception of the lease, other than the passage of time.*

- 97 *The ED requires that:*

- (a) Index or rate-based variable lease payments should be measured initially using the index or rate that exists at the date of commencement of the lease;*
- (b) Index or rate-based variable lease payments should be reassessed at the end of each reporting period; and*
- (c) Changes in the measurement of index or rate-based variable lease payments should be reflected:*
  - (i) in net income to the extent that those changes relate to the current reporting period; and*
  - (ii) as an adjustment to the right-of-use asset to the extent that those changes relate to future reporting periods.*

**EFRAG's response**

- 98 EFRAG welcomes the IASB's decision to exclude usage and performance-based variable lease payments from the measurement of the lease liability and lease receivable.
- 99 We support inclusion of variable payments based on an index or rate, but are concerned that the notion of 'in-substance fixed payments' is not fully clear. The IASB has not provided a principle to identify in-substance fixed payments so the application of this notion will be based mostly on the Illustrative Examples.
- 100 Examples cannot replace principles-based requirements and may be interpreted in different ways. Example 17 requires recognition of an amount that is due irrespective of the level of sales. In our view, this amount would qualify as a fixed payment. If this is the only type of payment that the IASB wants to capture, there is no need to introduce a notion of in-substance fixed payments.
- 101 We fully agree that variable lease payments should not be recognised only because they are highly probable. Example 18 is quite useful in making clear that if payments are based on future sales, no payment is recognised regardless of the fact that the entity will certainly generate sales in future.
- 102 There are other types of clauses that could qualify as in-substance fixed, for instance when the contingency is not genuine, or a significant payment is triggered by an extremely low threshold. If these are the payments that the IASB intends to capture, then it needs to provide a clear principle - in our view example 17 would not provide a robust basis to require the inclusion of these payments in the measurement of the liability.
- 103 The issue of variable payments is surfacing in other projects; for instance contingent consideration is addressed in the revenue recognition project and the IFRS Interpretation Committee is currently discussing contingent payments on the acquisition of tangible and intangible assets. We recommend that the IASB should reach consistent conclusions on the treatment of contingent and variable payments across different projects.

**Question to constituents**

- 104 Do you agree that more guidance is needed for in-substance fixed payments? If so, do you have suggestions on how to develop it?

**Question 7: transition**

Paragraphs C2-C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not what transition requirements do you propose and why?

Are there any additional transition issues that the boards should consider? If yes, what are they and why?

**EFRAG's response**

- 105 In general terms, EFRAG is in favour of full retrospective application. However, lease arrangements may have long durations and lessees may not have the information to apply new requirements fully retrospectively. We agree with granting practical reliefs that lead to the reduction of implementation costs.
- 106 We also agree with the proposal to carry forward the amounts recognised before the transition date for leases previously classified as finance leases. This will avoid that expenses already charged in the lessee's profit and loss are recognised for a second time after adopting the new Standard.
- 107 Paragraph C4 of the ED requires that an entity adjusts equity at the beginning of the earliest comparative period presented. However, paragraph C8 of the ED requires the use of the lessee's incremental borrowing rate at the effective date. EFRAG believes that it would be more consistent to require the use of the lessee's incremental borrowing rate at the beginning of the earliest comparative period.
- 108 EFRAG also believes that entities should not be required to recognise lease liabilities and right-of-use assets for leases previously classified as operating leases, if the term has ended before the end of the period in which the new Standard is applied.

**Question to constituents**

- 109 Are there additional transitional relief that the IASB should consider?

**Question 8: disclosures**

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what change do you propose and why?

- 110 EFRAG welcomes the requirement in paragraphs 59 and 99 of the Exposure Draft that an entity should consider how much emphasis to place on each requirement to satisfy the objectives. The list of requirements is extensive and we believe that it should be clearly stated that not each of them will be needed in all situations.
- 111 Presentation requirements in the ED will allow lessees to present the impact of leases in different lines of the statement of financial position, statement of comprehensive income and statement of cash flow. This is partly the effect of the dual measurement approach (which EFRAG does not support as mentioned in the discussion above) but also of the exemption allowed for short-term leases.
- 112 EFRAG thinks that users would benefit from a requirement to disclose in one location comprehensive information about total rights and obligations and related income and cash flow effects inherent in lease contracts of which the entity is part of.
- 113 EFRAG recommends providing a better explanation of why entities should provide reconciliations of balances for Type-B leases, or why separate reconciliations for Type-A and Type-B liabilities are necessary although their measurement is the same,

**Question to constituents**

114 Do you have suggestions to improve the disclosure requirements?

**Note to constituents**

115 Questions 9, 10 and 11 in the ED are for FASB only.

**Question 12: consequential amendment to IAS 40**

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property. Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

**Notes to constituents**

116 *Under the current guidance relating to leases of investment properties, an investment property leased under a finance lease is measured, presented and disclosed under IAS 40 Investment Property. This guidance allows also lessees to elect for an option to account for investment properties held under an operating lease, under a fair value model. Current guidance does not allow cost model accounting for such investment properties.*

**EFRAG's response**

*View A – support measurement at fair value of right-of-use asset when the leased property is investment property*

- 117 As mentioned above in our reply to question 2, EFRAG recommends that a lessee should not recognise Type-B leases and usually leases of real estate would qualify as such. If lessees were required to recognise Type-B leases, then the proposed amendment seems a logical consequence and we would agree that a right-of-use asset of an underlying investment property should be measured in accordance with IAS 40.
- 118 However, we are concerned that the guidance in IAS 40 and IFRS 13 *Fair Value Measurement* should be amended to assist preparers in dealing with options. Under the current requirements, IAS 40 is usually applied only to interest in investment property held under a finance lease. As noted in paragraph 312 of the Basis for Conclusions of the ED, finance leases typically do not include variable lease payments or unrecognised optional lease payment. So currently the application of fair value model does not usually need to deal with these components.
- 119 This issue would become more important following the proposed amendment, because existing operating leases of investment property are more likely to include options or variable payments. Applying IAS 40 measurement requirements would involve measuring the market value of the options. As noted in paragraph 137 in the Basis for Conclusions, options may be difficult to be measured reliably.

*View B – reject measurement at fair value of right-of-use asset when the leased property is investment property*

- 120 EFRAG believes that a fair value measurement is appropriate only when the lessee eventually obtains the ownership of the investment property. In many cases (currently accounted for as operating leases) the carrying amount of the right-of-use asset will be equal to nil at the end of the lease term, such that the lessee is normally unable to realise the fair value of the right-of-use asset.

**Question to constituents**

- 121 Do you support View A or View B on fair value measurement of the right-of-use assets classified as investment property?

*Interaction between variable lease payments and the rate the lessor charges the lessees*

**Note to constituents**

- 122 *Paragraph 72 of the ED states that if the lessor incorporates an expectation of variable lease payments in the rate charged to the lessee, it should incorporate them in the initial measurement of the residual asset. Paragraph 82 states that the lessor in subsequent periods shall derecognise a portion of the carrying amount of the residual asset in each period and recognise a corresponding expense in profit or loss.*

**EFRAG's response**

- 123 The proposals in the ED imply that a lessor has an option to either incorporate an expectation of variable lease payments in the discount rate or not. The ED then requires a different measurement of the residual based on the choice taken.
- 124 EFRAG would rather recommend that the ED defines the conditions under which a lessor would be required to include or exclude an expectation of variable lease payments when assessing the discount rate.

*Costs to return the asset in a specified condition at the end of the lease*

- 125 Paragraph 40 of the ED requires to measure the right-of-use asset initially at the amount of the initial measurement of the liability plus any lease payments made before commencement, less any lease incentive received by the lessee and plus initial direct costs. According to paragraph B10, initial direct costs include payments made to existing tenants to obtain the lease.
- 126 EFRAG welcomes that the IASB has explicitly addressed payments made by and to the lessee to enter into the lease arrangements. However, we note that a lessee may incur costs to return the underlying asset in the specified conditions and location at the end of the lease term. The ED does not address these costs, although the related amendment to IFRIC 1 has been proposed. EFRAG recommends an explicit mention of these costs in paragraph 40, as an element of the initial measurement of the right-of-use asset.

Accretion of residual asset

**EFRAG's response**

127 In its comment letter on the 2010 ED, EFRAG concluded after consultation with its constituents that the measurement should depict the return that lessors earn on the total investment in the lease, which includes both the receivable and the residual. We note that under the finance lease model in IAS 17 lessors are able to recognise a constant yield on the total investment. EFRAG concluded that accretion of an interest component on the residual conveys more relevant information because:

- (a) the initial measurement of the residual is based on the present value of its expected value at the end of the lease (excluding a deferred sales profit for manufacturers). Given how this initial carrying amount is determined, it is logical to unwind the discount;
- (b) the residual represents the portion of leased asset that is not encumbered by the transfer to the lessee of the right to use the underlying asset. As the lease term progresses, this asset becomes progressively less encumbered because the lessor comes closer to reuniting all the rights associated with the asset. Accretion depicts this progression.

128 However, some constituents challenge the unwinding of the discount on the residual asset, on the basis that:

- (a) Accretion is perceived as inconsistent with a cost-based measurement of a non-financial item; and
- (b) The lessor does not perform any revenue-generating activity in relation to the residual asset during the lease term.

**Question to constituents**

129 What is your view in relation to the accretion of the discount on the residual asset?

Presentation of Type-B leases

130 The proposals require a lessee to present amortisation of the right-of-use asset and unwinding of the discount for Type-B leases as a single lease expense in its statement of comprehensive income. In the Basis for Conclusions, the Board argues that presenting a single amount provides more useful information because, for such leases, the lessee is paying to use the underlying asset and does not acquire a significant portion of the underlying asset itself.

131 EFRAG believes that this argument is in conflict with the requirement to present the amortisation of right-of use assets (paragraph 61) and the unwinding of the discount (paragraph 64) as separate items in the reconciliation of opening and closing balances. This is another example where the right-of-use model cannot readily be applied to Type-B leases.

132 Also, EFRAG notes that paragraph 193 of the Basis for Conclusions identifies lease liabilities as financial liabilities (although presented separately from other financial liabilities). The different accounting treatment of Type-B leases and the presentation of its cost in the statement of comprehensive income do not seem consistent with a presentation of the liability as a financial liability.

- 133 EFRAG also believes that it would be appropriate to reconsider whether the current requirements in IAS 7 *Statement of Cash Flows* applicable to leases provide the most useful information – namely, around presenting a lease as a cash or non-cash transaction at commencement, and presenting lease payments as repayments within financing activities or as payments to acquire property, plant and equipment within investing activities.

Presentation of lease assets in the lessor's statement of financial position

**Note to constituents**

- 134 *The proposals require a lessor to present lease assets (i.e., the sum of the carrying amount of lease receivables and residual asset) separately from other assets; the lessor can choose to either present the lease receivables and the residual assets as separate amounts on its statements of financial position, or disclose them in the notes.*

**EFRAG's response**

- 135 EFRAG questions that the lessor should be allowed to present the lease asset as a single amount in its statement of financial position. EFRAG notes that:
- (a) The lease receivable and the residual asset are different in nature. The lease receivable is a financial asset – although some of the measurement requirements may be different from requirements in IAS 39; the residual is a non-financial asset, as confirmed by paragraph 257 of the Basis for Conclusions;
  - (b) The lease receivable and the residual are intended to be recovered in different ways and are subject to different risks.
- 136 EFRAG believes that the aggregation of items in the main statements should be based on shared qualities. Although the lease receivables and the residual are recognised as the result of the same transaction, we do not think that this is sufficient to aggregate them in a single amount.
- 137 Moreover, we question if it is not more appropriate to identify the 'receivable' rather as a 'lease asset'. The amount may not qualify as a receivable as the lessor's legal title to collection does not depend only on the passage of time. In the ED on revenue recognition, these amounts are identified as 'contract assets'.

Variable lease payments in interim reports

- 138 Paragraph B7 of the Illustrative Examples in IAS 34 states that contingent lease payments are an example of a legal or constructive obligation that is recognised as a liability. An entity should recognise contingent lease payments based on a certain level of annual sales, if that level of sales is likely to be achieved and the entity has no realistic alternative to make the payment.
- 139 It is not clear if this requirement creates a conflict in the current literature. IAS 17 is silent about the treatment of variable payments. In July 2005, the IFRS IC noted that the standard would allow alternative treatments for variable payments, but decided not to issue an interpretation because there was no evidence of diverging practices – most preparers recognise variable payments only when they are due.
- 140 The IASB is now proposing that variable lease payments linked to future performance or use would not be included in the measurement of lease assets and lease liabilities. EFRAG believes that paragraph B7 of IAS 34 – that many perceive as an exception to the requirement to use the same accounting policies for interim reports as in annual reports - will now create a conflict with the proposals in the ED.

- 141 Assume a scenario where an entity pays a variable lease payment if at the end of a two-year period it reaches a certain revenue threshold. If at the end of the first six months it expects to attain the threshold, paragraph B7 of IAS 34 would require accruing a portion of the variable lease payments; but at the end of the first year, the entity would have to reverse the accrual even if it has not changed its expectation, because under the ED those payments are recognised only after reaching the threshold.
- 142 EFRAG believes that IASB should align the treatment of variable lease payments in interim reports to the proposals in the ED.

Consequential amendments to IFRS 3 Business combinations

**Note to constituents**

- 143 *The proposals require that an acquirer in a business combination shall not recognise assets or liabilities for leases of the acquiree that, at acquisition date, have a remaining maximum possible term under the contract of 12 months or less.*

**EFRAG's response**

- 144 EFRAG notes that under the proposed amendment, the acquirer would not be able to recognise the acquiree's leases with a remaining term of less than 12 months even if the acquiree had an option to purchase the underlying asset. This would lead to a strange outcome – the acquirer would be forced not to recognise the contract at acquisition, but would then recognise the underlying asset if the acquiree exercises the option at the end of term. We do not think this is appropriate.
- 145 Therefore, we recommend that the revised paragraph B54B of the IFRS 3 *Business Combinations* should refer to 'leases that if assessed at acquisition date would meet the definition of short-term leases' rather than 'leases that have a remaining maximum possible term under the contract of 12 months or less'.
- 146 EFRAG also believes that the acquirer should be allowed not to recognise those contracts, but not prevented from doing so. Allowing an option to the acquirer would simplify the adjustment process for consolidation purposes.