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Rome, 6 July 2009

Re: Comments on IASB's Discussion paper Leases

Dear Sir/Madam,

The OIC is pleased to provide its comments on the proposed changes to the accounting standard on leases (IAS 17) drawn up by IASB and FASB, presented in the related discussion paper (hereinafter "the DP").

While OIC is interested in such modifications, it nevertheless stresses that as of today the DP covers only part of the accounting aspects and issues, and then it requires further research and analyses to be completed, to make it both simpler and more specific to provide users with more useful information. OIC wishes also to emphasize that the more complex the accounting rules are, more uncertainties arise, and greater is the risk of misuse. This would jeopardize the advantages sought in the proposed changes.

OIC also notes also that any change entails significant administrative costs. Consequently, the adoption of a new approach must be weighed carefully in terms of costs/benefits. OIC believes that new rules should be issued only if they are immediately complete and consistent within a stable framework, to avoid the risk of having to intervene again in the same area with other changes. Each subsequent rule change means further administrative costs and also renders adopted rules less credible, and thus less useful for users.

Hence, in terms of the amendment process, it is in our view more appropriate first to complete the project on the framework and then the lease one. Only in this way it will be possible to ensure, immediately, consistency between any new standard and an amended framework. The same holds true for all DPs that seek radical new approaches to standards (revenue recognition as an example).

To avoid continuous subsequent changes, OIC also recommends also that the DP be immediately complete. It is thus necessary that it also include accounting standards for the lessor. These rules should be symmetric with those of the lessee. In particular they must be consistent and operational also in the case of "subleasing" (see. DP, point 10.31), in which the intermediate subject is both a lessee and a lessor. Ensuring such consistency and symmetry is essential for confirming the correctness of the new methodology to be adopted for lease accounting. We are thus strongly contrary to the idea of maintaining the current standard of IAS 17 for the lessor while changing it for the lessee. The result would be detrimental in terms of the credibility of accounting rules, which would be presenting non comparable information and problems of uniformity in the case of subleasing.

Because of the above, this letter does not limit itself to commenting on the questions posed by the DP, but it also includes some brief considerations on accounting for leases – for both the lessee and the lessor – which appear to satisfy the need for correct and consistent information, without significantly raising costs for the entities applying the standard. These considerations have been developed with reference to a numerical example in order to facilitate their understanding.

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?
If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

In general terms, we agree that the scope be the same as IAS 17 except for excluding the case of instalment purchases, in which IAS 18 would apply. OIC recommend to clearly define the scope of the standard to avoid the risk of its overlapping with the provisions of IAS 38. In addition, it seems appropriate to exclude service (executory) contracts from the scope of the standard, in order to avoid further uncertainties.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Although we at OIC appreciates the reasons behind the proposal we nonetheless believe that it is difficult to – draw – a clear-cut line distinguishing between core business and non-core business. This gives rise to uncertainties and possible misuse.

Question 3

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

OIC agrees that the rights and obligations of the contract respond to the framework's definition of assets and liabilities. We recall, however, that this holds true if referred to the current framework. It would then be more appropriate to apply it with reference to the new framework once the relative project is complete.

Question 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)

(b) a liability for its obligation to pay rentals.
Appendix C describes some possible accounting approaches that were rejected by the boards.
Do you support the proposed approach?
If you support an alternative approach, please describe the approach and explain why you support it.

OIC is generally in favour of the new approach, providing significant simplifications are made to the proposed rules.

Question 5

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

Question to EFRAG's constituents

As the paragraphs above show, EFRAG members are divided on this issue. Some believe that the approach the DP proposes is the only practical approach and is also the most useful (it focusing on the expected cash outflows from the lease); whilst others believe that that approach will result in amounts being recognised that are not understandable or comparable and misrepresents the flexibility the lessee has. We would therefore particularly welcome your views on the issue. Do you agree with the approach proposed in the DP? If not, what are your major concerns and why do you believe that the components approach is capable of practical implementation?

OIC favours the recognition be made by means of a single asset and a single liability

Question 6

Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?
If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

In order to reduce the risk of uncertainties and increase the comparability between entities, OIC favours the use of the implicit interest rate. The difficulty of estimating the value of the asset results in measuring it on the basis of the related cost. To measure the liability, the only interest rate capable of reducing uncertainties and increasing comparability is the implicit interest rate, to the extent it is available; if not, , the best rate is the incremental borrowing rate, although it would reduce comparability between entities entering into equivalent contracts. Finally, OIC agrees with adopting the initial linked recognition of the transaction.

Question 7

Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?
If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

OIC agrees.

Question 8

The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

With reference to the sample case presented in the DP, OIC does not agree with the methodology proposed; on the contrary, OIC believes it is appropriate to adopt the linked approach to subsequent measurements.

In OIC's opinion, assets and liabilities can be recognized only if (a) they are linked and (b) the right is related to a real obligation, in view of the nature of the contract. The DP itself takes into account the linked nature for both the original entry and for subsequent valuations of options (6.51) and contingent rentals (§ 7.29).

As a result of the linked representation of the lease operation, OIC believes the following should not be recognized in the balance sheet: options to (a) extend the lease on payment of additional rentals, (b) accelerate termination of the lease, (c) purchase the leased asset on payment of an additional amount, and obligations to pay variable rentals or contingent rentals.

To illustrate the above, consider the following. If the method proposed by the DP were adopted, when analysing the representation of accounts from the lessor's point of view, for instance of a leasing contract with the option for the user to extend the contract's duration from 10 to 15 years, the lessor would claim *by symmetry* the option of presenting in the balance sheet the right to receive lease rentals for 15 years when it assumes it is likely that the option will be exercised by the lessee (perhaps the mere fact that the lessee presented in its own accounts the right of use for 15 years, may induce the lessor to estimate such a likelihood). This would result in an inappropriate representation of an asset by the lessor, consisting in a *right to receive rentals* (or rather the part relating to the 5 additional years) that are not certain.

On the other hand, OIC believes that the obligation to compensate the lessor if the value of the leased asset declines below a specified value (residual value guarantees in line with the provisions of IFRIC 1) should be recognized.

The asset should be measured according to the amortised cost method applicable to liabilities. This treatment is consistent with the nature and the likely benefits of the transaction. Otherwise, should the lessee withdraw from the contract prior to its expiry, it would recognize a capital gain or loss solely because of a mismatch between the value of the asset and that of the liability. The asset and the liability should be balanced when applying the amortised cost provided by IAS 39. This does not imply that the asset cannot be written down. When there is a recovery in its value, the amortised cost will represent the maximum value. This would ensure consistency between asset and liability while recognizing any loss that may have occurred in the meantime.

The lack of consistency between the valuation of the right and other IASs derives from the nature of the transaction, since it appears impossible to obtain full coherence with other IAS/IFRS standards, as already observed in the DP itself (§5.36).

Question 9

Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

OIC believes that it should first be made clear that the notion of fair value should refer to the lease contract taken as a whole and not to the individual asset and liability components, as these elements cannot be separated and cannot be sold separately. Having said this, the fair value valuation might be part of the disclosures, indicating the potential value of the contract should it be sold to a third party. In this way, it will also be possible to assign a value to the various options included in the contract. It should, however, be remembered that such fair value is normally estimated by means of models (level 3). Because of this, OIC believes that only a broad disclosure of the contractual clauses and intentions of the entity should also be made.

Question 10

Should the lessee be required to revise its obligation to pay rentals to reflec changes in its incremental borrowing rate? Please explain your reasons.
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

No. The remeasurement of the liability due to a change in the market’s incremental borrowing rate in a linked representation of the transaction offers information of no relevance. In addition, this change would not be consistent with the provisions of IAS 39 on amortized costs, and above all it would be costly and complex.

Question 11

In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have

been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

OIC agrees.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.
Would you support this approach? If so, for which leases?
Please explain your reasons.

Although in a linked approach the amortisation of the right is calculated with the financial method, we believe it cannot be considered a rental expense. It remains the amortisation of a right, even if it is linked to a liability.

Question 13

The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Question to EFRAG's constituents

As the paragraphs above show, EFRAG members are divided on this issue. We would therefore particularly welcome your views on the issue. Do you agree with the approach proposed in the DP? If not, what are your major concerns? And what approach would you favour instead?

OIC does not agree. If the right and obligation approach is followed, it is necessary to recognize the assets and liabilities generated by the contract. The option to extend the lease on payment of additional rentals, until it is actually exercised, does not have a related liability, thus it cannot be recognized. The case where an entity has a ten-year contract with an option for a further 5 years is economically different from that of a company with a 15-year contract. There is a difference in terms of costs and operating flexibility. With an asset obligation approach, information as to this option should be included in the disclosures.

Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.
Would requiring reassessment of the lease term provide users of financial statements with more relevant information?
Please explain why.

No. See comment to question 13

Question 15

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.
Do you agree with the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Yes. See comment to question 13

Question 16

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.
Do you support the proposed approach?
If you disagree with the proposed approach, what alternative approach would you recommend and why?

No. Contingent rentals (actual and future) should be recognized only when the trigger event has happened.

Question 17

The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.
Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Question to EFRAG's constituents

We would particularly welcome views on this issue. Do you think the measurement of the lessee‟ s obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable or should be on the basis of the most likely rental payment?

No. If the price for contingent rentals changes, the lessee's performance and usage are parameters to measure the greater or lesser cost incurred during the year. Their recognition in the profit and loss statement is consistent with the general principle of the accruals basis. Of course, disclosure of the contractual terms, including the existence of contingent rentals is an essential piece of information.

Question 18

The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.
Do you support the proposed approach? Please explain your reasons.

Yes. Their recognition in the profit and loss statement is consistent with the general principle of the accruals basis.

Question 19

The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.
Do you support the proposed approach? If not, please explain why.

No. See comment to question 13.

Question 20

The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

No. See comment to question 13.

Question 21

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.
Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

The Residual Value Guarantees may provide for a payment of an amount independent from the will or control of the lessee, since at the completion of the lease contract the asset may actually have a value below that contractually guaranteed. OIC believes that this case should be treated in accordance with IFRIC 1 provisions. The measurement of this potential liability should be carried out in accordance with IAS 37.

Question 22

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.
What additional information would separate presentation provide?

The financial liability should be presented separately since it is a liability linked to a lease contract. Separate presentation of both assets and liabilities relating to the lease is fundamental for allowing the users to interpret correctly the significant increase in the assets and liabilities of lessees resulting from the recognition of all leasing operations.

Question 23

This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.
How should the right-of-use asset be presented in the statement of financial position?
Please explain your reasons.
What additional disclosures (if any) do you think are necessary under each of the approaches?

Question to EFRAG's constituents

We would welcome your views as to whether describing a lease asset as an intangible asset is consistent with adopting a right-of-use approach.

The right of use should be presented separately according to the nature of the underlying leased item, in order to provide a meaningful information on the company's operations and the special status of these assets.

Question 24

Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

With reference to the timing of initial recognition, OIC agrees that at the time the contract is entered into rights and obligations that could meet the framework definition of asset and liability are created. However, it should be considered that the use of the leased item and thus the related obligation to pay rentals usually begins only upon delivery (inception). Consequently, OIC believes that rights and obligations should generally be recognized on that date. Nevertheless, there are particular cases, such as a lease of real estate still to be built, where the lessee, upon acceptance of the progress reports, commits itself to repay the sums advanced by the lessor to the builder. It is then necessary to define specific rules for those cases where, even prior to the effective date, it is appropriate for both the lessee and the lessor to recognise their respective assets and liabilities.

Question 25

Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Yes. It meets the (present) framework's definition of assets.

Question 26

This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.
Which of these two approaches do you support? Please explain your reasons.

OIC favours the recognition of a receivable (the logical counterpart of the lessee's payable) and, if any, the net present value of residual value.

During the life of the lease, the lessor revenues in profit and loss statement will include the interest on the receivables (the value of which could be not the same as that calculated by the lessee only because the rate of interest of the latter might be different from that used by the lessor, if no rate is explicitly indicated in the contract) and, if any, the interest on the residual value.

It should be noted that the correctness of the accounting methodology thus suggested – thanks to the symmetry and consistency of the approach it is based on – is highlighted when it is applied to a sub-lease contract, as described in point 10.31 of the DP. It also resolves the problems deriving, for the lessor's accounts, from the existing IAS 17 method regarding operating leases.

The attachment gives a numerical example which – with reference to a sub-lease – makes it easier to appreciate the suggested methodology.

Question 27

Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

The standard should be complete. It is thus necessary to specify when it would be appropriate for a lessor to recognise income at the inception of the lessee. It would be desirable, to the extent possible, to ensure consistency with other standards.

Question 28

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

Yes. The principle should be complete and consistent in its various treatments. Wherever possible, further changes to principles and policies should be avoided. Standards should be issued after a careful and in-depth analysis once they are complete. It is not a good idea to begin with incomplete or fragmented rules that will be detrimental to the quality and the comparability of information, with the risk that it will then be necessary to change the rules, leading to further costs and doubts as to the credibility of the process adopted to issue them.

Question 29

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

No.

Yours sincerely,

Angelo Casò
(OIC Chairman)