SVENSKT NÄRINGSLIV
CONFEDERATION OF SWEDISH ENTERPRISE

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

commentletters@iasb.org

cc: info@efrag.org; main@businesseurope.eu

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Discussion Paper DP/2009/1
Leases - Preliminary Views

The Swedish Enterprise Accounting Group (SEAG) is a forum for Chief Accountants from the largest Swedish listed companies. The Group is administered by the Confederation of Swedish Enterprise, to which most participating companies of SEAG are joined.

Representing preparers' point of view, SEAG welcomes the opportunity to comment the above-mentioned Discussion Paper. Before answering the specific questions, we would first like to highlight a few key concerns:

§ We acknowledge the importance of leasing as a source of finance for companies and we agree on the need for a complete and understandable picture of the leasing activities of a company. We also constantly experience the resources needed for both us as preparers as well as users to distinguish between operating and finance leases. Having said that, we welcome any clarification and simplification in the area of lease accounting. However, we question whether the proposed changes would answer to the purpose of changing the model. We believe that the current model of having two different accounting treatments for leases depending on the nature of the arrangements, with additional disclosures in the notes, actually results in financial statements that provide the user with very useful information.

§ There are already today quite extensive disclosure requirements for leases, easy to find in a separate note, in order for users to make any adjustments needed for their analyses purposes. Different users use the information of the annual report differently and leasing is not the only area for which users may make adjustments, but that is not a reason for us to consider changing our accounting model before having established that we really want to change the fundamental underlying accounting principles.

- For many companies operating leases typically consist of a large number of lower value components, such as IT-equipment or rental agreements on real estate. The cost of reporting lower value components as assets and liabilities with reassessments of lease periods, conditions etc at every reporting date for all reporting entities would exceed any benefit we could possibly gain from recognising these assets on the balance sheet. Defining the value of a right-to-use asset from a real estate rental would require enormous resources and lead to volatility if needed to be fair valued. Adding on scope limitations with regard to non-core activities or short-term leases would create a similar situation as the one we have today (the need for a distinction between finance and operating leases). In addition, operating lease agreements are often connected with service agreements and we would still need to make a distinction between the asset part and the service part. We are concerned that the proposed model would be exposed to even more subjectivity in interpretation than the lease reporting under the current model. An example of this is the boards' tentative guidance when determining the likely lease term. It is our view that for many cases external evidence will not be available.

- We understand the time factor inherent in reviewing the full lease accounting model from both a lessor and lessee perspective. However, it is simply not acceptable to change the model for one side only with reference to time constraint. Especially not if disclosure requirements could be adjusted to meet the requirements before a complete and well functioning model is in place. In other projects such as revenue recognition, there are discussions regarding when performance obligations have been fulfilled and control has passed. In the consolidation project it is stated that control cannot be shared. Opening up for a double recognition of assets in both lessor and lessee accounting may be contra dictionary to the development in these parallel projects. A complete leasing model needs to be elaborated and the fact that lessor accounting relates to other ongoing projects make it even more important to start at the right end of the discussion, in the Framework. Many of our member companies are both lessors and lessees and foresee difficulties in communicating a set of financial statements recognizing in full operating leases in both roles.

- There are still issues in the Discussion Paper that are not resolved, such as impairment, whether the revaluation model would be permitted to be applied to a "right-of-use" asset and method of transition. The boards will discuss those issues after comments are received on this Discussion Paper. Depending on what the boards will determine regarding the method of transition, the effect and impact on lease agreements existing at the effective date could be rather extensive and the transition will be costly for many companies.

- § Bearing in mind that neither the lessor perspective nor all-important issues from a lessee perspective have been considered due to lack of time, we see further reasons to postpone the discussion paper until the whole picture could be presented, to save costs for the full model implementation when fully elaborated.
- § With this introduction and our answers to the specific questions, we explain why we disagree with the proposed revisions to the lease accounting model. If anyway the proposed model would become a standard, there are details that we find particularly important to comment. The likely lease term should be based on the entity perspective and management intent, rather than on a model based on what is likely for a certain type of business in a geographical location.

To sum up the fundamentals of this discussion, the importance of a common definition of an asset and a liability cannot be neglected. In times when more and more countries with different accounting traditions are striving to adapt to IFRS, there is a need for a fundamental stable ground of core principles before implementing changes to satisfy certain needs, with the result of temporarily having a skewed accounting model. In addition, creating a common model must cover the deviations that we have today between IFRS and US-GAAP for all areas related to leasing and be far-stretched enough in order to avoid different interpretations.

We would strongly recommend a continued use of the current model until a complete lease model has been elaborated. A complete lease model should cover both lessee and lessor accounting, should be built on the conclusions from the ongoing Framework project and should have a strong connection to other related projects such as revenue recognition and derecognition.

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.

We agree with the scope.

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.

In accordance with the discussion regarding this matter in the DP, we believe that the exclusion of non-core assets or short-term assets would lead to constant debates on definitions. However, considering the enormous amount of work that risk to be put into continuous follow-ups on operating lease agreements for assets *with the nature of being* non-core or short-term, there is a need for some kind of threshold in scope based on materiality.

One of the criticisms of the current accounting model is that current standard provide opportunities to structure transactions to achieve a particular lease classification. Introducing an exclusion of non-core assets and short-term asset will increase the possibility to structure a transaction to achieve a particular lease classification.

Accordingly, the materiality discussion needs further clarification. A distinction based on materiality could include a possibility to exclude assets that are individually immaterial, fungible and not part of the production or distribution process of the lessee.

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.

As stated in the introduction to this letter, we have some concerns regarding the analysis of assets and liabilities arising in a simple lease contract.

- The purpose of the proposed model is to present for the user "the true balance sheet". The model means that the asset value is equal to a theoretically calculated liability, not being a "legal liability". The thus theoretical asset values based on right-of-use will most likely cause confusion for the user. Right-of-use values will not represent the value as if, for example, facilities where owned by the entity, mainly due to the following reasons:

  - The NPV of lease payments based on most likely lease term will for recently built facilities probably be lower than the present market value.
  - For older facilities, leased during a longer period, the recognized amount might be higher than the book value of an owned facility, due to that owned facilities will over time be depreciated to zero.

We question what the right-of-use value really represents?

- As for the definition of liabilities we believe that it is fair to disclose the current obligation to pay future lease payments which gives users of financial statements a possibility to make desirable adjustments in their analysis. Additional likely lease payments are according to our view not a present obligation but a result of future events and decisions.

- We are concerned whether the introduction of "right-to-use" will and could be applied for other arrangements and what impact that would have on the financial statements.

We would like to see the Framework project and its discussion on a definition of assets and liabilities being finalised before changes are being proposed to a current model. When comparing asset definitions in parallel projects, we do not see that we have the exact same direction. We are not interested in having a preliminary model for a certain time that might be further adjusted when lessor accounting, the Framework project and other projects are finalised.

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.

See our answer to question 3 regarding our concerns with the proposed approach.

In the light of the proposed approach, we support to maintain the approach adopted in existing standards until a full lease model, including both the lessor and lessee perspective, has been developed and that are aligned with the definition of asset and control in other projects and standards.

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?

We support the idea of *not* recognising individual assets and liabilities on every component of the contract.

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.

We agree. The effect of discounting is larger the higher the rate. On the other hand the amounts to pay and the fact that weaker companies many times are offered shorter leasing periods would offset the impact of discounting based on a higher rate.

We believe that the most common method today is to calculate the present value using the lessee's incremental borrowing rate, since it is often difficult to determine the interest rate implicit in the lease (especially regarding lease contracts containing service arrangements).

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.

Yes, we agree that if recognised on the balance sheet, the asset should be measured at cost.

However, we believe the cost approach needs to be further clarified. The proposal is comparing the cost approach with IAS 16 Property, Plant and Equipment and IAS 38 Intangible assets. In these standards the cost-based measurement includes direct costs such as transportation costs and dismantling costs. It should be clarified whether this approach also is applicable when measuring the cost for right-of-use asset.

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.

We agree with the amortised cost approach.

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.

No, it would not add transparency to the statements and would risk to further deteriorate the comparability between companies.

Question 10

Should the lessee be required to revise its obligation to pay rentals to reflect 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. Costs for this would outweigh the benefits.

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.

We agree with the principle of the alternative approach to require lessees to account for the obligation in accordance with existing guidance, as defined in relevant standards, on financial liabilities. See also question 3.

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.

We believe that the current model of classifying the payments as rentals (and interest cost) in the income statement is the most suitable approach to present the lease fees according to their nature. Hence, we do not believe that a right-of-use-model and amortisation is the best solution.

If however operating lease assets would be recognised in the balance sheet, contra dictionary to our view, then it needs to be clarified how the information and roll-forward of the assets should be presented. In such a case, the most suitable solution would be to classify decreases in value as amortisation or depreciation, however with a different treatment in the cash-flow compared to amortisation or depreciation on acquired assets.

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.

We disagree with the proposed approach, as we believe that the reported obligation should reflect the entity's real obligation towards the lessor. See also our answers to questions 3 and 11. If anyway the proposed model would become a standard, the likely lease term should be based on the entity perspective and management intentions, rather than on a model based on what is likely for a certain type of business in a geographical location.

For most sites/buildings an entity would not have access to market data required by the DP and would therefore have to buy this information (adding costs) and/or there is no market data (as for smaller cities, regions etc) available, leading to subjective valuations. We don't see that the benefit of such valuation exercises exceeds the cost, especially not when the alternative is to disclose the obligation according to the lease contract as we do in the current model.

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.

As stated in the answer to the previous question, we believe that the reported obligation should reflect the entity's real obligation towards the lessor, i.e. the minimum of lease payments that the entity has an obligation to pay. Accordingly we are not of the opinion that the lease period should be reassessed from a change in the likely lease period, but it should be reassessed in case the lease term is prolonged so that the lessee's real obligations to pay have been extended.

If a right-of-use asset should be recognised under the proposed model, then a change in the real obligation to pay should be reflected in the asset value and not in the income statement.

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.

Since we find it important to reflect the obligation based on what minimum lease payments we are obliged to pay under the current agreement (see question 3) with no consideration to options to extend the contract or to purchase the asset, the recognition of an asset would accordingly not include those possibilities either.

Our experience is that the purchase price included in options often is close to market price. If it is likely that an option to purchase will be exercised is thus dependent on current market price and assessed market price at maturity date. We therefore foresee difficulties to assess whether is likely that such options will be exercised and that the assessment of the most likely outcome could vary a lot during the leasing period.

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?

Amounts payable under contingent rental agreement should be included in the obligation in accordance with the outcome of the project discussing treatment of obligations under IAS 37.

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.

See our answer to the previous question. However, applying probability-weighted estimates would be very time-consuming if having many lease contracts with different possible outcomes. The assessment of both forecasts and probabilities of possible outcomes would create complexity and subjectiveness into the model. We foresee a risk that the financial statements loose understandability and reduce comparability for users.

As discussed in the introduction, we believe that it is important to have a common basic principle established in the Framework when it comes to the definition of liabilities and how and to what extent an entity's obligation should be reflected in the balance sheet and in contingent liabilities. That established principle should then be recognised in the different standards including the model for lease accounting.

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.

See our answers to question 16 and 17.

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.

See our answers to question 16 and 17. Yes, if believed to be in accordance with IAS 37 when finalised.

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.

We believe there is a strong connection between the right-of-use asset and the obligation to pay rentals. A misjudgement (or a reassessment) of the obligation would hence also be a misjudgement of the right-of-use asset. From our perspective, the profit and loss should be a measure of an entity's performance. As we see it, changes in liabilities to pay rentals due to misjudgement do not measure performance, especially not in economic recessions when we foresee a risk that estimated possible outcomes are overstated.

See also our answer to question 14.

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?

Yes, we agree.

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?

Yes, it should be clear to the user of the financial reports what kind of liability it is. Today we disclose future minimum lease payments in a specific note, which is easy to find and gives enough information in our view. The very same information should not be hidden among other liabilities under a revised model. That would be a step back from current disclosures.

It is also important to understand that there are different elements of risk in both the obligation to pay rental and the right-of-use asset compared with other owned assets and other obligations. This information should be clearly concluded for users of the financial statements. However, we also believe there are different elements of risk between in-substance purchase (today's finance leases) and other leases (today's operating leases) which also should be concluded in the financial statements. In that sense, we believe that the current model is good enough to fulfil requirements from users without making the lease accounting model more complex and subjective.

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?

We are sceptical to the right-of-use model and believe that the current model or smaller changes to the current model in terms of revised or somewhat increased disclosures may cover the need in a meantime. See the introduction to this letter.

Question 24

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

The proposal only deals with residual value guarantees from a lessee perspective. Many lease contracts often contain residual value guarantees or repurchase guarantees undertaken by the lessor. It is not clarified if such guarantees affect the lessee's accounting.

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.

As stated above we would like to see the discussion on definition of an asset to be finalised in the Framework before being interpreted in the different ongoing projects. Even though you have a right to receive payment and an obligation to provide the leased assets, this is something that one haven’t done yet. To recognise an asset in the sense of a right to receive payment for something that you have delivered to the customer as in the case of an accounts receivable is easy for the user to comprehend, but to recognise an asset on something that you have not yet fully delivered may be more complicated to communicate, especially to present that asset and liability gross. When comparing to the ongoing discussion in the revenue recognition project, it is not easy to understand how the principles will interact. We as preparers find it very difficult to understand how these new principles combined will affect entities that under the current lease model and revenue recognition model use the operating lease model, from a lessor’s perspective for sales with residual value commitments.

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.

We support the model when the leased item is derecognised by the lessor. Otherwise, as we see it, total assets will be double counted in the balance sheet. The total assets according to our opinion should reflect assets that operates in the company for the purpose to yield return and that would be as lease asset or a machine.

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.

It is important that the project for lessors accounting is based on the outcome of the final standard of revenue recognition. However, we also believe that the boards need to clarify how to interpret the income recognition criteria connected to lease accounting. As mentioned before we are still of the opinion that there is a great difference in economic substance between lease contracts that are in-substance purchase and other lease contracts, which existing model reflects in spite of other imperfections. The economic substance of a lease contract must reflect revenue recognition in the financial statements in order to measure an entity's performance. For example, in cases where a lease arrangement is a strong request from customers as an alternative to an outright sale, income should be recognised at lease inception (in the case of a manufacturer type lease) since it is, in substance, a sale.

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, to include all areas when building the model is necessary. It is of less importance whether the written principles on investment property ends up in a leasing standard or in a separate standard as long as it has been considered whether the proposed lease model would work for all areas.

Question 29

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

Yes, as stated in our answers to previous questions we believe that it is necessary to reflect both the lessor and lessee side of the transaction when developing a model that will replace the current accounting principles. With the increased focus on control and derecognition of assets and liabilities in the sense of having passed on the control to another party that are being discussed in other relevant agenda projects, these elements must be in the centre of a leasing model.

We are pleased to be at your service in case further clarification to our comments will be needed.

Yours sincerely,

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Claes Norberg
Secretary of the of the Swedish Enterprise Accounting Group