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RE: EFRAG's draft comment letter on the IASB/FASB's joint Discussion Paper 'Preliminary Views on Leases'.

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), has considered EFRAG's draft comment letter on IASB/FASB's joint Discussion Paper (DP) Preliminary Views on Leases.

We thank you for this opportunity to comment on your draft response to the IASB.

CESR is generally supportive of the comments EFRAG has made in its response to the DP on 'Leases' and is pleased to provide you with some additional comments:

1 CESR appreciates the efforts of the IASB and the FASB to develop a common standard on lease accounting with a view to ensuring that assets and liabilities arising from lease contracts are properly recognized in the statement of financial position. Although CESR is disappointed that the Boards have postponed consideration of lessor accounting, we appreciate the Boards' practical response to many of the criticisms of current lessee accounting.

2 Like EFRAG, CESR would support a "right-of-use" approach for all leases leading to the recognition of an asset representing the right to use a leased item for the lease term, and of a liability for its obligation to pay rentals as long as a complimentary approach is expected for lessors. However, we wonder whether including short-term and small value leases within the scope of any proposals would pass a cost/benefit test. We would recommend the Boards to conduct further field tests on this.

We encourage the Boards to consider carefully the relevance of providing specific guidance on materiality considering leases that are individually of low value may be material when aggregated.

3 Although CESR is supportive of the broad direction of a pragmatic single asset and liability approach, this will require lessees to apply judgment and make estimates about the lease term, contingent rentals and residual value guarantees. This could be challenging and, in some circumstances, result in increased balance sheet volatility. Whilst being in favor of a "most likely" approach in determining the lease term, contingent rentals and residual value guarantees, CESR believes that detailed disclosures should be provided to help financial statements users understand the nature and amount of each of the significant components included in lease liabilities.

In addition, we think that it might be helpful to obtain opinions from preparers on whether their accounting systems are sufficiently robust to deal with a frequent reassessment and re-measurement process in relation tolease assets and liabilities. CESR is not in a position to assess the implications of such an approach for IT systems, but would invite the Boards to consider whether conducting a cost-benefit analysis on the implications for IT systems would be relevant.

4 With regards to the use of the lessee's incremental borrowing rate in determining the obligation to pay rentals, CESR supports the proposals contained in the DP and encourages the Boards to provide preparers of financial statements with more guidance on how to determine this incremental borrowing rate with a view to enhancing comparability for users. In addition the Boards should consider requiring appropriate disclosures in the notes to the lessee's financial statements giving appropriate information about the assumptions and criteria taken into account in the determination of this incremental borrowing rate.

Furthermore, as stressed by EFRAG, CESR believes that lease liabilities should not be revised for changes in the incremental borrowing rate after initial measurement of the obligation to pay rentals as the revision of lease liabilities for changes in this rate would not be consistent with the IASB's view of adopting an amortised cost approach for the subsequent measurement of the lease obligation.

CESR also supports EFRAG's recommendation of a consistent approach being taken to measuring the uncertainty that arises from term options and contingent rental payments. We would however prefer a most likely outcome approach rather than a probability weighted estimate approach.

5 Lastly, CESR notes that the discussion paper would result in significant changes to existing practice. We would urge the IASB and the FASB to consider carefully the practical implications and the disclosures which will be required by the new standard on leases to maintain an appropriate level of information in the notes to the financial statements.

Our detailed comments are set out in the appendix to this letter. Please note that we have not answered questions 25 to 29 as we believe it inappropriate to respond to those questions on the basis CESR thinks that lessor accounting should be considered more carefully.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of CESR-Fin

Appendix: Answers to the questions included in the DP

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.

CESR thinks all leases should be included in the scope of the proposed new standard. However, we wonder whether including short-term and small value leases would pass a cost/benefit test. We would recommend the Boards conduct further field tests into this.

Acknowledging that leases which are individually of low value may be material when aggregated, we would encourage the Boards to consider carefully the relevance of providing specific guidance on materiality.

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.

CESR believes that whenever an arrangement is classified as a lease agreement, it should be included in the scope of the proposed new standard irrespective of the nature of the underlying leased asset and of the duration of the agreement – except for assets that are currently within the scope of another standard. Consequently all lease agreements which lead to the existence of a right to use an asset should be accounted for according to the proposed new standard.

We would refer to our response to question 1.

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.

Based on the IFRS Framework for the preparation and presentation of Financial Statements, CESR agrees with the Boards' analysis of the rights and obligations and of the assets and liabilities arising in a simple lease contract.

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.

CESR supports the proposed model which requires the lessee to recognise an asset and a liability for all lease contracts as far as this recognition properly reflects the substance of the lease agreement.
However, CESR encourages the Boards to consider requiring more detailed disclosures in the notes to the financial statements to help users understand the nature and the amounts of the significant components included in lease liabilities.

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 would refer to our response to question 4.

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.

Bearing in mind the difficulties that issuers currently experience when determining the implicit interest rate in lease contracts using a discounted cash flow method, CESR supports the tentative decision to measure the lessee's obligation at the present value of the lease payments discounted using the lessee's incremental borrowing rate. Even if this method, involving as it does more judgement, would lend greater subjectivity to the assessment.

Paragraph 4.10 of the DP defines the lessee's incremental borrowing rate as "the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset".

CESR would like to invite the Boards

a) to provide preparers of financial statements with more guidance on the determination of this incremental borrowing rate to enhance comparability for users; and
b) to consider requiring appropriate disclosures in the lessee's notes about the assumptions and criteria taken into account in the determination of this incremental borrowing rate – namely, the credit standing of the lessee and the nature and quality of security provided as mentioned in paragraph 4.10 of the DP.

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.

CESR agrees with the initial measurement of the right-of-use asset at cost which is consistent with other standards dealing with the measurement of non-financial assets.
Moreover we appreciate that this approach would be easier and less costly for preparers to apply than requiring the use of fair value.

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 favor and why.

Although in general CESR supports the Boards' approach for the subsequent measurement of both the obligation to pay rentals and the right-of-use asset, we are concerned about inconsistencies between the

proposed new standard and the existing IAS39 *Financial Instruments: Measurement and Recognition*. Indeed, those parts of IAS39 which deal with the measurement of financial liabilities at amortised cost exclude leases from their scope.
CESR invites the Boards to clarify this potential inconsistency and to provide further explanation on the nature of liabilities arising from the obligation to pay rentals.

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.

To be consistent with IAS39 which requires the measurement of non-lease financial liabilities at amortised cost, CESR is of the view that an option of measuring the obligation to pay rentals at fair value should not be given in the proposed new standard on leases.

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.

CESRis view is that changes in the lessee's incremental borrowing rate which reflect changes in market conditions should not lead to a requirement to remeasure the obligation to pay rentals for reasons of complexity and cost-benefit. Furthermore, CESR shares the opinion suggested by the analysis contained in paragraph 5.23 of the DP showing that such a requirement would lead to an inconsistency between the way many non-derivative financial liabilities are subsequently measured and the amortised cost approach.

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.

CESR has no opinion on this question.

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.

CESR considers that given the Board has described the right of use as an asset, all subsequent decreases in value should be presented as amortisation or depreciation as is usual for others kinds of tangible and intangible assets.

Question 13
The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. 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.

CESR is of the view that once a decision about the lease term is taken using the "most likely lease term" approach, tere is no other alternative but to ignore the existence of the option. However, CESR prefers this approach to the probability weighted estimate approach.

CESR would nevertheless like to stress that it has concerns about the nature of the obligation related to the measurement of renewal options. In such cases, there is no enforceable obligation, and therefore recognising a liability as arising from such an option would not be consistent with the definition of a liability provided by the Framework for the preparation and presentation of Financial Statements.

We are also concerned by the reliability of the assessment of the most likely outcome and we strongly support the Boards' tentative decision to provide guidance on the factors used when considering the determination of the lease term (as detailed in the paragraph 6.39 of the DP).CESR believes that the Boards should elaborate on the nature of the business factors to be considered in the assessment of the most likely lease term, and clarify whether such an assessment includes lessee intent and past practice. CESR is concerned that without such guidance, entities will be tempted to use simplistic approaches, such as considering only the minimum contractual duration, which in turn would affect the decision-usefulness of the information provided.

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.

CESR supports this decision.

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.

The proposed approach seems reasonable to CESR.

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?

CESR agrees with the proposed approach, especially given the disadvantages of excluding the obligation to pay contingent rentals from the measurement of the liability as noted by the Boards.

Nevertheless, CESR considers the main problems with this approach stem from the measurement of liabilities arising from contingent rental arrangements. See our response to question 17.

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.

A measurement approach based on probability weighted payments has the disadvantages of being complex and costly for preparers as well as incorporating a high level of subjectivity into the determination of the probability of each possible outcome.

Having weighed the advantages and disadvantages of the two approaches, CESR does not have a definitive opinion as to which of these approaches is the more relevant. However, to achieve consistency with the approach used to determine the lease term when options exist, we would favor the "most likely" approach.

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.

CESR supports the FASB's tentative view and thinks it is in line with existing standards for lease accounting.

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.

CESR supports the Boards' decision provided remeasurement of contingent rental payments and residual value guarantees is required on a basis consistent with that required to reassess the lease term (i.e. at each reporting date, on the basis of any new facts or circumstances).

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.

CESR is of the view that a remeasurement resulting from a change in the estimated lease term and a remeasurement resulting from a change in estimated contingent rental payments should not be accounted for similarly since only the former affects the right-of-use asset. Therefore, from a purely technical and logical viewpoint, CESR believes a change in the estimated lease obligation arising from certain changes in estimated contingent rental payments should be recognised in profit or loss.

However, considering the potentially significant issues that arise in terms of application, CESR would agree to there being only one approach which resulted in all changes to the estimated contingent rental payments being treated as an adjustment to the carrying amount of the right-of-use asset. This approach would also be consistent with the single asset/liability model adopted for decommissioning liabilities in IFRIC1.

In addition, as the Boards state that the right-of-use asset should be reviewed for impairment, the approach of adjusting the lease asset will require appropriate impairment models. Consequently CESR thinks that the robustness of the impairment model the Boards ultimately propose is critical. To this end, obtaining preparers' feedback on the consequences for theirIT systems of dealing with annual reassessment and re-measurement processes for lease assets and liabilities could be helpful. CESR is not in a position to assess the cost-benefit implications of such changes for IT systems but would invite the Boards to consider conducting a field test on the capability of IT systems to manage these changes and any proposed impairment models.

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?

CESR supports the proposal that the recognition and measurement requirements for contingent rentals and residual value guarantees be the same.

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?

We note that EFRAG members would not favor separate presentation of the lessee's obligation on the face of the statement of financial position because its difference from other liabilities is not considered significant. CESR however would prefer a separate presentation as we see this as consistent with the presentation proposed for the right-of-use asset (see question 23).

If this separate presentation is not retained by the Boards, CESR would encourage them to consider requiring appropriate disclosures in the notes to financial statements in order to provide relevant information to users and enhance comparability.

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?

CESR supports the Boards' preliminary view of requiring separate presentation of right-of-use assets on the face of the statement of financial position.

In addition of this presentation, CESR considers that additional information should be provided in the notes to the financial statements distinguishing each class of leased assets from those purchased.

Question 24

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

CESR has not yet identified any issues that should have been addressed in the DP, but are not.

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.

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.

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.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

CESR notes that the DP focuses on lessee accounting and is disappointed that the Boards have not really addressed lessor accounting. We think that the subject needs to be considered more carefully and have therefore decided not to respond to the above questions.