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Email: Commentletters@efrag.org

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**Subject: Response to ED/2010/9 Leases**

Dear Mr Flores,

Banco Español de Crédito, S.A. appreciates the opportunity to comment on the EFRAG's proposal response to the IASB's Exposure Draft on Lease Accounting (ED/2010/9) (henceforth ED) published on August 17.

We give our support to the efforts of the European Financial Reporting Advisory Group (EFRAG) and the IASB, to improve International Financial Reporting Standards, in order to provide users of financial statements with information which is of better quality and of greater relevance, thereby aiding comparability.

The existing accounting model for leases has long been criticised for failing to meet the needs of users of financial statements. However, we are not convinced that some of the proposals included in the ED offer an effective improvement in comparability or provide additional relevant information to the users of financial statements and we deem it introduces very significant changes in the lease accounting treatment that might even affect the economic rationale of some types of the lease business if the final standard is not modified.

Firstly, we want to express our general support to the observations and suggestions included in the draft of the EFRAG response letter, though we have some minor dissenting opinions that will be elaborated later in the detailed answers to the questions proposed by the IASB.

As for the IASB's ED, we believe it does not really meet the reasons why it is said the current accounting model for lessees should be modified, i.e., to enhance the comparability among the financial statements of different companies and to better suit the need of users of financial statements. In this regard, although the proposed standard might make easier to put side by side the financial statements of companies with different ways of financing their properties and other significant assets, it introduces a new distortion that certainly will make harder to compare the performance of lessees in different stages of the investment cycle. Moreover, we consider that the proposed standard is contrary to the principle of correlation of incomes and expenses, as it introduces an artificial distribution of lease costs, that can cause the net result of a contract (the benefits obtained from the underlying asset minus the lease cost) whose expected cash flows through the term of the operation are always positive and which is expected to render an overall profit to the lessee being significantly in the red in the early years of the lease. If the lease operations are significant enough this may result in an overall profitable company making public negative results. We deem extremely doubtful that this outcome can be regarded as an improvement.

Conceptually, it seems very difficult to understand the change in the accounting treatment of the so-called right-of-use (ROU), as the definition of this ROU in the application guidance of the ED (B.4) is essentially the same that the one in the current standards (IFRIC 4.9) -which is only natural as the rights and obligations associated with a lease contract have not changed in the meantime- and the conceptual framework in which the criteria for the recognition of an asset in the financial statements are established remains unchanged.

It is said in the basis for conclusions on the ED (BC 7) that the proposals are consistent with the existing conceptual framework but none justification is offered for the change in the treatment of an item which had not been previously classified as a recognizable asset. In our opinion the characterization of the ROU of the leased item for the lease term as an asset itself does not fit in the current IFRS framework and, as we elaborate later in our response to the IASB's questionnaire, it is based on the confusion between an asset and the requisites required for its recognition in the financial statements.

Although the Board may be well aware of the problems that can arise from such as inconsistency and it is also said in the basis for conclusions on the ED that the consistency between the lease accounting model and the conceptual framework currently being developed would be possibly only once the framework project has advanced further, we deem it is an unwise approach to develop it to suit an already developed standard. It is our conviction that the framework should be established in advance of any particular standard if the purpose is to develop a high quality complete and consistent set of standards and in consequence we do find the Board's approach rather troublesome, specially taking into account that the recognition and derecognition of assets has been a highly questioned point in the aftermath of the failure of some financial institutions.

Additionally, we do not share the Board's proposal about the lessee's accounting treatment of the expenses linked to a lease contract. In short, we believe that all of them should be recognized in the lessee's income statement on the basis of a direct association with the economic benefits which are expected to arise from the leased item. In other words, if the benefits are deemed to be distributed following a straight-line

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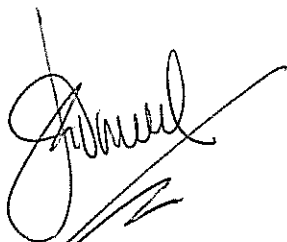
pattern over the term of the lease, the same criterion should be used for the expenses. The advantages of this allocation are, in our opinion, very significant, as it is simpler for lessees to apply, it aligns the income statement and the tax treatment of leases -at least in some jurisdictions-, it reflects the way in which most lease contracts are priced and, it remains the strongest reason in favour of this approach in our opinion, the allocation of expenses reflects the pattern in which the economic benefits from the leased item are received by the lessee.

In practical terms, this implies that the amortisation of the ROU and the liability -the obligation to pay rentals- would net to zero in the income statement through the entire term of the lease and also that, if there is no impairment of the ROU, its amount and the one of the liability would remain the same in the subsequent measurements. Although the IASB rejected in the preliminary Discussion Paper the so-called linked-approach, which has a similar impact on the profit and loss account, the reasons for that rejection - mainly, that a liability always must have a financial cost- are not, from our point of view, irrefutable and, as we will further elaborate, the same net effect can be obtained with the appropriate temporal allocation of the amortization cost of the ROU.

Finally, we agree with the EFRAG's criterion that rentals that are under the control of the lessee, such as contingent rentals on usage or performance of the asset, should not be included in the measurement of lease assets and liabilities. Moreover, in our opinion this criterion should also be applied to the other types of contingent rentals, since we believe that all kinds of them are contingent liabilities and consequently should not be included in the measurement of assets and liabilities arising from a lease.

Please find attached our comments to questions from the ED.

Thank you in advance for your consideration of these comments.



Yours sincerely,

## Question 1: Lessees

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

We share the EFRAG's opinion that the ED seems to have been developed on the conceptual premise that an asset is a bundle of rights. In our opinion, the logical implication of the said conceptual premise is that the lessor should derecognized part of the underlying asset and the lessee should recognized partially the same asset in the financial statements.

Consequently, we do not agree with the recognition of the right of use as an asset in the lessee's balance sheet but, on the other hand, and for certain types of leases, we consider that the underlying asset might be recognized in the lessee's financial statements. As it is elaborated in the following paragraphs, we deem a step in the wrong direction to reflect in the financial statements not the assets that fulfill the criteria for their recognition, but the rights of the company over the said assets.

In our opinion, the characterization of the right-of-use of the leased item for the lease term as an asset itself is (1) neither convenient nor necessary as a feasible balance sheet item and (2) does not fit in the IFRS conceptual framework and introduces confusion between an asset and the requisites required for its recognition in the financial statements.

(1) We believe the recognition of the right of use as an asset itself is unnecessary **because the underlying asset meets the requisites established in the conceptual framework for the recognition of an asset in the balance sheet of the lessee company.** According with the conceptual framework paragraph 49, a) an asset is: (i) a resource controlled by the entity (ii) as a result of past events (iii) and from which future economic benefits are expected to flow to the entity.

From our point of view, a company can obtain the right-of-use of a certain item through different legal ways and with or without restrictions. The purchase of an asset grants to the owner, among other rights, the right-of-use without any temporal limit, a contract currently classified as a financial lease transfer to the lessee the right-of-use of the leased asset for the greatest part of its useful life, whereas, in the case of a operating lease the temporal span of the right-of-use can be much shorter. Although these diverse situations should be taken into account in the measurement/valuation of the item<sup>1</sup>, it should be emphasized that in every occasion the three mentioned requisites for the

<sup>1</sup> The asset must be measured initially for the acquisition cost, i.e. the present value of the contractual future payments, as established in IAS 16:

- IN 8. An entity is required to measure an item of property, plant and equipment acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, at fair value unless the exchange transaction lacks commercial substance.
- 16.4. Other standards may require recognition of an item of property, plant and equipment based on an approach different from that in this standard. For example, IAS 17 Leases requires an entity to evaluate its recognition of an item of leased property, plant and equipment on the basis of the transfer of risks and rewards. However, in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this standard.

These conditions are similar to those used in the application guide ED, B.4, *a* and *b*.

recognition of an asset are clearly satisfied: (i) the entity controls the underlying asset<sup>2</sup> (iii) future economic benefits<sup>3</sup>, embodied in the asset object of the mentioned contract, are expected to flow to the entity, usually through its use in the production of goods or services to be sold, as it is stated in the paragraph 55 of the framework<sup>4</sup>. Last, if we assume, as the FASB and IASB maintain, that in the case of the lease agreements the lessee controls the asset as a result of past events (i.e. the lease contract) the requisite (ii) is also fulfilled.

Moreover, the paragraph 57 of the framework clearly establishes that the ownership is not a requisite for the recognition of an asset -so a different accounting treatment for the underlying asset can not be justified on the basis of the existence of a purchase agreement versus a lease one- and even it is said in the mentioned paragraph that in a finance lease the underlying asset (and not the right-to-use it) can be recognized as such asset<sup>5</sup>.

In conclusion, we deem that as the underlying asset meets all the three requirements, it should be recognized in the lessee's balance sheet<sup>6</sup> and, consequently, the introduction of a new brand asset such as the right of use is quite unnecessary.

We also believe that the said recognition is inconvenient. It seems evident that the same criterion can be applied to any other legal agreement by which one company acquires the right-of-use of a certain asset including the purchase of that item. Therefore, the use of a consistent approach should demand the recognition in the balance sheet of the right-of-use of any item of property, plant and equipment, instead of the underlying asset. It does not seem easy to find a clear justification of the reason to recognize in the balance sheet sometimes an asset sometimes a right to use the asset other than the source of the legal rights of the company (owner vs. lessee, which has been rejected by the Board).

**(2) From our view, according to the conceptual framework, the right-of-use is a requisite for the recognition of any asset, rather than an asset itself.** If the issuer of the

<sup>2</sup> From our standpoint there is no material difference between to control the asset (for the term of the lease) and to control the right of use of the asset (specially considering that the underlying asset can usually be sub-lease)

<sup>3</sup> With regard to requirement (iii) it should be emphasized that the framework does not require that the entity is entitle to receive all the future benefits embedded in the asset, on the contrary it is enough that some future economic benefits are expected to flow (otherwise, any legal o de facto restriction on an asset would impede the asset recognition even of an item owned by the company).

<sup>4</sup> Paragraph 55 of Framework for the Preparation and Presentation of Financial Statements: The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:

- (a) Used singly or in combination with other assets in the production of goods or services to be sold by the entity,
- (b) Exchanged for other assets,
- (c) Used to settle a liability, or
- (d) Distributed to the owners of the entity.

<sup>5</sup> Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property.

<sup>6</sup> The underlying asset itself might be recognized although only if the lessor has derecognized the very same asset in the portion correlative to the economic benefits transferred to the lessee and taking into account that the end in the right-of-use once the lease has expired modifies the value/measurement of the asset.

financial statements does not have the mentioned capacity to use an asset, this will fulfill neither the first criterion for recognition in the financial statements, i.e., (i) to control the asset and very likely nor the second (ii) to obtain benefits from it.

As a corollary, it does not make sense to ask if the right of use of any asset which qualifies for its recognition in the balance sheet meets itself the criteria. The answer will always be affirmative but referred to the asset. The legal right of use gives the company the power to control the asset and obtain its economic benefits as is stated in the framework, paragraph 57<sup>7</sup>.

To summarize, the former paragraphs lead us to the following consequences:

- (i) If and when an asset (the underlying asset) is recognized in the lessee's balance sheet as a result of the contract it should never be as an intangible one but as an item of property, plant and equipment or an investment (as it is established in the ED).
- (ii) The performance obligation model for the lessor's accounting has serious conceptual flaws. If the right-of-use is not recognized in the lessee's books, it seems indeed hard to justify the recognition of the correlative performance obligation in the lessor's financial statements. An asset should only be recognized in the financial statements of the lessee if and only if the lessor is derecognising (at least partially) the very same item<sup>8</sup>.

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

It has been established that we do not consider the right of use as an asset itself. In any case, we do not share the IASB and FASB's proposal about the accounting treatment of the expenses linked to a lease contract. In short, we believe that all of the expenses originated by the lease of an asset should be recognized in the lessee's income statement on the basis of a direct association with the economic benefits which are expected to arise from the leased item. So, if the benefits are deemed to be distributed following a straight-line pattern over the term of the lease, the same criterion should be used for the expenses.

In other words, the linked approach -or any other treatment with the same effect on the lessee's profit and loss account- is in our view the most faithful method to impute the expenses associated with the lease contract either the right of use is eventually recognized or the underlying asset is entered in the lessee's financial statements.

As it was mentioned in the preliminary Discussion Paper Leases (DP/2009/1) the linked approach has very significant advantages. It may be simpler for lessees to apply, in

<sup>7</sup> Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

<sup>8</sup> If the asset is considered a bundle of rights, the recognition of part of these rights by the lessee should entail the partial derecognition by the lessor.

some jurisdictions, it would align the income statement and the tax treatment of leases, it reflects the way in which some lease contracts are priced, and the last, and in our opinion the strongest reason in favour of this approach, the allocation of expenses reflects the pattern in which the economic benefits from the leased item are received by the lessee.

In a straightforward lease, the lessee pays for its right to use the leased item at the same time it receives the right and consumes its benefits; hence we believe the linked approach is the only way consistent with the criteria established in the conceptual framework for the recognition of expenses<sup>9</sup> and their allocation procedures<sup>10</sup>. If the economic benefits of the lease are distributed on a straight-line basis over the term of the lease (and we believe this is a very sensible assumption) all the expenses of the contract should follow a similar pattern.

The ED approach requires the lessee to recognize interest expense on the obligation to pay rentals and amortize the right-of-use asset, possibly on a straight-line basis, and it results in higher expenses in the early years of the lease. This feature not only is not compliant with the conceptual framework, but also **reduces comparability for users** as these higher expenses will not be offset by higher benefits from the leased item. In other words, a company in the mentioned early years of the contract will declare a worse performance than other whose lease agreement is near its term. To avoid this undesirable effect we believe there are two possibilities:

## 1) An increasing amortization of the right of use

In this sense, a increasing amortization of the right of use could have on the income statement net effect similar to applying the linked-approach, without the essential inconvenience to be rejected by the IASB tentatively in its Discussion Paper, specifically, that the liability recognized by the lessee does not bear interest. This approach, in addition to distributing the cost of the contract in a way that reflects the way in which its benefits are consumed, retains the advantages that the IASB itself recognized in that approach, mentioned above.

An additional argument in favour of increasing amortization of the right of use is the way it is calculated. Assuming that in a contract between independent parties, future rentals will be essentially equivalent to the utility that the lessee expected from the underlying asset, the net present value of the payments is also **the present value of the benefits expected from the leased asset**<sup>11</sup>.

<sup>9</sup> Paragraph 95 of Framework for the Preparation and Presentation of Financial Statements: Expenses are recognized in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events.

<sup>10</sup> Paragraph 96 of Framework for the Preparation and Presentation of Financial Statements: When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognized in the income statement on the basis of systematic and rational allocation procedures.... These allocation procedures are intended to recognize expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

<sup>11</sup> Although in our view the asset/right-of-use asset should initially be measured at cost, which equals the present value of the lease payments less direct costs we deemed reasonable to presume that in a transaction between independent parties the cost and the fair value should be very similar, if not equal.

We consider that this fact has to be taken into account in the subsequent measures of the right-of-use-asset so that its value should be obtained by:

- Subtracting the imputed consumption of economic benefits embodied in the right-of-use asset in the period (it seems that a straight-line pattern is sensible).
- Adding the increase in the present value of the remaining right-of-use the asset as a consequence of the pass of time.

The aforementioned increase in the present value should offset the financial cost imputed to the liability. In practical terms, the effect in profit and loss of the simultaneous recognition of the increase in the present value of the right of use, the consumption of economic benefits (linear amortization of the right of use) and the interest associated with the liability will be the same that the impact under the linked approach (the rental payments).

Another interesting feature is that (as long as the prices in the property and financial markets remain unchanged) the amortized cost calculated as it is established in the previous paragraph should be a proxy for the fair value of the right of use the asset. In conclusion, the increasing depreciation is the option which most accurately represents the temporal evolution of the value of repeated right of use.

## 2) The linked approach

From our point of view, the reasons for the rejection of the linked approach exposed in the preliminary Discussion Paper are questionable as it is explain in the following paragraphs.

We understand that (i) the first reason for rejecting the link approach makes reference to the interest component of the deal, both from an accounting and economic perspective, (ii) the second one refers to the complexity to regulate different types of leases, and (iii) the third one challenged the link between the right of use and the obligation to pay rentals after the inception of the lease. We consider the first argument is the only substantive one: simplicity is, undoubtedly, an advantage, but not reason enough for a lacking accounting standard and the lack of persistence of the link through the entire lease term, which is disputable, is not reason enough to reject the linked approach (i.e. the consequence of hypothetically lack of persistence would be that there is one reason less in favour of the linked approach, but is not in itself an argument against it).

### (i) The interest cost

It is said that non-derivative financial liabilities (other than those measured at fair value) give rise to interest expense and that the obligation to pay rentals in a lease contract clearly contains an interest component. We will analyze the performance obligation approach as we believe it clearly illustrates our point of view.

We deem that the declaration that liabilities give rise to interest expense **is not correct in the case of a liability which arises from an equally unperformed contract**, which is in our opinion the only situation that can justify the recognition of the respective



rights (right-of-use) and liabilities (performance obligation) in the lessee's and lessor's financial statements<sup>12</sup>.

If an agreement is going to be settled at least partially in a future date in which both counterparties will fulfill their obligations (as the Board assume it is the case with the leases), it seems unlikely that the price of the transaction includes an interest component. In consequence, even when these liabilities, and the correlative assets, may be registered in the financial statements (which it is not always the case), it would be wrong to assume that they give rise to interest expense<sup>13</sup>.

There is little doubt that the key idea is if one of the parties in the contract has fulfilled his obligations before the other, or if both have accomplished the terms of the agreement, including any cash payment, at the same time. Again, if we accept the basic idea of the performance obligation model (as the lessee acquires the asset/right-of-use of the asset, every year, and the lessor fulfilled his performance obligation, the correspondent payment is satisfied) there is not long term funding either in a legal or in an economic sense and neither the lessee nor the lessor should recognize any interest cost or income in their profit and loss account.

## **(ii) Complexity**

It was also argued that the linked approach requires the lessee to differentiate between finance leases and operating leases and this would add complexity to the proposed new standard and could result in similar lease contracts being registered differently. It is clear that this argument is only to be considered if in the financial leases are going to be registered in a different way. In our opinion, the reasons supporting the proposed approach for the contracts currently classified as operating leases are equally valid for the finance leases, so the linked approach plus impairment should be the model for any kind of leases.

## **(iii) Link between the asset and the liability**

Last, it is said that although the measure of the right-of-use and the obligation to pay rentals are clearly linked at the inception of the lease, this is not necessarily the case afterwards as changes in the value of the right-of-use do not necessarily result in a change to the rental payments.

Although it is true that the present values of the rental payments and of the right to use may vary in a different way after the inception this does not mean that both item are not linked, on the contrary, the relationship between the liability and the asset endures

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<sup>12</sup> One difficult point is the coincidence of two alleged mutual unconditional obligations: for the lessor, the ongoing performance obligation to continue to permit the use of the leased asset, and for the lessee, the unconditional obligation to make rental payments. We believed that the only scheme under which two mutual unconditional future obligations can be classified is the so-called in the conceptual framework obligations under contracts that are equally proportionately unperformed.

<sup>13</sup> As for the supposed interest component of the contract, we consider that some clarification is needed: the fact that an amount prepaid would equal the present value of a series of future payments (lower than the total amount of them) can only inform us about the level of the market interest rate, but does not reveal if an interest cost is embedded in the future payments or if by satisfying their present value the payer has cancelled the debt before the service or good were supplied and so the difference between the present value and the amount of the future payments should be classified as a financial income.

through the entire term of the lease, as they represent the present values of mutual unconditional rights/obligations derived from an equally unperformed contract<sup>14</sup>.

On the other hand, in the alternative approach proposed by the Board and except in the unusual event of impairment -which also could be contemplated in the linked approach- this hypothetical changes will neither have any impact in the value of the linked asset and liabilities in the lessee's financial statements as both will be measured by its amortized cost.

As a consequence, the hypothetical changes in value of the right of use can only be regarded as an argument against the linked approach or in favour of the Board's proposal if the former does not contemplate the possible impairment of the right of use which is a deficiency really easy to settle.

## **Question 2: Lessors**

***(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?***

**(i)** We believe that the lessor should not apply the performance obligation approach under any circumstance. We deem that the performance obligation approach looks severely flawed as it leads to the creation of duplicate assets without a real economic foundation and the correlatively recognition of liabilities that do not fit properly in the definition established in the conceptual framework.

Firstly, lessors continue to recognise the entire value of their leased assets, together with receivables for their rights to receive rental payments, and the lessees recognise the aforementioned right-to-use. It is difficult to understand why entities that draw leases have bigger balance sheets of those that offer other forms of finance such as secured loans.

Secondly, it does not seem consistent with the conceptual framework that one asset generating one stream of economic benefits would see its economic value, measured by the amounts recognized in the balance sheet of both companies as the asset itself and the right-to-use it, increased when some of the rights attached to it are split and transferred to another party as a consequence of a lease.

Thirdly, we believe that there is little consistency between the leases ED and ED/2020/6 "Revenue from contracts with customers", as: (i) the lessor's so-called performance obligation linked to a lease contract does not seem to fit well in the definition of performance obligation included in it<sup>15</sup>, as it seems difficult to identify the service or good which will be transferred in the future (ii) even if we do not take this into account, the only performance obligations recognized in the financial statements under the mentioned ED are the onerous ones, which is not necessarily the case for the lessor's

<sup>14</sup> At least under the performance obligation model.

<sup>15</sup> Performance obligation: an enforceable promise (explicit or implicit) in a contract to transfer a good or service to a client.

and (iii) last, even if it is onerous in some lease operations, the amount recognized will be very different under both standards.

Therefore, it is very dubious that the so-called performance obligation meets the requisites for its recognition established in conceptual framework which as it is well known are: (a) the lessor has a present obligation (b) this obligation arises out of past events -the signing of the lease contract and the delivery of the item by the lessor to the lessee- and (c) the obligation is expected to result in an outflow of economic benefits.

From our point of view, it remains to be seen that the lessor has a present obligation. It has been said that the lessor has the ongoing performance obligation to continue to permit the use of the leased asset but,<sup>16</sup> as far as the lessor is not entitled to prevent the lessee of using it, this performance obligation seems void of any real substance, so, it is a present obligation only in the text of the standard. The same can be said of the future outflow of economic benefits.

(ii) If, as we have sustained in the precedent paragraphs, the lessee should recognize in its balance sheet the underlying asset, once it has been measured taken into account the span of time in which the economic benefits from the asset will contribute to the company's profits, a consistent criterion should be utilized in the lessor's financial statements. In our opinion, this means that the lessor should derecognize the asset either partially (if the entity has not transferred substantially all risks and rewards) or in full (if that is not the case).

The only justification for the recognition of the very same asset in the financial statements of the two companies is that both are going to receive the economic benefits embedded in it, but in a different period of time (the asset is a bundle of rights). Consequently, the measurement of the asset has to reflect this circumstance and the lessor must derecognize the economic value that is transferred to the lessee by virtue of the lease agreement.

In other words, we advocate for the derecognition model which we believe it is the only one consistent with the conceptual IFRS framework, and depict the economic realities of leases and the leasing business providing useful information to financial statement users.

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

We do not support neither the performance obligation approach completely nor the Board's proposal for the recognition of assets, liabilities, income and expenses. On the contrary, we agree whit the Board's proposal for the derecognition approach, but we

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<sup>16</sup> In our opinion if we want to classify it as an obligation, the so-called "performance obligation" should imply that the lessor is obliged to do something -which is not the case- or to restrain itself of doing something that otherwise (i.e. without the performance obligation) will be entitle to do. Once the lease agreement has been signed the lessor -if we accept the Board's view that the lessee has an unconditional obligation to pay for the full term of the lease- has no title to impede the lessee the use of the underlying asset.

believe that it should only be applied in certain circumstances, leases classified as financial leases according to present standard, and for the other lease agreements, in particular short term leases, we support a similar approach to the actually applied to operating leases.

### ***Question 3: Short-term leases***

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

*(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).*

*(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).*

*(See also paragraphs BC41–BC46.)*

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

The requirement to set up an asset and related liability for short term leases is likely to result in costs of tracking and accounting of such a leased items that exceed any benefit gained. ED also provides a choice of apply simplified requirements to both lessee and lessor, which could lead to different accounting treatments difficult to compare.

In our point of view, the ED definition should take into account the relationship of the underlying asset with the core business. In this regard, we believe that probably the time horizon of 12 months indicating the ED is reasonable as a general rule. In the case of contracts in which the underlying asset is not related to the lessee's core business we deem that increase the term of the operations under this treatment up to 24 months would no result significant damage to users and will significant alleviate the administrative burden.

Therefore, we agree with the time horizon of short-term contracts of 12 months prescribed in the ED, and we suggest that lease contracts over assets unrelated to the core business of the lessee with a term under twenty four months would receive the same accounting treatment. Both types of contracts in our opinion should be accounted according to the current IAS 17 of operating leases.

## **Definition of a lease**

*The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).*

### **Question 4: Definition of a lease**

*The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).*

*(a) Do you agree that a lease is defined appropriately? Why or why not?*

*If not, what alternative definition would you propose and why?*

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

We fully agree with the EFRAG's answer to this question, so we share the supplied arguments. In this sense, we think that the term could be defined more clearly, establishing a proper distinction between purchases or sales, services, and leasing contracts.

Moreover, we also believe there is an inconsistency with ED Revenue Recognition paragraph 25<sup>17</sup>, in which the only requisite to recognize a sale is the transfer of control of the asset, and that this might result in the same transaction being qualify as a sale under one standard and not under the other.

### **Question 5: Scope exclusions**

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

*Do you agree with the proposed scope of the proposed IFRS? Why or why not?*

*If not, what alternative scope would you propose and why?*

An adequate definition of the scope of the ED is critical to ensure that its objectives are achieved. We agree with the scope set in the ED.

<sup>17</sup> Paragraph 25 ED/2010/6 Revenue from Contracts with Customers: An entity shall recognize revenue when it satisfies a performance obligation identified in accordance with paragraphs 20-24 by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service.

## **Question 6: Contracts that contain service components and lease components**

*The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:*

*(a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.*

*(b) The IASB proposes that:*

*(i) A lessee should apply the lease accounting requirements to the combined contract.*

*(ii) A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.*

*(iii) A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.*

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

We support the FASB's position that lessee and lessor should apply the lease accounting requirements to the combined contract for reasons of operational simplicity. We do not find arguments to justify a separate application for lessee and lessor; on the contrary, we believe that allowing different accounting would damage the comparability.

## **Question 7: Purchase options**

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

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

We agree with the ED in that purchase options are not a lease payment and should not be included in the measurement of assets and liabilities arising from a lease. In consequence the purchase options only should be accounted when they are exercised, i.e., when it terminates the lease and the lessee purchases the underlying asset.

## **Question 8: Lease term**

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

As EFRAG, we maintain the position that for the determination of the lease term they should not take into account the effect of any options to extend or terminate the lease. Only the amounts due under the primary lease term should be included in the estimation of the assets and liabilities associated to the lease.

Thus, lease payments for extensions of contracts do not meet the definition of obligation under the conceptual framework, the same way the receivables during these periods do not meet the definition of assets. In addition, the lessee may have no reliable information on each reporting date on future market rentals for the particular asset, and therefore do not know if the extension option is favourable or not. On the contrary, the lessor may not know the intentions of the lessee, which would influence the chance for obtaining rentals

Not considering the options in a lease would lead to a more uniform application of the standard and would increase the comparability of financial statements across companies because predicting the probability of exercising lease options introduces volatility and subjectivity implying that similar leases could be accounted differently.

We think costs of implementing and maintaining the method proposed by the ED will outweigh benefits, in special for large entities with a considerable number of leases which will have to establish new systems of internal control, data collection processes and software development.

To summarize, we consider not advisable to include rentals of optional extension periods in the register of leases, but we propose the only realistic approach to our understanding, which is to provide such information in the notes to the lessee and lessor's financial statement.

#### ***Question 9: Lease payments***

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

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

We share the EFRAG's response that rentals that are under the control of the lessee, such as contingent rentals on usage or performance of the asset, should not be included in the measurement of lease assets and liabilities, but we believe that the same accounting treatment should be applied to the other types of contingent rentals, since we see no reason for a different approach, it would increase the complexity and comparability would be lost.

We believe that contingent rentals are not a present obligation. Contingent rentals only arise if a specified future event occurs, so we believe they meet the definition of contingent liability, i.e., a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events. In this regard, we may also consider the nature of the contingent rental that we are dealing with. We can make a distinction between payments of various types:

Contingent rental that is linked to the use of an asset (such as mileage), which is under the control of the lessee, since the latter decides to what extent to use it;

- Lease payments that are contingent on the performance of the asset are less under the control of the lessee, and are similar to a profit-sharing agreement;
- Lease payments that are contingent on an index or other variable are totally outside the control of the lessee (such as a price index).

It seems clear that the contingent rental that is linked to the use of an asset and those contingents on an asset's future performance do not meet the definition of obligation until the time when the asset is used or its performance is obtained, respectively. Similarly, the rent contingent on an index will only be confirmed by the occurrence of one uncertain future event not within the control of the entity, so it seems to meet the definition of a contingent liability and accordingly it also shall not be recognized in the financial statements.

In other words, we do not share the EFRAG's conclusion that rentals that are contingent on a future price index meet the definition of an unconditional obligation where the uncertainty only relates to the measurement of the amount to be paid. In absence of any additional agreement it is possible that the lessee does not have to pay any contingent amount (i., e. a zero or negative price index) so the uncertainty does not only relate to the amount to be paid but also to the very existence of the liability<sup>18</sup>.

Even if the Board does not share our view and confirm that lease payments that are contingent on an index are actually liabilities, we deem that their amount cannot be measured reliably, so they should also be considered as a contingent liability according to the current standards. Therefore, the most reasonable approach would be to disclose all the relevant information in the notes to the financial statements, but not take them into consideration in accounts, since once more their amount would be based on estimates that were difficult to verify and volatility would increase.

It is also worth to mention that in the current IAS 17 the lessee recognizes as a financial liability, at the most, the present value of the minimum lease payments which do not include any kind of contingent rentals. We deem that the Board has not explained properly the justification for that change in the treatment of contingent rentals when the definition of a liability and the requisites for its recognition in the financial statements, according to the conceptual framework, remain the same.

Consequently, **contingent rentals should not be included in the measurement of assets and liabilities arising from a lease** because they should not be recognized in the financial statements -as contingent liabilities are not<sup>19</sup>- although a description of their nature and an estimate of their financial effect should be disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

The inclusion of such contingent rentals in the estimate of the lessee's liabilities would highly increase the complexity in the implementation of the ED and, because they can not be estimated reliably, would increase the subjectivity in the elaboration of financial

<sup>18</sup> We understand that this is not the case covered by IAS 32, paragraph 25 which, in our opinion, also assumes the existence of a liability of uncertain amount.

<sup>19</sup> IAS 37.27 "An entity shall not recognize a contingent liability".



statements and the uncertainty of some of their figures, thus decreasing their comparability. It should be noted that the very long term of leases of strategic assets would oblige the parties in a lease contract to make estimates of different magnitudes for periods as extensive as twenty or even thirty years to comply with the established ED. Of course, this would generate enormous subjectivity.

The complexity of the prediction of future events for very long periods is highlighted by the fact that other international standards like IAS 36<sup>20</sup> consider the financial budgets/forecasts of one company for periods greater than five years not reliable enough to be used in the impairment test, a prudent criterion which seems inconsistent with the established in the leases ED which requires to estimate future events during the entire life of the contract.

This apparent lack of consistency could have an undesirable effect in the impairment test of cash-generating unit which includes among its assets a right of use (measured as the counterparty of a liability estimated including all the contingent rentals through the entire term of the operation). It seems plausible that the issuers of financial statements would be required to impair the goodwill of the cash-generating unit due to the use of five-year financial projections, while the mentioned right of use has been recorded considering the full duration of the contract.

In practice, we believe that such long-term projections are unreliable. The element of uncertainty in these time horizons is so significant that any estimation can reasonably be discussed and there are no reasonable means to mitigate it.

As a conclusion, we believe contingent rentals should not be included in the measurement of assets and liabilities arising from a lease because they represent a contingent liability that should not be recognized in the financial statements. Moreover, we think that they can not be measured reliably and their inclusion on top of being against the rules set down in other standards would deteriorate the quality and comparability of accounting information. As it has been said, their existence should be disclosed in the notes to financial statements. In this way, users of financial statements would receive the relevant information and contingent rentals would have accounting impact only when the future event had taken place, which would be consistent with IAS 37.

### ***Question 10: Reassessment***

***Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not?***

<sup>20</sup> IAS 36. Impairment of Assets, paragraph 35: Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

*If not, what other basis would you propose for reassessment and why?*

As we explained in the replies to Question 8 and 9 above, like EFRAG, we do not support the proposal that options to extend the lease term and contingent rentals are included in the measurement of lease receivables and payables as proposed by FASB and IASB.

In addition, we believe that the most reasonable treatment would be that the only events requiring remeasurement should be exercise of a renewal option, significant change in a residual value guarantee or early termination of the lease contract.

### ***Sale and leaseback***

*The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).*

### ***Question 11***

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

As we explained in question 4, we think that a proper distinction should be established between the lease and sale contract, defining more clearly the terms.

In any case, we agree with the treatment for lessees in a leaseback transaction, according to which if the transfer meets the definition of a sale, the seller/lessee will derecognise the asset and will recognise the lease based on the proposals in the ED; and if the transfer does not meet the definition of a sale, the seller/lessee will not derecognise the asset and will recognise a financial liability.

However, we can not agree with the treatment given to the lessor in the event that the transfer meets the definition of a sale, because we do not agree with the performance obligation approach, as we explained in several questions above, and we defend only one model for lessors, the derecognition approach.

### ***Presentation***

*The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).*

***Question 12: Statement of financial position***

**(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)?**

**Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?**

As maintaining EFRAG, we agree with the proposed treatment of separate presentation to the lessees to distinguish the leased asset of other tangible asset that they own in property, plant and equipment or investment property, and the lease payments separately from other financial liabilities.

**(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

Like EFRAG, we do not agree with the model of performance obligation and if the ED maintains that model, we would suggest requiring a net presentation of the underlying asset and performance obligation to avoid duplication of assets that have no economic content.

**(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

In implementing the derecognition model, we agree with the separately presentation of rights to receive lease payments from other financial assets and residual asset separately within property, plant and equipment, not in inventories like EFRAG proposes.

**(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?**

We agree with sublease proposed presentation.

### **Question 13: Statement of comprehensive income**

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

**Why or why not?**

As EFRAG, we support separately presentation for lease income and expense from other income and expenses in the statement of comprehensive income.

## ***Question 14: Statement of cash flows***

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

Unlike EFRAG, we do not believe that the separation of cash flows from the lease contract of other cash flows provide information relevant to the users of information, therefore we consider that the introduction of this additional element of complexity will increase the administrative burden.

## ***Disclosure***

### ***Question 15***

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

***(a) Identifies and explains the amounts recognised in the financial statements arising from leases; and***

***(b) Describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?***

As explained by EFRAG, we believe that the disclosures required in the ED, both quantitative and qualitative are excessive, irrelevant and not necessary. Therefore we consider particularly important paragraph 71 of ED in which companies are allowed to decide the detail and aggregation or disaggregation disclosures according to their own opinion, but we understand that it should be spelled out more clearly that the specified disclosures of paragraphs 73 to 86 are not mandatory to be reasonably cost-benefit.

## ***Transition***

### ***Question 16***

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

***(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?***

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

The same way as EFRAG, we think it would be desirable to establish a full retrospective application of the proposed lease accounting requirements in accordance with IAS 8. However, we understand that in some cases the application of the rule in a fully retrospective approach could be costly for some companies. That's why we propose the possibility of a simplified retrospective approach being applied voluntarily

if the issuer considers it appropriate, provided do it evenly to all leases and properly expressed in the notes to financial statements.

## ***Benefits and costs***

### ***Question 17***

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

From our point of view, shared with the EFRAG, we believe the new model of accounting for lease contracts is complicated, contradictory, costly and time-consuming. In this sense, the complexity and the costs associated with the implementation of the lease accounting proposal would considerably outweigh the benefits without improve the comparability of the information provided by the financial statements to the stakeholders.

## ***Other comments***

### ***Question 18***

***Do you have any other comments on the proposals?***

We are concerned about subjectivity and judgement that will be required by the new proposal, particularly concerning lease term and contingent rentals because new standards would be more difficult and complex than transparent, consistent and efficient. Also, we are worried about the impact on capital requirements that the new rules would have in the banking industry and the consequences of the new proposal in ratios and debt covenants. Not forgetting the cost of implement the changes recommended in the ED, which apply to all entities, not just those with complex leasing strategies. In conclusion, in our view, costs outweigh benefits because as we mentioned earlier, we do not believe that adequate information is provided to users of information.