

Madrid, 25 November, 2010

European Financial Reporting Advisory Group (EFRAG)  
35 Square de Meeûs  
B-1000 Brussels  
Belgium  
Cc: [commentletters@efrag.org](mailto:commentletters@efrag.org)

*To the attention of Françoise Flores, Chairman*

**Re: Comments on Exposure Draft Leases**

Dear Sirs,

We appreciate the opportunity to provide you with our comments on Exposure Draft ED/2010/9, *Leases* (the "ED") published by the International Accounting Standards Board (IASB) in August 2010 and your draft comment letter on ED Leases published in September 2010.

We the undersigned give our undivided 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. Therefore, we support the decision to develop an accounting model to replace the existing IAS 17. 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.

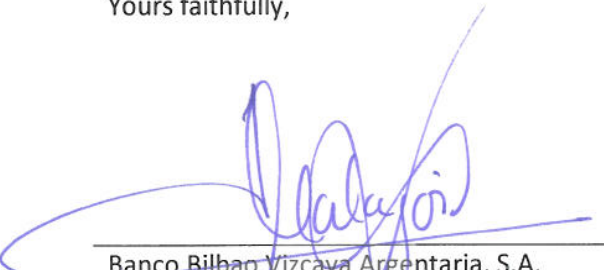
In general terms, we would like to express our agreement with most of the statements included in your draft comment letter on ED Leases. Additionally, in order to cooperate in improving the aforementioned standard prior to its definitive issue we wish to manifest to you our concerns regarding certain aspects of the aforementioned ED which, in our opinion, may not be consistent with the conceptual framework established by the IASB itself and, in particular, we wish to emphasise the new features that we consider give rise to most concern due to their potential impact on financial statements and on the work to be performed by entities in applying the standard.

Notwithstanding the foregoing, we consider that certain amendments to the ED could give rise to a standard that equally meets the needs of the various users of the financial information, which would be easier to implement for the reporting entities and which would reduce income statement volatility (unjustified from our standpoint) that could arise as a result of the current wording of the ED.

The IASB has received many comment letters on ED Leases and arranged meetings with companies due to concerns regarding the new standard. We believe that the IASB should further develop and perform field tests on all the concerns, suggestions, and its own considerations, so more time is required to make the final standard robust and ensure that it is supported by all the users of financial statements.


We would be pleased to discuss our comments or answer any questions that the Technical Expert Group may have. Please contact Manuel Fernández-Marcote (+34 91 451 97 18) regarding our submission.

Yours faithfully,



---

Banco Bilbao Vizcaya Argentaria, S.A.  
Javier Malagón Navas  
Chief Accounting Officer



---

Banco Santander, S.A.  
José Tejón Borrajo  
Executive Vice President  
Financial Accounting and Control



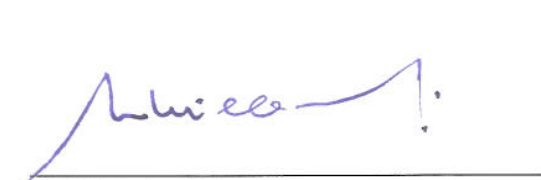
---

Banco Español de Crédito, S.A.  
Jose F. Doncel Razola.  
Chief Financial Accounting and Control



---

El Corte Inglés, S.A.  
Carlos Martínez Echavarría  
Director



---

NH Hoteles, S.A.  
Gabriele Burgio  
Chairman



---

Iberia, Líneas Aéreas de España, S.A.  
Enrique Dupuy de Lôme  
Chief Financial Officer

## **Appendix 1 – Comments on Exposure Draft and EFRAG’s draft response to ED**

### **1. General accounting model**

In general terms, we agree with EFRAG’s position regarding the accounting treatment for lease agreements by lessees and lessors. Specifically, we share EFRAG’s concern about lessors double accounting for certain assets as a result of applying the performance obligation approach. Therefore, we support the partial derecognition approach for lessors.

Also, we consider in some cases such as contingent rent, purchase options or options to extend, as explained below, a more disclosure-focused approach provide better information to users of the financial statements than recognition in the statement of financial position.

### **2. Consistency of the ED and the IFRS conceptual framework**

We wish to manifest to you our concerns regarding certain aspects of the aforementioned ED which, in our opinion, may be not consistent with the conceptual framework established by the IASB itself. In this regard, we deem 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) and the IFRS 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 aforementioned change of the treatment of an item which had not been previously considered as a recognizable asset. Although 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 a conceptual framework 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 rules 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.

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, or at least one of the same kind of the underlying (i.e. usually an item of property plant and equipment).

Moreover, we deem a worrisome approach to include in the financial statements not the assets that may fulfill the criteria for their recognition, but the rights of the issuer of the financial statements over the said assets, and believe that it can not be applied on a consistent basis (i. e. as the lessee recognizes the “right of use” trough the term of the lease instead of-

partially- the leased item, the owner of an asset should recognize the “ownership”- or its economic effects such as the “right of use” through the entire life of the asset, etc.- instead of the asset itself).

### 3. Non-core and short term leases

In order to ensure that the application of the new standard does not become unnecessarily costly for the issuers of financial statements, there are certain aspects of the contracts which, in our opinion, must be taken into consideration in order to determine if it is advisable the application of the ED approach to them. These aspects, in general, relate to the fact that the aforementioned contracts may or may not be significant in economic terms for the reader of the financial statements, compared with the cost and effort required to prepare them based on the requirements of the ED.

Certain of these aspects are as follows:

- a) Relation of the assets to the core business of the lessee: as indicated by the EFRAG in its letter, in general the leases taken out for assets not used in the lessee’s core business are aimed solely at obtaining the use of such assets for a given period of time, or even the provision of a service, although rarely may it be considered that objective of the lease is to take control of the asset or acquire the risks and rewards of its ownership.

This is the case of the contracts entered into for the lease of administrative or back office equipment, such as computer hardware, reproprinting equipment, vehicles, etc.

In the case of leases for this purpose, the IASB should provide an exact definition of which assets are considered to be related to the lessee’s core business and those which are not.

- b) Lease term: one of the factors that may serve as an indicator that the true objective of the lessee is not to take control of the asset or assume the risks and rewards of ownership is the term of the lease. We agree with the EFRAG that the standard should include a clear definition of what should be considered to be a short-term lease.

In this regard, we consider that, probably, the time horizon of twelve months indicated in the ED could be reasonable, provided that other factors are taken into consideration such as the aforementioned relatedness of the leased asset to the lessee’s core business, since it is habitual practice to arrange leases for a term of around 24 months (or even longer) for assets unrelated to the core business. The application to such leases of the treatment of operating leases in the existing IAS 17 would not, in our opinion, significantly impair the information offered to users of the financial statements, although it would lessen the administrative workload arising from applying the standard for the lessees.

In our opinion, in accordance with the criteria set out above, both of the mentioned leases could be registered in accordance with the current IAS 17, in line with the suggestions of the EFRAG.

#### 4. Measurement

In view of the complexities, in certain cases, currently arising from lease contracts, we consider that it is necessary to explicitly define the components of such contracts that should be taken into consideration when they are recognised for accounting purposes, i.e. the measurement of the right-of-use and the payment obligation in the case of the lessee, and the portion of the asset to be derecognised in the case of the lessor.

When measuring rights and obligations, there are certain habitual variables in the lease contracts that should be considered, relating primarily to:

- The term of the lease, due to the different accounting treatment to be given to options to extend; and
- The amount of the payments to be made, which will vary depending on the consideration given to the purchase options, contingent components of rentals, residual value guarantees, payments under term option penalties and other contingent payments.

Extension periods: firstly, the EFRAG's draft comment letter on the ED includes certain observations that we consider to be of particular significance in order to consider this matter:

- Rentals payable in an extension period do not meet the definition of a liability based on the conceptual framework;
- Rentals receivable in an extension period do not meet the definition of an asset based on the conceptual framework;
- The lessee may not have reliable information at every reporting date about future market rentals for the specific asset and, therefore, be unable to assess if the option to extend is favourable or not;
- The lessor may not be aware of lessee's decisions that may impact the likelihood of the renewals; and
- Including these amounts in the measurement of future payments increases volatility and may reduce comparability.

As a result of the foregoing, we agree with the EFRAG that it is ill advised to include rentals from optional extension periods in the recognition of lease contracts.

However, it is also true that the existence of these options is relevant and endows the lessee with an asset of greater value than for a lessee that does not have such options. Furthermore, if the options to extend were not considered in the recognition of the lease, it could give rise to lease contracts of an initially short duration with the lease term based to a large degree on periods of extension, in order to, unduly, avoid the recognition thereof for accounting purposes.

Nonetheless, we believe that to continue to measure and recognise each one of these options, as the EFRAG suggests, would be excessively costly for a great many lessees who would also

have to review the measurement of the leases at each reporting date. Moreover, since there is no market for trading these specific options in order to extend the lease term for a certain asset, the measurement criterion used, the related assumptions and any estimates made could have a significant impact on the accounting records and it would be difficult to compare them with objective information.

Accordingly, it would be absolutely essential for the IASB to provide an uncomplicated measurement criterion that truly assisted lessees and lessors in providing the required information in their financial statements at a reasonable cost and effort; however, even in such circumstances, the uncertainty and volatility would be significant.

Consequently, in our opinion, the only realistic approach consists solely of providing such information as disclosures in the notes to the financial statements of the lessee and lessor.

Purchase options: the ED proposes that both lessee and lessor ignore the existence of purchase options at the end of the lease until such options are exercised. In this regard, we also agree with the EFRAG that this treatment would be erroneous, as it would give rise to two leases being measured for accounting purposes equally, even though one of them contained an option to purchase the underlying asset and the other did not.

However, as we indicated when discussing options to extend, one of our concerns is that the cost -both for lessees and lessors- of implementing this standard should not be unduly high. In this regard, the recognition of these options and the subsequent measurement thereof at each reporting date, in addition to being subjected to new subjective assumptions, uncertainty and volatility, could create a complex and very costly task. It should also be taken into account that in many cases these options have an exercise date established at very long term, such as 15, 25 or 30 years, which are periods over which it is impossible to make reliable projections.

For this reason, we consider that it would be reasonable in the case of the options at market price, in which the exercise price does not differ significantly from the market value of the related asset, for the issuer of the financial statements to have the option to recognise the fair value of the option separately, without the need to review it at each reporting date.

As regards bargain purchase options, in which the exercise price is sufficiently low to be able to consider that the exercise thereof is highly probable, we consider that the accounting treatment envisaged in the ED is adequate.

Contingent rentals: in view of the habitual term of leases for an entity's strategic assets, in order to comply with the provisions of the ED, issuers of financial statements will be obliged to make estimates of the various financial aggregates for protracted periods such as 15 or even 30 years, for example.

In the same way as other international standards, such as IAS 36, consider that the forecasts of future events made more than five years in advance may not be sufficiently reliable to support an impairment test and the impact thereof, if any, on the financial statements, it also seems logical to affirm that, in the case at hand, managing uncertainty would be no easier. Accordingly, in accordance with IAS 36.35, and due to the volatility of certain industries, the projections prepared by the issuers of financial statements in order to verify the existence of impairment has been limited to a maximum period of five years. Bearing this in mind, the current version of the new ED may give rise to an inconsistent approach to estimating future

financial performance (IAS 36 only five years, compared to the new ED on leases that establishes the full term of the lease). This could even have a contradictory effect, since, depending on the circumstances, the issuers of financial statements could be obliged to recognise impairment losses for a cash generating unit with the related rights of use as a result of using financial projections at five years, whereas the right-of-use itself had been recognised on the basis of the full lease term.

In practice, the preparation of long-term projections is not very reliable. The element of uncertainty over such timeframes is highly significant and there are no sufficient means of mitigating such uncertainty to a reasonable extent.

We should also consider the nature of the contingent rent 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 this regard, 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>1</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.

---

<sup>1</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.

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.

We the undersigned are convinced that the limitation on the use of estimates of future events and the simplification of the way in which such estimates are made is critical to the success of the new standard on leases.

To this end, based on the considerations set out above, we believe that the best alternative is to exclude contingent rent from the calculation of future lease payments, although the existence thereof should be disclosed in the notes to the financial statements.

Accordingly, the users of the financial statements would receive relevant information, and only the contingent rent already paid would have an impact on the financial statements, which would be in line with IAS 37: "A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability."

## **5. Implications for the statement of comprehensive income**

The application of the new standard for leases, as described in the ED, would have a significant impact on the statement of comprehensive income of issuers of financial statements. However, like the EFRAG, we consider that this matter has hardly been addressed in the analysis of the IASB. Moreover, apart from indicating the need for a more in-depth study of this area, the EFRAG itself hardly considers these, in our view, absolutely essential implications.

In order to assist in the consideration of the effect of the ED on the statement of comprehensive income, we set out below a brief summary of the most noteworthy matters.

Under the current IAS 17, if the lease is classified as an operating lease, monthly lease payments are recognised in the statement of comprehensive income as an expense on a straight-line basis over the lease term. No asset or liability is recognised, except for the difference between the accumulated lease expense recognised on a straight-line basis and the actual amount paid.

Under the proposed model, the lessee would recognise a right-of-use asset and a corresponding obligation to pay rentals. The right-of-use asset would initially be measured at the present value of the future lease payments with a corresponding liability for the obligation to make lease payments, discounted using the lessee's incremental borrowing rate. The right-of-use asset would subsequently be amortised over the lease term, and the financial debt subsequently measured at amortised cost, with the corresponding charge to finance costs in the statement of comprehensive income.

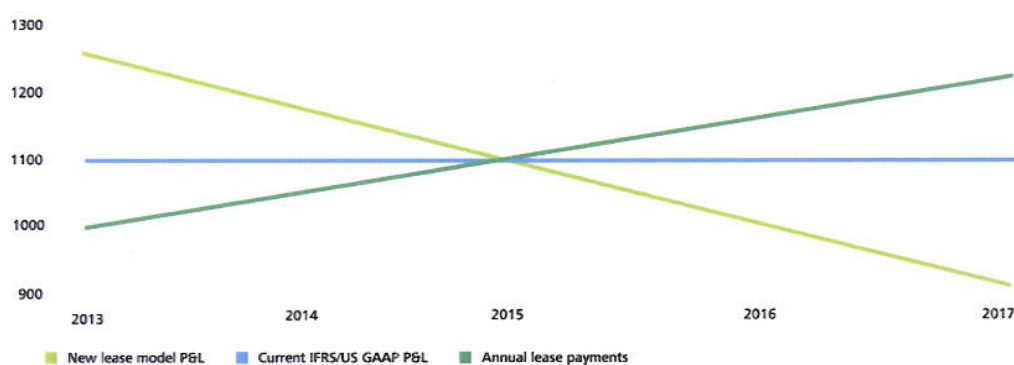
The projected impact of this new accounting model on the lessee's statement of comprehensive income is that the sum of the amortisation of the right-of-use asset and the interest expense arising from the obligation to make future payments will exceed the rental



expense recognised under the current IAS 17 during the first half of the lease but will subsequently be lower due mainly to:

- Amortisation of the right-of-use asset on a straight-line basis;
- Decreasing finance costs due to the measurement at amortised cost of the future lease payment obligations, as opposed to
- Rental expense recognised on a straight-line basis under the current IAS 17.

Chart 1. Expenses related to the lease



The analyses performed indicate that the new accounting model brings the lease expense forward to a considerable extent. This effect does not begin to reverse until approximately 55% of the lease term has elapsed and the expense is fully offset only at the end of the lease term.

This effect may have a highly considerable impact on profit before tax, entailing much lower returns on standard projects during more than the first half thereof, followed by higher returns. Consequently, under the new accounting model a project with a sustained cash-generating capacity over time would be heavily penalised in the statement of comprehensive income for a number of years, improving subsequently to reach a significantly higher rate than the actual performance of the project transactions, resulting in confused and counter-intuitive information that does not represent the reality of the business.

Unfortunately, it seems that the new accounting model for leases would not contribute to presenting transactions fairly because by altering the pattern of returns over time to a growth rate that does not coincide with the actual revenue generated by the projects, it breaks the fundamental income and expense matching principle.

In our view, various approaches could be adopted with respect to the recognition of the amortisation expense of a right-of-use asset that could be analysed in order make the new model a better reflection of the pattern of returns over the life of projects operated under leases. These approaches could include a different distribution over time of the amortisation expense and finance costs to cover the entire the lease term (such as an increasing amortisation model, which could be justified by the fact that the expected returns on the project also increase over time).

In this regard, an increasing distribution over time of the amortisation of right-of-use assets could have a net effect on the statement of comprehensive income similar to the application of the so-called “linked-approach”, without the fundamental disadvantage that gave rise to the tentative rejection of this approach by the IASB in its Discussion Paper (DP/2009/1), i.e. that the liability recognised by the lessee did not accrue interest. In addition to distributing the lease expense in order to reflect the consumption of benefits, it retains the benefits of the approach, which were also recognised by the IASB: a) it is simpler for lessees to apply; b) it aligns the statement of comprehensive income and the tax treatment of leases; and c) it reflects the way in which lease contracts are priced.

Another argument in favour of the increasing amortisation of right-of-use assets is the way in which amortisation is calculated. If we assume that in a contract between independent parties the future lease payments will essentially be equivalent to the use that the lessee expects to obtain from the underlying asset, the net present value of the rentals is also equal to the discounted value of the benefits that the lessee expects to obtain from the subject-matter of the contract. The value of the right-of-use asset decreases over time as it is used in the process to produce goods and services – which may reasonably be assumed to occur on a straight-line basis over the lease term – but increases due to the reduction in the discount rate applied to the future cash flows. In short, increasing amortisation better reflects the time pattern of the repeated use of the right-of-use asset.

Another alternative would be for the IASB to analyse in depth in what category of liability the obligation to pay rentals would fall. After recognise a right-of-use asset and a liability at the present value of the lease payments, if this liability were considered to be a non-financial liability, the amortised cost method should not be used, as would be the case of a deferred tax liability. In each payment the difference between the liability and the real payment should be recorded as lease expense. In this case, all the adverse effects described above would be mitigated.

## **6. Transition**

Since, according to the ED, the new accounting model for leases would be applicable to all leases outstanding at the date of first-time application, the right-of-use asset and the liability that reflects the obligation to pay rentals would be recognised at the present value of remaining payments, using the lessee’s incremental borrowing rate.

As indicated above, the time pattern of the lease expense is significantly modified under the new accounting model, bringing forward the recognition of the expense.

Let us take the example of an entity that carries on a series of projects under leases of which the portion of the lease term elapsed varies, i.e. the progress of the leases is distributed more or less uniformly over time in the entity’s portfolio.

In this case, under the first-time application model put forward in the ED, regardless of the point in time of the leases at the transition date, the right-of-use asset and the obligation to pay rentals would be calculated on the basis of the remaining payments, i.e. a new time pattern for returns would begin for each lease in which returns would be artificially penalised for over half of the remaining lease and would not be linked in any way to the actual pattern of project returns.

However, if the new standard were applied full retrospectively for the first time, for the hypothetical entity described above with a balanced portfolio in terms of the lease term elapsed, such first-time application would situate the various leases at different points in time with respect to the pattern of returns, i.e. certain leases would be in the first stage of bringing forward expenses whereas others would be reversing the amount brought forward.

Consequently, we believe that it would be appropriate to establish as the basic scenario the full retrospective application of the new standard. There are no conceptual reasons to prohibit when entities have the relevant information available.

However, we understand that only in the case of an entity that has not available the relevant information to apply full retrospective approach, the IASB could allow simplified retrospective as an option for transition.

## **Appendix 2 – Response to questions raised in the EFRAG’s draft comment letter on ED Leases**

*Question in paragraph #41: Do constituents believe that a distinction between leases and sales/purchases is required? If so, do they believe that the criteria are appropriate?*

We agree with the EFRAG on their interpretation of the definition of a lease and that the aforementioned definition should be consistent with that established in the *Revenue Recognition ED*.

In particular, we believe that a distinction between leases and sales/purchases is critical, given the different legal implications that derive from each different situation, and therefore require a different presentation in the financial statements. Regarding the applicable criteria, we agree with EFRAG’s considerations in this connection.

*Question in paragraph #61: Do constituents agree with EFRAG’s suggestion on the lessee’s treatment of a contract that includes non-distinct services? If not, what other approach do you support?*

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 approaches would damage the comparability

*Question in paragraph #97: Do constituents believe that separating different categories of contingent rentals might be too complex?*

We believe that separating different categories of contingent rentals is meaningless, given that our suggestion is to exclude all of such rentals from this accounting treatment, considering the significant implications this would have in terms of complexity, uncertainty and volatility, as indicated in Appendix 1.

*Question in paragraph #123: Do constituents agree with the analysis and the EFRAG’s proposals for the treatment of sale and leaseback transactions?*

We agree with the IASB’s treatment for lessees in a sale/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.

As for the performance obligation approach, we share the EFRAG’s considerations and conclusions as we defend only one model for lessors, the partial derecognition approach.

*Question in paragraph #135: Paragraph 44 of IAS 7 Statement of Cash Flows requires treating the acquisition of an asset by means of a finance lease as non-cash transaction. The proposals do not change the requirement. Do constituents agree with the treatment? Or do constituents believe that a lease is essentially a financing transaction and therefore should be presented in*

*the statement of cash flows in the same way an entity presents the purchase of an asset financed by way of a bank loan?*

We believe that only an actual acquisition of assets should be presented as cash flow transactions in the Statement of Cash Flows. Since it cannot be asserted that the ultimate purpose of all leases is to acquire assets (take control of the asset and assume the risks and rewards associated therewith), it would be confusing to treat all of them as purchase transactions financed by the lessor. Therefore, in order to prevent arbitrariness arising from the application of rules regarding the existence of indications of a purchase transaction, as under the current IAS 17 concerning the distinction between finance and operating leases, the separate effect of the cash flows from investing activities which are offset by the cash flows from financing activities for the same asset which, in reality, was merely held under a lease, should not be recognised in the Statement of Cash Flows.