To : Françoise Flores, Chair, EFRAG Technical Expert Group

Leaseurope's Response to EFRAG's Draft Comment Letter on the IASB's Leases Exposure Draft

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Dear Françoise,

This letter sets out Leaseurope's comments on EFRAG's Draft Comment Letter (DCL) on the IASB's Leases Exposure Draft (ED).

Leaseurope welcomes EFRAG's DCL and is very supportive of the conclusions reached in the letter, although we maintain that the better approach to revising current lease accounting would have been to remove references to bright line classification and to improve the level of disclosure required under the standard.

We believe that EFRAG has correctly identified the most significant issues arising from the ED. In particular, we fully agree with EFRAG that:

- The proposed standard is weak at its boundaries (e.g. leases vs services and leases vs sales/purchases). The definition of a lease, in addition to being insufficiently robust, is too broad; contracts involving generic, interchangeable assets should not be leases.
- The conceptual premise of the right of use model has not been reflected consistently throughout the proposed standard (as is visible in the proposals for lessors and sale and leasebacks).
- Intangibles should be covered by the scope of the future standard.
- The proposals for the treatment of options and contingent rentals are inconsistent with the Conceptual Framework, particularly burdensome for preparers and do not necessarily provide users with appropriate information.
- Substantial simplification is still required for lessees of short term contracts.
- The performance obligation model for lessors has no conceptual or economic foundation and the proposed hybrid approach for lessors begs the question of why lessees do not also require several models. Consequently, partial de-recognition should be applied as the general model for lessors (but with accretion of residual assets as explained in our response below).
- More work needs to be done by the IASB to assess the true informational needs of users of accounts.
- A full analysis of the effective benefits of the proposals, weighted against the total costs for preparers (including accounting impacts but also broader economic effects), is lacking.

Leaseurope has repeatedly called on the IASB to i) seek to better understand the reality of businesses' use of leasing and ii) to perform a comprehensive impact assessment of its proposals. We have yet to see any compelling evidence of this.

We therefore rely heavily on EFRAG to ensure that any new standard the IASB develops does not create a disproportionate burden for preparers operating in a European environment[1]. As they currently stand, the proposals are far from being a workable solution. We have evidence that plain vanilla, small ticket equipment leases will be the most affected by the proposals, which is highly paradoxical given the objectives of the standard setters[2].

We have focused this response on what we view as being the most important issues raised by the IASB's ED, as well as on particular elements of feedback that EFRAG is seeking. We take the view that EFRAG's DCL addresses most of our concerns with the ED and have therefore highlighted those areas we think EFRAG should give further consideration to in its final response to the IASB. We believe that one aspect in particular requires further reflection by EFRAG, namely the subsequent measurement of residual assets for lessors.

As already mentioned, Leaseurope agrees with EFRAG that a partial de-recognition approach should be the general model that lessors apply if a right of use model is to be adopted as it is the only model that is consistent with the right of use approach developed for lessees. Nevertheless, we believe that the de-recognition approach presented in the ED contains a fundamental flaw with respect to the measurement of residual assets by proposing to freeze their measurement. This does not provide meaningful information to users of accounts and leads to a significant distortion of a lessor's revenue and return on assets. If such an approach were to apply, there is a major risk that lessors could withdraw from the market, thus depriving the European economy of a vital source of investment finance, for businesses of all sizes, and in particular for Europe's SMEs where leasing may often be their only means of obtaining the use of assets. We are concerned that EFRAG may not have considered this issue in sufficient detail and therefore call on EFRAG to examine the consequences of freezing residual assets further. We have provided detailed conceptual and technical reasons as why residual assets should accreted over the lease term below[3].

In addition to signalling its preference for the partial de-recognition model to the IASB, EFRAG should also make it clear that this is an area where the IASB should not bow to pressure from the FASB. The hybrid model proposed in the ED is clearly the result of poor compromise between the Boards, which should not be the outcome of the convergence process[4].

Our full response to the questions raised in the ED can be found in our comment letter to the IASB, which we will communicate to EFRAG. We encourage EFRAG to refer to this for further information on our position regarding the individual ED questions.

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[1] In line with EFRAG's objectives to provide input on "possible consequences of proposed accounting solutions or proposed standards for companies operating in the European environment with the objective that the European concerns and practice are properly taken into account." – see §2.3, *Working Arrangement between the European Commission and EFRAG*.

[2] See our full response to the IASB or the survey "Preparers' Views on new Lessee Accounting: European Impact Survey 2010", PwC

[3] Including numerical examples which can be found in the appendix

[4] There are other examples of areas where convergence has lead to poor compromise rather than progress, such as the decision to exclude intangibles. We encourage EFRAG to be very firm on these points.

In particular, we wish to draw EFRAG's attention to the alternative right of use model we have described in our letter to the IASB. This model illustrates that it is possible to achieve a simple right of use approach that can apply to all leases, without imposing unjustifiable burdens on preparers. The proposals set out in the ED do not achieve this. It is therefore necessary for the IASB to take the time required to produce a high quality final standard. We are concerned that if the IASB were to remain inflexible with respect to their self-imposed June 2011 deadline, they may not obtain this result. We are supportive of the convergence process, but it should not come at the expense of appropriate process and robust standards. We call on EFRAG to ensure that the future IFRS Leases standard will live up to the expectations of European preparers and users of accounts.

We have very much appreciated the willingness of EFRAG to engage with Leaseurope on this important project and remain committed to working closely on lease accounting with EFRAG and its staff going forward.

Please do not hesitate to contact us or Leaseurope's Senior Adviser, Jacqueline Mills (j.mills@leaseurope.org - +32 2 778 05 66) for any questions you may have on our comment letter.

Yours sincerely,

Tanguy van de Werve
LEASEUROPE DIRECTOR GENERAL

Mark Venus
CHAIR, LEASEUROPE ACCOUNTING COMMITTEE

Question 1 – The model for lessees

We note that EFRAG agrees that lessees should recognise amortisation of the right of use asset and interest on the lease liability, but does not make additional comments on the subsequent measurement proposals for lessees.

Our understanding of the current proposals for subsequent measurement is that they imply that lessees will in practice be required to amortise the right of use asset on a straight-line basis. This creates a number of significant issues for lessees, including a lack of comparability between lessee accounts, a permanent increase in lease costs, a mismatch between lease costs and cash rentals paid and a misrepresentation of the economics of the deal. These issues are detailed in our full response to the ED.

While we do agree that subsequent measurement should be done on an amortised cost-basis, we consider that this should reflect the fact that a lessee's asset and liability are intrinsically linked. Indeed, the asset and liability form an inseparable package, originating from the same contract, contrary to say a purchase of an asset financed by a loan where the loan and the purchase have distinct contractual origins. In a lease, the lessee cannot sell the liability without selling the asset or vice versa.

The Boards themselves recognise the linked nature of lease assets and liabilities for the purposes of initial measurement but have not made a case of why this should cease to be the case for subsequent measurement. There may be instances where the right to use asset becomes impaired or increases in value without there being a change to the lease payments. However, this does not prevent a lessee from using a form of measurement reflecting the linked nature of its lease assets and liabilities and otherwise performing impairments or revaluations as required, effectively de-linking the asset and liability values when necessary.

Consequently, we advocate a measurement approach whereby the lease liability is apportioned between a finance charge and a reduction in the outstanding liability and the decrease in the lessee's right of use asset is determined by using mortgage-based amortisation. Importantly, the use of mortgage-based amortisation would resolve most of the issues that occur for lessees under the current proposals for transition. We therefore encourage EFRAG to reconsider this issue.

Question 2 – The model for lessors

We are supportive of EFRAG's preference for the partial de-recognition model. The reasons for why we believe that the de-recognition model is the only model that i) is consistent with the right of use model for lessees and ii) appropriately reflects the economics of a lease are set out in our full response to the IASB. We do not advocate the application of the performance obligation model in any circumstances and consider that EFRAG should provide a clear signal to the IASB that this is an issue where they should not compromise.

However, in order for the de-recognition model to appropriately reflect the economics of a lease, it is necessary that residual assets are accreted over the life of the lease (and not frozen at initial measurement as suggested in the ED). This is a crucial issue for lessors.

The lessor's residual asset, i.e. the rights it has retained, is the present value of the expected value of the asset at the end of the lease, excluding a deferred sales profit amount in the case of manufacturer/dealer lessors. This is because lessors use the fair value (normal selling price) of the underlying asset as the basis for calculating lease payments and thus the value of the right of use of the asset (i.e. the present value of lease payments). In performing this pricing exercise, the lessor will decide on the level of residual it is willing to accept at the end of the lease, considering this amount to be the last cash flow in the lease.

Given that the initial measurement of the residual is based on the present value of its expected value at the end of the lease (excluding a deferred sales profit for manufacturers), we consider that this discount should be unwound over the term of the lease. If the residual asset is frozen as suggested in the ED, the accounting will not reflect the lessor's constant contractual yield. Instead, the lessor's return on assets will i) be lower than contractual yield, ii) decrease through the lease term and iii) increase significantly when the lessor sells or releases the asset.

Freezing the residual also hampers comparability between 3rd party and manufacturer lessors as for the same lease contract the returns shown by these two parties would not be the same. This is illogical as the accounting for the same financing transaction should yield the same results regardless of the type of entity granting the deal. The only difference between a 3rd party and a manufacturer lessor's accounts should be the sales profit that the manufacturer is seeking to realise. We recall here that the 3rd party lessor has no such profit to recognise and indeed is not in the business of selling assets.

Users of financial statements of lessors are interested in obtaining information on the level of residual risk a lessor faces. Freezing the measurement of residual assets will therefore not provide users with the best information available. Given that the initial measurement of the residual asset is on a present value basis, the most relevant information to the users of accounts in subsequent periods is the fair value of the residual asset and the best proxy for fair value is the discounted expected future value of the asset. We do not advocate a full fair value approach to subsequent measurement given the difficulties of establishing current fair values of future second hand prices, a present value basis is far more informative than freezing measurement at the initial amount.

We note that under IAS17, residuals are effectively accreted over the lease term. The only difference with the finance lease accounting model[5] and the de-recognition model is that under a finance lease, the lessor's residual is not shown separately from its right to receive rentals whereas de-recognition splits these two assets, thus providing better information to users.

Additionally, it is important to understand that a lessor's residual asset represents its remaining rights to an asset after it has transferred the right to use the asset to a lessee. It is therefore not directly comparable to the underlying asset itself (e.g. the car or the equipment). Rather, it represents a future physical asset or the asset the lessor will have once the lease has come to term and when all of the rights associated with the underlying asset (i.e. ownership and usage rights) have been reunited. As the residual represents the lessor's rights to control of the underlying asset in the future (i.e. at the end of the lease), we consider that its subsequent measurement should reflect the time value of money and that this would not be inconsistent with a cost-based approach to measurement.

[5] Ignoring the difference between the two models for accounting for options and contingent rentals. Leaseurope does not support the proposed treatment of options and contingent rentals. For more information, see our response to questions 7, 8 and 9 below.

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Yet another way of looking at a residual asset is to describe it as the remaining portion of the leased asset that is not encumbered by the transfer to the lessee of the right to use the item. As the lease term progresses, this asset becomes progressively less encumbered (i.e. the lessor comes closer to reuniting all the rights associated with the asset). Subsequent measurement of the residual asset should therefore reflect this progression. In other words, residuals should accrete at the rate inherent in the lease so that they equate to the expected asset value at the end of the lease term (absent impairment).

Lastly, we note that the accretion of residual assets is supported by IASB member Stephen Cooper in his alternative view to the Leases ED.

Numerical illustrations of the effects created by the non-accretion of residual assets are provided in the appendix.

Question 4 – Definition of a lease (leases & sales/purchases)

EFRAG asks its constituents to provide views on whether the distinction between leases and sales/purchases within the Leases standard is required and if so whether the criteria are appropriate

Leaseurope does not agree with the IASB proposal. We consider that such a distinction is not required as it creates a new bright-line classification requirement between different kinds of leases. We note that the current standard IAS 17 does not include such a distinction as the accounting for these contracts can very well be catered for under the existing accounting which provides similar results to accounting for outright sales/purchases. We think the same is true of the new standard where lessees will acquire rights to use that are equal to or near 100% of the rights associated with the underlying asset and where the lessor will de-recognise those same rights[6].

We recall that the only reason for introducing the notion of “leases that are sales or purchases” into the leases guidance was the need for manufacturer/dealer lessors to be able to recognise sales revenue at least in some circumstances as under the performance obligation model (that was the only model considered initially for lessors) manufacturers are not able to recognise such revenue. Now that (partial) de-recognition has been introduced (and we argue should apply as the general model for lessors as does EFRAG), there is no longer any need to scope out such contracts from the existing guidance.

Not only is this distinction no longer required for above purpose, as EFRAG points out, it introduces into the IFRS literature several definitions of what constitutes a sale. Paragraph B9 of the Leases ED defines a sale or a purchase as the transfer of control and all but a trivial amount of risks and benefits associated with the underlying asset, whereas the Revenue Recognition ED refers only to control. Consequently, there may be cases where a contract qualifies as a sale under the Leases definition, but not under the Revenue Recognition definition.

[6] The only difference would be accounting for contingent rentals and options. Again, these are proposals that we do not support (see questions 7, 8 and 9 below). We understand that this is also EFRAG’s view.

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Moreover, although the definition of a purchase/sale in the Leases ED is slightly narrower than the definition of a finance lease today, in practice the two are not very different. This is because the criteria of “all but a trivial amount of risks and benefits” is very similar to the criteria for determining finance leases today. Some Leaseurope members report that a majority of their existing finance lease contracts would likely qualify as sales under this definition.

This would have a number of practical implications:

1) Under the lessor model currently proposed, although the criteria for distinguishing between de-recognition leases and performance obligation leases are not necessarily clear, it could be that in reality there will be very few cases where de-recognition effectively applies (leaving a sales model and the performance obligation model as the *de facto* accounting approaches for lessor).
2) The lessor’s ownership rights to the asset will not be visible, jeopordising its position in the event of lessee default. Even though such contracts may bear some similarities to outright sales, they are not outright sales as the lessor continues to have legal title to the asset. Legal title does not have to be a decisive factor, but does play a role as it is indicative of a higher security lien than other forms of secured lending. Applying the right of use model to such contracts recognises legal title of the lessor but provides equivalent accounting to that for secured loans or financed sales.
3) The distinction may possibly lead to a number of other consequences e.g. in terms of the tax treatment of leases and the regulatory environment that is applicable to lessors (lessors will no longer be lessors but lenders and sellers). We appreciate that these consequences are beyond the scope of the IASB’s work, however decisions taken in the field of lease accounting will influence other areas of legislation and these effects on European businesses should not be ignored by EFRAG.

Consequently, we are supportive of the conclusions EFRAG reaches in its response to Question 4. However, we think that §38 should be reworded, as it suggests that EFRAG could accept the definition of a sale/purchase within the Leases standard if additional indicators are included in B10. For the reasons set out above, we do not think this would be appropriate.

Question 6 – Contracts that contain both service and lease components

EFRAG asks its constituents whether they agree with the suggestion on the lessee’s treatment of a contract that includes non-distinct services or if there are any other approaches they would support.

We broadly agree with the proposed EFRAG response to Question 6 and are fully supportive of EFRAG’s suggestion that lessees assess the economic substance of the transaction and account for it accordingly as either a lease or a service if they are unable to otherwise allocate lease and service components. Nevertheless, we feel it is important to make a few clarifications with respect to leases with service components from the perspective of both lessees and lessors.

Treatment of leases with services from the perspective of lessees

We question whether the notion of “distinct services” can be applied to lessees. Indeed, this concept has been developed in the context of the revenue recognition guidance for entities entering into contracts to provide goods or services, not for entities *acquiring* such contracts. Therefore, we consider that the Boards should define *specific* guidance for lessees.

We suggest that lessees be required to *estimate* service components. If this is not feasible, instead of the default to treatment of both right of use and service components as a lease contract, lessees should make an assessment of whether the contract they have entered into is in-substance a lease or a service, which is in line with EFRAG's recommendation.

We note that if the Boards resolve the issues surrounding the boundaries between lease and service contracts, lessees should encounter relatively few cases where they are required to make that assessment.

Treatment of leases with services from the perspective of lessors

From the point of view of a lessor, any service components granted in conjunction with a lease will *always* be distinct service components, separable from the lease. We provide the reasons for this in our response to the IASB's ED. Although we disagree that there would ever be non-distinct service components in a lease, we do therefore support the IASB's approach to always require separation of services components from lease payments when applying the de-recognition model. We do not advocate the application of the performance obligation model in any circumstances.

Questions 7 and 8 – Purchase options and lease term

Leaseurope is fully supportive of the arguments made by EFRAG in relation to the proposals for the treatment of options. While we agree that options may constitute assets for lessees, we think that the proposed approach is inconsistent with the Conceptual Framework, will be extremely difficult for preparers to apply and will not necessarily result in improved information and comparability for users of accounts as EFRAG describes.

As an alternative, we suggest an approach where only lease payments required to be made during the initial contractual lease term are recognised. This would include any amounts that are required to be paid by the lessee either to obtain the ability to extend the lease term beyond the initial contractual term or to obtain the ability to purchase the asset at the end of the contract in addition to any amounts the lessee is required to pay if the lease contains a renewal or purchase option but where the lessee does not renew the lease or purchase the asset. The maximum amount payable under a residual value guarantee provided by a lessee to the lessor should also be included in the payments that are recognised[7].

We consider an approach that requires the above amounts to be taken into account would mitigate any potential negative side-effects of not separately accounting for options or considering their impact in determining a likely lease term, while at the same time effectively reflecting their value and the commitments and risks that a lessee has under a lease, which we believe would be in line with the view expressed by EFRAG.

[7] We note that this is the approach currently adopted in IAS17 for lessee provided residual value guarantees

This is because renewal options will fall into one of the following categories:

1) *Renewal options allowing the lessee to extend the lease after the initial lease term at the then market rate (or an equivalent one-off payment.)* Such an option has no intrinsic value as the lessee could simply obtain a new lease at the end of the initial lease.
2) *Renewal options allowing the lessee to extend the lease after the initial lease term at a rate lower than the then market rate rentals (or an equivalent payment).* Renewal options at lower than market rentals (or an equivalent payment) will either have been priced into the level of rentals of the initial lease term (which will be higher than if there is no such option) or will be granted in conjunction with a residual value guarantee designed to protect the lessor from the risk of the lessee not renewing the lease. In the first case, the value of the option reflected in the higher rentals will already have been taken into account into the lessee's obligation to make rental payments and its right of use asset. In the second case, the maximum amount payable under a residual value guarantee is included in minimum lease payments. Consequently, the value of the option is appropriately taken in to account.
3) *Renewal options allowing the lessee to extend the lease after the initial lease term at a rate higher than the then market rate rentals (or an equivalent payment).* Renewals could also be granted at an above market rental. In such situations, if the rentals in the initial lease period are lower than they would be otherwise, the lessor is exposing itself to a significant risk that the lessee will not renew the lease (indeed, the lessee has not obligation to renew). The de-recognition model for lessor accounting will reflect this situation clearly, by showing a large residual asset that will be clearly visible to users. Lessors will therefore only grant such leases if they are effectively comfortable with taking on such risk. In practice, it is unlikely that they will do so to any great extent but even if such contracts are granted, the accounting model will always appropriately reflect the true risks and commitments of both parties.

We consider that the same treatment can and should be applied to options other than renewal options (i.e. termination and purchase options).

We note that, were the IASB to pursue a single asset and liability approach, EFRAG recommends in §80 of its draft comment letter that the lease term be based on the term that has the highest probability to occur. We think instead that the probability threshold should be based on whether the exercise of options is "highly probable". The current proposals for a threshold of "longest possible lease term more likely than not to occur" is very low and consequently will imply that preparers will be required to recognise assets and liabilities for the full amount of rentals under optional periods in situations where there is little compelling evidence that they actually will exercise the option. This is precisely why the approach will not provide truly meaningful and reliable information. Therefore, a higher, more robust threshold could be chosen for determining the lease term, where only optional features with a "highly probable" chance of being exercised are taken into account. In such cases, preparers would be required to consider whether they are economically incentivised to do so. We view this approach as being consistent with the alternative view presented in the ED.

Question 9 – Lease payments

EFRAG asks its constituents whether they believe that separating different categories of contingent rentals might be too complex.

We fully agree with EFRAG that rentals that are under the control of lessees should not be included in the measurement of its assets and liabilities. We believe that a distinction should be made in the types of rentals that are currently grouped under the heading “contingent rentals’ in the ED. The distinction should be variable rentals and contingent rentals as described below. We do not see this as being a source of complexity at all.

Variable rentals

Payments that are based on changes in an index or rate are simply variable rentals and are different in nature to contingent rentals. With the former, the lessee is unable to avoid making the required payment, whereas with the latter, the lessee is only obliged to make payments once the contingent event has occurred. This should be therefore reflected in the accounting model for leases. We suggest that they be included in the lease payments that are recognised, using the index or rate existing at inception of the lease upon initial measurement. Changes in amounts payable arising from variations in the underlying rate or index should be recognised in profit or loss in the period in which they become payable. This would be consistent with the treatment of other financial liabilities.

Contingent rentals

Rentals that are contingent on a performance or usage factor are not liabilities for lessees, nor are they assets for lessors, because lessees have the discretion to avoid such payments. Consequently, we see no justification for recognising and measuring these items on the basis of a probability weighted outcome technique. It is important to understand that when granting such leases, a lessor is exposing itself to the possibility that the contingency will not arise and thus that it will not receive payment. It is therefore exposing itself to risk, a situation that will clearly be reflected in the accounts of the lessor using the de-recognition model, as these will show a higher residual asset than if it had granted a lease with fixed rentals.

We observe that rentals which are entirely contingent and based on a performance factor such as turnover are extremely rare in equipment leasing contracts. This type of feature can more typically be found in commercial property developments. In order to ensure the presence of an anchor tenant (such as a well known supermarket or fashion chain) in the development, the lessor will base the rentals of the anchor tenant on a percentage of its future sales. It is unlikely that the lessee will effectively be able to avoid payments as there is clearly an underlying economic rationale for its choice to establish a commercial premises. Consequently, we suggest that the standard captures contingent rentals *only in such cases*, i.e. when contingent rentals are being used as a means to “disguise” minimise rental payments. A principle for recognising such situations could be “*situations where contingent rentals are included in lease contracts to compensate for below market committed rentals*”.

When “disguised minimum lease payments” are identified, lessees should include them in their lease liability on the basis of a most likely outcome approach. All in all, we believe that this approach would discourage the use of contingent rental payments as a method to simply minimise rental payments.

Residual value guarantees

Residual value guarantees are different to contingent rentals as they relate to the value of the leased item. We think that lessees should include the maximum amount payable under a residual value guarantee in their lease payments, as is the case today.

From a lessor point of view, residual value guarantees are important features of lease contracts and the implications of such features have not been sufficiently deliberated by the Boards. This is visible in the ED which is completely silent as to how lessors should account for 3rd party residual value guarantees, although they would intervene in determining the model lessors should apply. For lessors, we consider that the appropriate approach would also be to continue to apply the method in the existing leases standard, where both lessee and 3rd party provided residual value guarantees are included in the lessor's receivable.

We find EFRAG's §96 of its draft comment letter slightly confusing. Our reading of Appendix A is that it includes guarantees provided by *lessees* only rather than the lessor only as you state. Residual value guarantees can either be provided by the lessee (or by a party related to the lessee) or by a party that is neither related to the lessee nor the lessor (the latter are referred to as 3rd party residual value guarantees).

Question 11 – Sale and leaseback

EFRAG asks its constituents whether they agree with its analysis made for sale and leasebacks and whether they support its proposals for the treatment of sale and leasebacks.

We do not agree with the ED proposals for sale and leasebacks but instead support the treatment suggested by EFRAG whereby the conceptual premises that an asset is a bundle of rights that can be separated should apply in the case of sale and leasebacks too. The decisive element in determining whether the residual asset should be de-recognised from the financial statements of the seller/lessee should be whether control of the residual has been transferred to the purchaser/lessor, as defined in the Revenue Recognition guidance.

Leaseurope also considers that there is a need to distinguish between sale and leaseback situations where the asset has been that of the lessee for certain period of time and where the lessee decides to enter into a sale and leaseback in order to generate cash flow for instance[8] and those cases where the lessor's route to title of the asset happens to be through a transaction involving a sale of the asset from the lessee to the lessor but where the lessee is simply seeking a lease.

In practice, there are two alternative routes to title for the lessor at lease inception. In the first, the lessor purchases the asset directly from the supplier on the lessee's behalf and title to the asset does not pass through the lessee. The second is technically a sale and leaseback since the supplier sells to the lessee who makes a more or less immediate onward sale to the lessor. These "route to title" situations are and should be treated as normal leases and should not be covered by the provisions for "true" sale and leasebacks.

[8] We note that under the right of use model, the assets and liabilities of a lessee under a sale and leaseback will always be recognised. These types of contracts will not be able to be used to obtain off-balance sheeting financing, but will only be entered into in order to generate cash flow or to reduce asset risk for instance.

Question 14 – Statement of cash flows

EFRAG asks the following question of its constituents: Paragraph 44 of IAS 7 Statement of Cash Flows requires treating the acquisition of an asset by means of a finance lease as a 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 agree with the ED proposals. Leases do not have an impact on current cash flows, as described IAS7 §44.

Question 17 – Benefits and costs

Like EFRAG, we are entirely unconvinced with the analysis of costs and benefits of the proposals presented in BC 200 – 205.

We note that the so called "simplifications" that have been made by the IASB (i.e. the omission of a present value calculation for lessees of short term leases and the requirement to remeasure contingent rentals and options only when there is an indication of material changes) provide little relief to preparers in general and in particular do little to alleviate the complexities cited specifically in §146 of EFRAG's draft comment letter.

Additionally, we note that there are many other types of complexity that will arise under the proposals. These are detailed in our response to the IASB but are summarised here:

- Firms will be faced with complex judgement calls when determining whether they have a lease contract or a service contract. Companies who make use of lease documentation to effectively outsource asset related needs will be faced with managing asset registers and accounting for these assets. Even the simple aspects of accounting for rights of use will be problematic for these entities as they will have chosen to lease because they are able to account for these contracts today as straightforward operating expenses.
- Businesses will have to analyse the service components that are part of lease contracts. Currently, one of the major benefits of a lease is that lessees do not have to consider such aspects. Instead they receive a single invoice encompassing all the costs related to the use of the asset.
- Lessees opt for leasing as it offers them a degree of simplicity that other arrangements cannot convey. However, in the future they will be required to account for their leases in a way that destroys this simplicity.
- The subsequent measurement proposals for lessees will force firms to have to manage book/tax timing differences.
- Requiring firms to make assessments of their most likely lease term or contingent rental payments will create significant burdens as many companies will simply not possess the data or the resources to do so. This is true for companies of all sizes and is a particular problem when it comes to those firms who have many small leases that will need to be dealt with in this way.
- Requiring reassessments of these estimates at each reporting date will lead to even more costs for lessees.

- It should be noted that whilst firms may be able to manage some of the complexities noted above at the level of a single lease contract, a much more significant form of complexity arises in the organisational process required in entities to collate, verify, assemble and present reporting on the many small ticket leases that are managed in varying locations around the company. These leases will all be different from one another and in many cases cannot be aggregated and dealt with in “batches”.

In addition to these complexities, the IASB has ignored potential impacts that go beyond accounting complexity. For instance, there are still as yet unresolved issues as to how lessees operating in regulated industries, such as the banking industry, will be required to hold regulatory capital for their new right of use assets. While the ED suggests that these be presented as tangible assets, it clearly implies that right of use assets are intangibles. Unless European (and international) prudential regulators decide otherwise, under current capital requirement treatment, lessees may have to raise capital of an amount equal to the full value of their right of use assets if this issue is not clarified. We recall also that the performance obligation approach is entirely inconsistent with current capital requirement treatment of lessors and would, if ever adopted, have potentially huge implications for lessors’ regulatory capital, with the possibility that many European lessor shareholders may no longer consider leasing to be a viable business.

We therefore very much welcome EFRAG’s position on the lack of cost/benefit analysis that has been performed to date and believe that, if anything, EFRAG should further strengthen its comments on the need for thorough effects analysis to be conducted in its final letter to the IASB.

Appendix – Why residual assets should be accreted
Numerical Illustration

Consider the following lease contract

- Equipment cost (purchased at normal cash price): €10,000.00
- Lease term: 5 years
- Payments: annual, in arrears
- Lessor's expected residual: 30%
- Lessor's rate: 10%

Example 1. De-recognition *with* accreting residuals

Under a de-recognition approach where the residual asset is accreted at the rate in the lease to its expected value at the end of the lease, a 3rd party lessor's financial statements would be as follows:

Balance sheet		Initial	Y1	Y2	Y3	Y4	Y5
Underlying Asset	10,000	0	0	0	0	0	0
Residual Asset		1,863	2,049	2,254	2,479	2,727	3,000
Receivable		8,137	6,804	5,338	3,725	1,951	0
Total Assets	10,000	10,000	8,853	7,592	6,205	4,679	3,000
D&E (balancing #)	10,000	10,000	8,853	7,592	6,205	4,679	3,000
P&L							
Interest			814	680	534	373	195
Accretion of resid			186	205	225	248	273
Net result			1,000	885	759	620	468
ROA			**10.00%**	**10.00%**	**10.00%**	**10.00%**	**10.00%**

Here, the sale of the residual asset at the expected amount would have no impact.

Example 2. De-recognition *without* accreting residuals

Under the same example where the residual is *frozen*, the financial statements would be:

Balance sheet		Initial	Y1	Y2	Y3	Y4	Y5
Underlying Asset	10,000	0	0	0	0	0	0
Residual Asset		1,863	1,863	1,863	1,863	1,863	1,863
Receivable		8,137	6,804	5,338	3,725	1,951	0
Total Assets	10,000	10,000	8,667	7,201	5,588	3,814	1,863
D&E (balancing #)	10,000	10,000	8,667	7,201	5,588	3,814	1,863
P&L							
Interest			814	680	534	373	195
Accretion of resid			0	0	0	0	0
Net result			814	680	534	373	195
ROA			**8.14%**	**7.85%**	**7.41%**	**6.67%**	**5.12%**

Under this approach, the profitability of the lessor is understated throughout the lease. However, a large catch-up would occur at the end of the contract for instance if the lessor were to sell the asset. In this example, if the lessor sells the asset after the lease term at its expected value (€3,000.00), it would make a profit of €1,137.24 whereas under the previous example it would have no such profit.

Example 3. Finance lease treatment

Under finance leases, a lessor presents the asset it holds as a receivable at an amount equal to the net investment in the lease. The net investment is the sum of minimum payments (i.e. guaranteed residual value amounts included) and unguaranteed residual values accruing to the lessor discounted at the interest rate implicit in the lease.

Balance sheet		**Initial**	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**
Underlying asset	10,000						
Receivable		10,000	8,853	7,592	6,205	4,679	3,000
Total Assets	10,000	10,000	8,853	7,592	6,205	4,679	3,000
D&E (balancing #)	10,000	10,000	8,853	7,592	6,205	4,679	3,000
P&L							
Interest income			1,000	885	759	620	468
ROA			**10.00%**	**10.00%**	**10.00%**	**10.00%**	**10.00%**

Note

We have purposely tried to keep these examples short and to the point. Additional examples, comparing for instance 3rd party and manufacturer/dealer lessors, illustrating that the only difference between the two situations is an amount of deferred profit for manufacturers , can be provided if necessary.