

POSITION PAPER

25nd November 2010

European Financial Reporting Advisory Group
(EFRAG)

Commentletters@efrag.org

EFRAG:s draft comment letter on the IASB/FASB Exposure Draft ED/2010/9 – Leases

Dear Sir/Madam,

We appreciate the opportunity to respond to the European Financial Reporting Advisory Group's (EFRAG) draft comment letter on the IASB/FASB Exposure Draft ED/2010/9 – Leases. This letter represents the views of the Swedish Bankers' Association and the Association of Swedish Finance Houses and the Associations' members (the Associations/we/our). The Associations are members of Leaseurope through AFINA. The Associations have played an active part in the handling of this matter by Leaseurope and by the European Banking Federation (EBF). The proposal on lease accounting is important to us nationally, and we have therefore also developed our own replies to EFRAGs draft comment letter below.

Our response follows the draft comment letter. We focus on the key issues we have identified and present proposals for solutions.

Re: Exposure Draft Leases (cover letter, page 1-2)

Yes, we share EFRAGs view that the proposals are not effective in addressing the concerns about complexity and lease accounting and comparability of information. As EFRAG, we are not convinced that the proposals result in information that is relevant to users of financial information.

We question the benefit of the ED as we do not consider that FASB/IASB have demonstrated that the benefits outweighs the costs associated with the envisaged new standard.

A thorough impact assessment is lacking, and this also applies to the issue of Knock-on effects on SMEs and other unlisted companies. Such an assessment should be done before any new standard is introduced.

If the proposal is implemented, the new standard, like IAS 17 and its principles, will be applied by a substantially wider circle than listed companies. In addition to this, there is IASB's new standard for SMEs, which is based on applicable IFRSs. Changes in IFRS standards may therefore affect the SME standard. SMEs with business offers including

leasing and service to IFRSs companies will be immediately affected, as such customers will consider other solutions. The proposal must consequently be assessed on the basis of what effects it has on unlisted companies, including SMEs.

IASB/FASBs complex proposal in the ED will, if implemented, affect the supply of financing and lead to higher costs for the customer's operation. The whole economy will consequently be affected in an undesirable way. These are effects that standard setters, legislators etc. must take into account, formulating instead standards that have long-term positive effects on business environment and the economy in general.

We also consider that the current standard for accounting for leases (IAS 17) works well and is an established and accepted standard that should be retained, where the requirements for supplementary disclosures can be developed.

If a new standard were to be introduced we believe that the accounting approach should start from the contractual aspect of the contract, i.e. what has been agreed between the parties to the contract. The focus in our approach is on the liabilities side of the statement of financial position – on what the lessee is obliged to pay as a minimum, which is to be recognised as a liability. Our approach could thus be termed the "liability-to-pay model". Consequently we do not agree with EFRAGs proposal regarding amounts due under options and contingent rentals. We agree that these components are distinct from the contractual unavoidable rental payments but they should be accounted for only when materialised or exercised. Reasons for such an approach include, among others, factors such as complexity, reliability and information accuracy. Instead we believe that information should be included in the disclosures of the financial statements.

Appendix 1 General observations (page, 3-6)

Yes, we support the views and comments expressed in Appendix 1 General observations.

We appreciate EFRAGs clear description of the many complex distinctions in the proposed standard. Starting from one distinction -finance or operational in IAS 17-, IASB/FASB now proposes not less than five new complex distinctions. As EFRAG we are concerned about the declinations between the different categories proposed.

Regarding reference's made in Appendix 1 to answers to specific questions, we present our comments to the answers presented in the draft comment letter below.

Appendix 2 – Response to questions in the Exposure Draft (page, 7-36)

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?

(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?

EFRAG's response (p. 4-7)

EFRAG acknowledges that the model has conceptual merits and can be supported, subject to the development of robust criteria for distinguishing between leases and service contracts.

The Associations favour retaining the current standard for accounting of leases (IAS 17) as we consider it to work well and to be an established and accepted standard. The issues that FASB/IASB has identified could be remedied by the requirements for supplementary disclosures in the financial statements of both lessees and lessors being expanded. The key element must reasonably be that relevant information is presented and not to introduce a new accounting model when there are simpler and more cost-effective solutions.

However, if the FASB/IASB insists that IAS 17 should be replaced, we are of the opinion that a new standard should be based on the above mentioned "liability-to-pay model" rather than the proposed "right of use approach". From a conceptual point of view we believe that the accounting approach should start from the contractual aspect of the contract, i.e. what has been agreed between the parties to the contract. The focus in our approach is on the liabilities side of the statement of financial position – on what the lessee is obliged to pay as a minimum, which is to be recognised as a liability.

The following can be mentioned among the benefits of our approach: our model is less administratively burdensome than the proposal in the ED, our model provides a fairer picture (see IASB Board Member Stephen Cooper's alternative view in the Basis for Conclusions), and creates better stability in statements of financial position and statements of comprehensive income, thus resulting in less volatility in the financial position and results of entities.

If the focus in the approach is on the "liability-to-pay model" instead of on the "right-of-use model", several of the problems with which the ED is associated disappear. An example of this is the treatment of options to extend and contingent rentals. Regarding the treatment of options in leases, we consider that these form an important part of the contracts, but that information on these should suitably be given in the supplementary disclosures.

Contracts relating to premises are specific types of contracts where the proposal for accounting for lessees in the ED is not at all suitable, i.e. these contracts should be excluded from the standard. The proposal in the ED will, in all probability, have very substantial effects on, among others, entities in retailing, which in several cases may lead to entirely unreasonable effects on the balance-sheet totals of these entities. Examples of this are the entity's plans to retain its office premises or contingent rentals which are linked to the tenant's usage or performance. The entities business plans are normally not exceeding 5 years. To consider a lease term exceeding both the business plan and the contractual term would mean recognition of assets and liabilities lacking the evidence that is required in all other transaction, for example support from management budgets and other types of plans. We question whether users of financial statements will find information useful, which is not supported by a company's usual planning process. In addition, applying the right of use approach amounts may in many situations exceed market values, especially for certain types of real estate such as retail shops and offices in good locations.

The proposal in the ED makes it difficult for the lessee to distinguish between lease and service in the contract. For these reasons we do not support this part of the ED as we regard the proposal as excessively complex.

We believe that the FASB/IASB approach to lessee accounting is inconsistent with the Framework and will not provide users of accounts with improved information. We therefore do not favour the proposed approach.

Should the proposed standard in the ED be applied we agree that the lessee should recognise amortisation of the right of use asset. We however do not agree with the proposed method of amortisation in accordance with today's requirements for tangible assets/owned rights. We instead favour a linked approach where the liability is amortised using a mortgage-based amortisation and the asset is amortised according to the same methodology.

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?

(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?

EFRAG's response (p. 11-23)

EFRAG supports a single partial derecognition model for lessors.

Yes, we support EFRAGs response in p. 11-23.

Question 3: Short-term leases

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?

EFRAG's response (p. 26-31)

EFRAG believes that the IASB should propose a more meaningful relief for lessees.

Yes, we support EFRAGs response. However regarding paragraph 31, we believe there should be optional to use the simplified requirements on all short term leases (or the exemption proposed by EFRAG).

Question 4

(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 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?

(c) Do you agree with the criteria in paragraph 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?

EFRAG's response (p. 34-41)

EFRAG believes that the criteria to identify a lease put excessive weight on the physical delivery or access to the underlying physical asset rather than the benefit or the right-of-use that is actually transferred with the lease itself.

EFRAG believes that the criteria for distinguishing leases and sales/purchases are inconsistent with those set in the Revenue Recognition ED.

EFRAG's question for constituents (p. 41)

Do constituents believe that a distinction between leases and sales/purchases is required? If so, do they believe that the criteria are appropriate?

Yes, we support EFRAGs response. However EFRAGs response in p. 38 needs to be clarified. Regarding p. 41, we agree that there are inconsistencies with the Revenue Recognition ED which requires further analysis to identify appropriate criteria.

Question 5: Scope exclusions

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?

EFRAG's response (p 46-51)

EFRAG believes that there is no conceptual basis for excluding intangible assets from the scope of the proposals.

No. On this point, we agree with the ED and the statements made in BC36. It may be mentioned as a reason for this position that there are already significant problems in the ED in distinguishing between leases and service contracts. We consider that further increasing the complexity of the standard by additionally introducing intangible assets into the scope of the standard would make it even more difficult to apply. Furthermore, we believe that a thorough cost and benefit analysis should first be carried out and presented before the boards consider including intangible assets into the scope of the standard.

Question 6: Contracts that contain service components and lease components

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?

EFRAG's response (p. 53-61)

EFRAG believes that when a contract includes both lease and non-distinct services, a lessee should identify the predominant component and treat the whole contract accordingly.

EFRAG believes that the lessor should always be required to account for the services and lease components of a contract separately.

EFRAG's question for constituents (p. 41)

Do constituents agree with EFRAGs suggestion on the lessees treatment of a contract that includes non-distinct services? If not, what other approach do you support?

We advocate the IASB model ahead of the FASB model. However, we see problems with application of the IASB model, which we consider to lead to unreasonable administrative requirements in application of the proposed standard. Our emphatic view is therefore that the benefit of applying such a model is disproportionate to the costs of applying it.

Regarding EFRAGs question in p. 61, even if it is possible to distinguish between lease components and service components either part can be a minor or insignificant in relation to the total agreement. Under such circumstances it would be a disproportionate requirement to account for the services and lease components separately. We therefore suggest that in such situations it should be possible to account for the agreement as a service or as a lease agreement depending on the predominant part. In any event - if a service component can be distinguished it should be possible to account for the service component separately.

Question 7: Purchase options

Do you agree that a lease 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?

EFRAG's response (p. 64-69)

EFRAG does not see a conceptual reason to treat options to purchase and options to extend a lease differently.

EFRAG believes that options should be recognised and measured separately.

No, we do not agree with EFRAG. Instead we favour the solution in the ED, as it is in line with our "liability-to-pay model". Options should only be accounted for when they are exercised. Reasons for that approach include, among others, factors such as complexity, reliability and information accuracy. Instead we believe that information about purchase options should be included in the disclosures of the financial statements.

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?

EFRAG's response (p. 73-80)

EFRAG does not support the proposal that amounts due under renewal options should be included in the lease receivable or lease payable.

EFRAG believes that options should be accounted for, but their measurement should reflect their values rather than the gross cash flows resulting from the exercise.

Yes, we agree with EFRAG that options to extend should not be included in determination of the lease term for either lessees or lessors. The reason for this position is that uncertainty

prevails as to whether the option to extend the lease will be utilised or not. The subjective requirements for assessments which the ED provides for may complicate analysis of financial information for analysts as the information is not comparable. We propose instead an approach under which only the contractual obligations are to be included in the valuation of liabilities ("liability-to-pay model). Options should only be accounted for when they are exercised. Reasons for such an approach include, among others, factors such as complexity, reliability and information accuracy. Instead we believe that information about purchase or renewal options should be included in the disclosures of the financial statements. We also consider this approach to be in line with the IASB Framework and the definition of liability.

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?

EFRAG's response (p. 86-97)

EFRAG believes that rentals that are under the control of the lessee, such as rentals contingent on usage or performance of the asset, should not be included in the measurement of lease assets and liabilities.

EFRAG supports a measurement based on a most likely outcome approach for components included in the measurement of lease assets and liabilities.

EFRAG's question for constituents (p. 97)

Do constituents believe that separating different categories of contingent rentals might be too complex?

Contingent rentals

We partially agree with EFRAG's response, however we believe that the current wording in IAS 17 regarding variable payments should be retained, i.e. they should not be included in any lease payments at all regardless of category of contingent rental. Consequently there is no need to separate different categories of contingent rentals.

In our opinion the contractual obligations should dictate the valuation of assets and liabilities. Since variable payment by definition is neither an obligation nor a right that is clearly stated at a fixed amount in a lease contract, they should not be subject to any balance sheet accounting. We consequently advocate variable rentals being carried as expense/income in the statement of comprehensive income as and when they arise for lessees and lessors.

Charges

Regarding charges such as term option penalties, we consider that these should not be included in any valuation until a decision has been taken to exercise such an option. They should then be treated as provisions in accordance with IAS 37.

Residual value guarantees

Regarding the lessee we consider that if the lessee has an established commitment at the start of the lease, for example to be responsible for a negative difference between book value and the fair value at the end of the lease, this obligation should be taken into account in the valuation of liabilities but only when that amount can be measured reliably. The converse applies that if there is no such commitment from the start of the lease, nor is any residual value guarantee to be recognised in the valuation of liabilities.

On the lessor side our opinion is that the lessor should regard the guaranteed amount as a lease payment under the derecognition approach. This should apply regardless of who the guarantor is, except for intra-group members such as a parent company, subsidiary etc. It is only when the residual value is not guaranteed by any party, that the lessor should recognise a residual value asset separately. This would be useful for users since the balance sheet clearly would state to what extent the lessor holds residual value risks.

Since we do not agree with the proposed performance obligation approach, we do not comment on any accounting for residual value guarantees under that approach.

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

EFRAG's response (p. 101-106)

EFRAG agrees that it would be onerous to require a periodic reassessment of changes in the obligation or receivable arising from changes in the lease term or contingent payments.

Yes, we support EFRAGs response in p. 101-106.

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?

EFRAG's response (p. 112-123)

EFRAG supports an alternative accounting model for sale and leaseback transaction based on a "partial asset" approach.

EFRAG disagrees with the requirement that a lessor in a sale and leaseback transaction shall use a performance obligation approach because EFRAG supports a partial derecognition approach for lessors.

EFRAG's question for constituents (p. 123)

Do constituents agree with the analysis and EFRAG's proposals for the treatment of sale and leaseback transactions?

Regarding EFRAGs question in p. 123 we do not consider there to be a need for any special rules on sale and leaseback transactions. Our conceptual point of departure is as follows. It should first be considered whether a sale exists or not. In the interpretation of the ED, the control concept in *sale* of an asset is based on the legal relationship rather than the economic substance of the transaction. In the event that no sale exists, nor does any “leaseback” of the object exist. If a sale exists, on the other hand, the “leaseback” transaction should be assessed like any lease. We consider our proposal for a “liability-to-pay model” to address this issue. The same requirements should apply whether it is a sale or a lease (principle of equal treatment). In addition, we consider that the concept of “financing” in paragraph 67 of the ED needs to be developed.

Question 12: Statement of financial position

EFRAG’s response (p. 124-131)

EFRAG agrees with the proposals for lessees.

EFRAG agrees with the proposal that a lessor using leases as an alternative way to realise an asset should disclose separately the lease income and expenses.

EFRAG is not persuaded by the presentation requirements for lessors applying a performance obligation approach.

Question 12 a-d and our response

(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 (paragraph 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?

We consider that, as a principal rule, the lessee should present separately the obligation to “make lease payments” and “right-of-use assets”. However, having said that, if the obligation or right is immaterial in relation to the principal activity of the entity or group, it should be possible for disclosure in the notes to be permitted in the standard. As we have already stated, we consider that liability should only include the contractual obligations in the lease (the “liability-to-pay model”).

(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?

As we have already mentioned, we have objections to the “performance obligation approach”. The reasons behind this position are partly conceptual, partly administrative, as well as the complexity that the proposals in the ED contain. A conceptual shortcoming we have noted in the performance obligation approach is the proposal to mix assets and liabilities on the same side of the statement of financial position, and we have difficulty in seeing the reason for this.

(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?

We consider that “residual assets” and “right to receive payments” should be recognised separately. However, we wish to clarify our position by noting that we consider requirements for separate recognition in a legal entity to be reasonable, but if the principal activity of the entity or group is other than leasing, disclosure in the notes should be a sufficient requirement in the standard.

(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 advocate the standard providing scope for freedom of choice on this issue, i.e. presentation in the statement of financial position or disclosure in the notes. We consequently advocate a management approach where the materiality of the item should guide the assessment.

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 BC 158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

EFRAG’s response (p. 133)

EFRAG supports the presentation requirements in the Exposure Draft and believes that it provides useful information.

We do not consider that the same requirements should be set for lessors as for lessees. Our view is that an assessment of materiality should instead dictate the requirements for recognition for both lessors and lessees. Provided that “lease income and lease expense” are material items in the entity’s activity, we consider it reasonable to have requirements for separate reporting from “other income and expense in profit loss” in a legal entity, but in the consolidated accounts a requirement for disclosure in the notes may be sufficient as the assessment of materiality may differ from the assessment in the legal entity.

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?

EFRAG’s response (p. 134)

EFRAG agrees with the proposals and believes that it provides useful information.

EFRAG's question for constituents (p. 135)

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 consider this issue to belong in the FASB/IASB project on "Financial Statement Presentation". The reason for our position is that we anticipate great changes regarding the content and presentation of the statement of cash flows. FASB/IASB should therefore await development in this project before adopting a position on how leasing should be handled in the statement of cash flows. From a conceptual standpoint, handling differently appears less appropriate.

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?

EFRAG's response (p. 137-138)

137 EFRAG welcomes the requirement in paragraph 71 of the Exposure Draft that an entity should consider the level of disclosures appropriate to satisfy the objectives in paragraph 70. The list of disclosure requirements is extensive and we believe that the IASB should state even more clearly that they should not be regarded as mandatory in all situations.

138 Some of the disclosure requirements are reflect the existence of a hybrid model for lessors or diverging recognition requirements for different options. As mentioned above, EFRAG does not support a hybrid model or a different treatment of options.

Yes, we agree with EFRAGs response in p. 137-138.

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?

EFRAG's response (p. 140-145)

Yes, we agree with EFRAGs response in p. 140-145.

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?

EFRAG's response (p. 146-149)

We encourage the IASB to expand its outreach activities to collect additional information on the costs associated with the implementation of the proposals and their potential effects.

Yes, we agree with EFRAGs response in p. 146-149.

Question 18

Do you have any other comments on the proposals?

EFRAG's response (p. 150-156)

We find it difficult to understand why FASB/IASB is treating the Leases project so urgently. We would prefer the quality of the envisaged new standard to take precedence over the time frame on which the project is based. Our view is that the focus should be on a product of high quality rather than political considerations dictating the time frame of the project and consequently its contents. We therefore support EFRAG's draft comment letter, in which it also argues that the Leases project should be given more time to ensure the quality of the project. We therefore presume that FASB/IASB will take account of the critical views received on the ED, and then send out a Reexposure Draft Leases for comments.

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