Comments on the Exposure Draft ”Leases”

December 15th, 2010

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Dear Sir or Madam,

Thank you for the opportunity to comment on the IASB Exposure Draft: Leases. As the representative of the German retail industry, we would like to provide you with the following remarks on the Exposure Draft in response to your invitation to comment:

General Remarks

Reporting all types of leases in the lessee´s balance sheet would risk losing the advantages associated with leasing (e.g. more flexibility and preservation of liquidity for the lessee). An accounting model which is detrimental to the business model of leasing companies would deprive the leasing business of its foundation. As a consequence, the proposed rules may adversely affect the liquidity of small and medium enterprises since these entities would be denied an essential way of financing their investments.

The existing advantages of a straight line approach to rental expense recognition and its steady effect on earnings would be neutralised by the proposed model's concept of falling capital costs. As is the case for finance leases today, expense profiles vary dependant on the stage of a lease lifecycle. Hence, younger leasing portfolios will be presented disadvantageously in comparison with older leasing portfolios. New leases of replacement items will lead to sudden differences in earnings. Comparability of financial statements of retailers will be decreased since the retailers´ leasing portfolios will impact differently on their respective earnings depending on the residual terms of the lease contracts.

When looking at the underlying motive for the reform initiative, one has to observe that the proposal falls short of its own goals. The objective of the new accounting standard for leases is on the one hand to ensure that the lessee recognises all leased assets, irrespective of the terms and conditions of the lease contract, and on the other hand to simplify the current standard with its lack of comparability and undue complexity resulting from the distinction between operating and finance leasing.

Whereas the new standard would achieve an equal treatment of operating and finance leases it would not meet its objective to provide useful and comparable information about lease arrangements. This is due to the following aspects of the new standard:

- The hybrid accounting model for the lessor is not conceptually linked to the lessee accounting.
- A reasonable measurement of the right-of-use asset and the lease liability on the basis of the most likely lease term and contingent payments is impossible to make, particularly with regard to long-term lease contracts. Such measurement would require estimates by the preparer that would inevitably be arbitrary and would provide no useful information to the user. Instead, they would create structuring opportunities which the IASB set out to eliminate. Predictions which do not materialise would lead to incorrect information in the financial statements and increased volatility in earnings. The inclusion of options and contingent payments in the measurement would lead to an overstatement of the right-of-use asset and the corresponding lease liability. Furthermore, information about underlying assumptions and judgments would be too comprehensive to be disclosed in the notes in a useful way. In cases of multiple lease contracts, only aggregated information could be provided.

- Periodic reassessments of the right-of-use asset and the lease liability in cases of changes in the lease term and contingent payments would result in higher volatility in earnings and lack of comparability of financial statements.
- The lessee accounting rules contain no useful exemption for short-term leases.

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?

As the framework´s asset and liability definitions are also currently under revision, it is presently impossible to bring the rights and obligations of the Exposure Draft into line with the asset and liability definitions. Therefore, the definitions in the framework should be finalised before the leasing accounting rules are revised.

We disagree with the right-of-use approach. The right to use a property does not meet the control criterion of the asset definition, since the lessee has no full control over the leased item (compared with a purchase). Options and contingent rentals do not meet the liability definition as they do not constitute a present obligation at the time of inception of the lease but are conditional on events in the future.

Furthermore, the proposal seems conceptually inconsistent. First, changing the rules for leases begs the question why the new approach is not applicable to similar types of contracts where a right of use is conveyed. Second, the rationale for the lessee accounting cannot be brought into line with the proposed lessor accounting rules. A lease liability on the lessor´s balance sheet under the performance obligation approach is irreconcilable with the recognition of a right of use on the lessee´s balance sheet since the latter would presume that the lessor has performed on their obligation. The triple accounting of the same asset (lessee’s right of use on the one hand and lessor’s property right and lease receivable on the other) and double accounting of the liability (lessee’s and lessor’s performance obligation) fail to provide useful information about the underlying economic transactions.

Moreover there are a number of short term leases within the scope of the new leasing standard, that may be material but reporting them on-balance would provide no useful information to the user:

- overnight stay at a hotel
- car rental for a couple of days or weeks
- rental of coffee machines, photocopiers or other equipment without operating purpose

Cost of recognising these assets and corresponding liabilites on the lessee´s balance sheet by far outweigh the benefits for the user. The proposed simplifications for short-term leases cannot provide sufficient relief.

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?

In terms of the simplification goal, the proposal is counterproductive. As under the current standard, lessors have to assess their exposure to risks and benefits associated with the underlying asset and on that basis have to decide which very different accounting models to follow. Moreover, lessor accounting would no longer be consistent with lessee accounting.

We recommend that only the Derecognition Approach be implemented. For the following reasons we reject the Performance Obligation Approach:

- A single future cash flow is recorded twice (asset and lease receivable).
- A performance obligation does not constitute a liability according to the framework.
- The value of a net asset to be recorded is a mathematical construction composed of three very different parts and therefore makes no economic sense. For that reason we support the Derecognition Approach, i.e. recording the receivable only and giving additional information about the lease contracts in the notes.

Question 3: Short-term leases

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

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

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

(See also paragraphs BC41–BC46.)

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

We appreciate that accounting for short-term leases is simplified. However, we propose that the simplification method proposed for lessors under (b) also be used for lessees, i.e., only the lease payments are recognised in profit or loss. Having to record the right-of-use asset and liability, even undiscounted, would still result in a burden for the lessee. Especially for transactions described under question 1 (overnight stay at a hotel, car rental for a couple of days or weeks, rental of coffee machines, photocopier or other equipment without operating purpose) the cost of recording the undiscounted asset and liability dramatically exceeds the benefit for users. Even short-term leases that begin and end within one single fiscal year would affect the books, and reconciliations of opening and closing balances of right-of-use assets and liabilities arising from such short-term leases would have to be prepared.

Question 6: Contracts that contain service components and lease components

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

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

(b) The IASB proposes that:

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

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

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

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

We agree with the general approach that a lessee should apply the lease accounting rules on contracts with non-distinct service components. However, we strongly recommend that this apply only to contracts where the lease component outweighs the service component. The standard setters should address the issue that with the proposed standard, the differentiation between lease and service contracts will become more important and probably the object of structuring efforts. Ideally there should be a clear cut dividing line. The Board should explore all options to avoid an unnecessary administrative burden for the preparer. In this regard, attention should also be given to the lessee who may not always have the information as to what extent service costs are contained in the “lease payments”. The lessor will have that information but will usually not be inclined to disclose it. Lacking any other source of information the lessee may have to conduct market research in order to evaluate prices for lease and service components. The standard should also give guidance for contracts where the ratio between lease and service component may vary over the lease term, as may be the case for real estate leases. At inception of the lease it is impossible to separate the maintenance component because it is impossible to estimate to what extent maintenance will be necessary during a given lease contract of 15 or 20 years.

Question 7: Purchase options

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

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

We agree that the lease contract should be regarded as terminated when a purchase option is exercised. We also agree that during the lease term the lessee and lessor should not account for purchase options separately. First, the price for purchase options is usually included in the lease payments and second, the information about the price of the purchase option is not available to the lessee.

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?

We believe that it is impossible to make reasonable and supportable estimates on the likeliness of a lease term, particularly where long-term leases are concerned. Such lease term assumptions are bound to be arbitrary and would provide no useful information to the user. Instead, they will provide structuring opportunities which the IASB set out to eliminate.

We agree that when determining the lease term one has to take into account lease extension or termination options. However, from our point of view it would be more practical to keep the definition of a lease term as set out in IAS 17: non-cancellable period plus any further optional terms if it is reasonably certain that the lessee will exercise the option.

Question 9: Lease payments

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

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

We disagree that contingent rentals should be included in the measurement of assets and liabilities resulting from a lease contract for the following reasons:

- Contingent rentals do not meet liability criteria due to their dependency on future events.
- It is impossible to estimate future indices such as inflation or rent levels. There are also no publicly available estimations to which the preparer could resort.

We also reject the use of the expected outcome technique due to the following reasons:

- The method is extremely complex. (e.g. in cases of companies with thousands of lease contracts)
- The result of the expected outcome technique would be a mathematical and artificial value.
- These values could be easily misinterpreted.
- Furthermore, these values would be calculated for accounting purposes only and would be of no interest to the management.

Question 10: Reassessment

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

We reject such reassessment for the following reasons:

- As mentioned before, contingent lease payments do not meet the liability criteria.
- Reassessing the lease contracts would result in greatly increased complexity in cases of companies with large numbers of lease contracts. At each reporting date the company accountant would have to request that the departments responsible for the lease portfolio review all lease contracts for
  - circumstances that indicate changes in value of the lease liabilities
  - any changes in expected lease terms or in the probability that options are exercised
  - any changes of index levels used for contingent rentals.

A database would consequently have to be established to track all those factors which are relevant for the subsequent measurements.

Question 11: Sale and leaseback

Sale and leaseback

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

Question 11

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

We agree.

Question 12: Statement of financial position

Presentation

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

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

(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?

(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?

(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 recommend presenting lease assets and liabilities separately from tangibles and intangibles.

Question 13: Statement of comprehensive income

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

We agree.

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?

We agree.

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?

From our point of view it would be necessary to disclose qualitative information about the character of the lease contracts. However, detailed information on the measurement of assets and liabilities would inevitably increase the complexity of the notes. In cases of numerous contracts, this would be impractical.

Question 16: Transition

(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?

We believe that the simplified retrospective approach would increase the measurement complexity while decreasing the comparability. Owing to the wide scope of the proposed standard, companies with large numbers of lease contracts would face an enormous burden were they to apply the new leasing rules retrospectively.

We, therefore, strongly recommend a prospective application of the new standard. As for the date of initial application, the standard setters should recognise the fact that implementation of the IT-systems and other related procedures would require at least three years.

Question 17: benefits and costs

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?

We disagree. From the lessee´s perspective very high costs have to be expected, mainly resulting from:

- implementation of a new database and IT system
- higher documentation effort

We find it impossible to assess the benefits, however would expect them to be only quite minor.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

Yours faithfully

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