Arteixo (Spain), December 15, 2010

International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

**Re: Exposure Draft Leases** 

Dear Sir or Madam,

I am writing on behalf of Industria de Diseño Textil, S.A., the parent company of the Inditex Group whose principal activity consists of the distribution of fashion items, mainly clothing, footwear, accessories and household textile products. Inditex carries out its activity through various commercial formats such as Zara, Pull & Bear, Massimo Dutti, Bershka, Stradivarius, Oysho, Zara Home and Uterqüe, which are managed separately but which share certain corporate functions. Inditex is domiciled in Spain, listed on all four Spanish stock exchanges and, together with its subsidiary companies, comprises the Inditex Group. Each concept's commercial activity is carried out through chains of stores managed directly by companies in which Inditex holds all or the majority of the share capital, with the exception of certain countries where, for different reasons, the retail selling activity is performed through franchises. Most of the 4,907 commercial premises in 77 countries as of October 31<sup>st</sup> 2010 through which the Group carries out its retail distribution activities are leased from third parties.

Further information about the Inditex Group and its activities is available on our website: <a href="https://www.inditex.com">www.inditex.com</a>.

Inditex is very pleased to provide comments to the International Accounting Standards Board on its request for views on the Exposure Draft *Leases* (ED). This letter is structured in two parts: General Remarks and Comments to Specific Issues. The first part presents remarks on the overall ED approach where we express our concerns about the entire concept behind the ED. The second part relates to the questions to be answered.

We would like to inform you that this issue has been discussed in meetings with other companies and several times with IASB members, and this exchange of opinions has been very helpful to improve the knowledge of each company about the potential effect that the application of the Exposure Draft might have. Nevertheless, although many of the following comments were shared during these meetings, we do have some specific comments which are shown throughout this letter. Hence, this letter is exclusively under the responsibility of Inditex Group.

If you would like to discuss any of the issues we describe in this letter, please do not hesitate to contact Mr Ignacio Fernández, Chief Financial Officer, at +34981185364 or by e-mail <a href="mailto:ignacioff@inditex.com">ignacioff@inditex.com</a>.

Thank you for your attention and we look forward to your views on the points raised in this letter.

Yours sincerely,

Ignacio Fernández Fernández

#### **General Remarks**

We are strongly concerned about the approach which has been proposed in the ED and we disagree with the proposed model for the reasons which are explained below. However, we positively accept a review of the current lease accounting rules through enhanced recognition rules and additional disclosures in order to simplify lease accounting and provide final users with clearer and more useful information.

We strongly believe that the proposed model will not improve the quality of financial information and will not provide users with more useful or clearer information. Conversely, there are serious risks of introducing elements of confusion that would lead to a lack of reliability. We disagree with the proposed model for the reasons which are outlined below:

# 1. The vast majority of users will not understand the new Financial Statements arising from the Exposure Draft.

Operating leases do exist and they are key part of the retail business. They are used in the retail industry as an alternative to the acquisition to gain flexibility based on contingent rents, options to renew or breaking options. A lease contract is a live contract usually opened to renegotiations, renewals or amendments very related to the business performance and which make it difficult to understand the concept of asset relying under the new proposal.

The model proposed in the ED would cause dramatic alterations to key financial measures that are commonly used to evaluate entities' performance and business models in general. As already mentioned, the retailers would be particularly affected in an important financial issue which is cash flow statement. The proposed change would take a significant operating cost from EBITDA- a widely used measure in the sector- to finance and depreciation costs, reducing the usefulness of this measure and the relevance of profit and loss account to measure operating performance. Additionally, the ED address cash flow statement presentation, on the financing activities which would be misleading, particularly in a retail context.

The proposed changes will present a balance sheet and income statement that does not reflect the *commercial understanding of the business*. A simple shareholder or final user would never imagine that a retailer should book an asset for the use of a store that is clearly and in substance owned by a third party landlord (particularly in shopping mall or high street arrangements). Further, the majority of users understand a P&L with "lease expense" as opposed to a "non commercial" presentation of depreciation of a theoretical asset and interest cost.

The existing executory contract approach to accounting for operating leases in the retail context is well established, well understood, is consistently applied by preparers of financial information and presents financial reports that users can easily link conceptually to the commercial operations of a retail business. While there may be some views that structuring opportunities have been established in certain industries, this is not the case in retail store leasing and consequently the proposed changes will significantly diminish the existing quality of financial reporting of retailers.

The *limited number of users who may adjust the existing "executory" approach* are generally sophisticated enough to be able to use the financial information currently presented to meet their individual needs (which in practice are invariably inconsistent from user to user).

We reject the view that users adjust balance sheets to create a "lease right to use" asset as proposed in the ED. We believe that users of the proposed financial information will continue to extract and adjust presented information to suit their own needs when assessing the business.

Moreover, with this new accounting rule for leases, retail industry analysts will request additional disclosures on real rental expense to be able to follow the business.

# 2. Lack of reliability and comparability in information for users.

A typical retailer can spread business over thousands of real estate lease contracts, in several countries with a wide range of lease clauses applying to contingent rents mainly based on store sales and PCIs, lease renewals, breaks, etc.. and featured usually by the long term of the agreements. We remark the risk of obtaining misleading information from the subjective assessment of the huge and diverse information arising from thousands of lease contracts, particularly, some categories of primary users of the financial statements, such as the investment community, that would expect to have clearer, less subject to judgmental estimates and less volatile information about the assets and liabilities recognized in the balance sheet.

- O Significance of estimates. For business models in which operating leases are a crucial part of the core business, the new model would produce completely different financial statements. In fact, the balance sheet might be affected by a significant increase in assets and liabilities, that would be initially recognized and measured based on very judgmental criteria.
- Reliability of long term estimates. Under the proposed model, accounting for long-term leases that relates to assets under long or very long lease term would require estimates based on projections for periods for which reliable estimates just cannot be made. A retailer like Inditex would be required to estimate the period over which it will maintain a store which has just opened (and past experience could not be used as a reliable source of information on a lease by lease analysis) and assess, in the event that contingent rental exists and is based on performance, how much sales it will attain through the store, and when. Additionally, the general practice of break options in retail business contracts, even from the first year on, with a previous notice, makes it even more difficult to estimate the period over which it will maintain a store.
- O Volatility of assets, liabilities and expenses. Given the significance of estimates and uncertainties in some scenarios, relevant changes could occur in the financial statements between periods. The need for reassessments during the lease term will lead to high volatility in the financial statements arising from amendments in assets and liabilities and impacts in the profit and loss account, which are not related with the reality of the business. These changes might not be, in many cases, the result of changes in the entities' assets and liabilities, but the result of changes in the entity's operational or marketing strategies, management's views and business. Even estimations on economic cycle would have to be made on a long term basis, increasing the lack of reliability.

Although we understand that *estimates and projections* of a similar nature are made for other purposes with respect to other non financial assets (i.e. IAS 36), generally, these do not support initial recognition and measurement based on objective information. Furthermore, even in such instances, estimates are usually restricted for periods exceeding the period over which projections may be considered reliable. In retail industry, where long term contracts are common (being the average lease term between 15 and 20 years), with break options even from the first year on, and with contingent rents based on PCIs and performance (sales) on a monthly basis, makes it impossible to estimate reliably and make projections for each and every one of the leases (currently for Inditex Group, more than 5,000 stores all around the world being most of them leased) at each reporting date (quarterly).

We must remark that retail industry will be obliged to make estimations for much longer period than the one used to manage business. This is inconsistent with principles of other IFRS like IFRS 8.

## 3. Significance of economic impacts on the Financial Statements.

For the retail industry, lease expense represents a high percentage of its total expenses. As a result, the new proposal will cause, the "classification of expenses" issue aside, a relevant impact overcharging the expense significantly during the initial periods of the lease term and undercharging the expense during the final periods with an accrual impact unaligned with the business operation, since correlation between sales income and one of the most relevant expense will be missed. This circumstance is particularly dangerous when contingent rentals and other unexpected circumstances occur.

# 4. The principle of balance between benefit and cost contained in the Framework for the Preparation and Presentation of Financial Statements is not met in the proposed ED.

While the benefits of the proposed approach are strongly arguable, the costs would significantly increase. There are no doubts about the increase in administrative burden related to the follow up of the lease contracts for accounting, legal and tax purposes. For certain types of businesses, the processes that would inevitably result necessary to account for, perhaps, thousands of lease agreements very material as a whole, would require massive efforts in terms of data collection, adaptation of the accounting systems and the budget management, employee training, implementing and monitoring internal controls, etc. Additionally to the implementation costs, the need to assess quarterly the lease estimations will mean relevant ongoing costs.

# 5. Inconsistency with the Framework for the Preparation and Presentation of Financial Statements and other International Accounting Standards.

We disagree with the ED proposal that the obligation to pay rentals, as currently defined, meets the definition of a liability as defined in the Conceptual Framework. Moreover, accepting such a definition of liability would again raise additional questions on other obligations and would therefore trigger the recognition of liabilities for future events or expenses, which is currently prohibited by IAS 37.

We disagree with the ED proposal that the right of use concept meets the definition of an asset, and we consider that the current "risks and rewards" approach as stated by IAS 17 is more appropriate. Current lease accounting reflects that where the lessee bears the risks and rewards associated to the underlying asset (financial lease); they recognize the asset and corresponding liability on their statement of financial position. Therefore, while the lessee does not take on the risks and rewards associated with the underlying asset (operating lease), they should not recognize the asset. In fact, following the approach proposed in the ED, any right that conveys the right of use an asset, controlled by the reporting entity and embodying economic benefits could potentially be recognized in the balance sheet. Example of these types of rights would be long-term supply contracts or service contracts.

An identification of the asset ("right of use") has to be made in the process, complying with the IFRS definition. In operating leases, risk and rewards of the leased asset are retained by the lessor and therefore would not comply with the asset recognition requirements (for example, the risk of damage to the underlying asset or the options to transmit the right of use, are usually under the control of the lessor).

We believe an enhance of IAS 17 regarding a better distinction between operating and financial leases, together with qualitative disclosures in the notes about contingent rents, options and similar uncertain items, would provide final users with more useful and transparent information. This would also be consistent with other disclosures that are a combination of quantitative and qualitative disclosures, such as those required by IAS 36 and IFRS 7.

### Comments on specific issues

We understand the Board's effort for improvement of financial reporting and convergence towards one global set of accounting standards. However, we consider that the improvements should seek quality and reliable financial information taking into account the practical aspects of producing financial data.

Having expressed our general view on the basic guidelines of the proposed model, we would also like to point out certain specific comments with respect to some questions raised in the ED. These comments are included in the following section of our letter.

#### **Ouestion 1: Lessees**

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

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

We agree that a right of use can be, in certain circumstances, an asset. However, we believe that the current "risks and rewards" approach as stated by IAS 17 is more appropriate. Current lease accounting reflects that where the lessee bears the risks and rewards associated to the underlying asset, they recognize the asset and corresponding liability on their statement of financial position. Therefore, while the lessee does not take on the risks and rewards associated with the underlying asset, they should not recognize the asset.

We also disagree that the obligation to pay rent fulfills the definition of a liability at the commencement date since it does not meet the definition of liability of the Conceptual Framework.

As stated above, we do not support the proposed approach as we believe it removes important information on the nature and management of leased assets and it is inconsistent with current Framework. Also, reflecting all lease contracts in the statement of financial position will not make any distinction between contracts where the lessee is in substance financing the purchase of an asset and contracts where the lessee is actually paying for the service rendered by an asset.

As explained in the "General Remarks", the proposed changes will present a balance sheet and income statement that does not reflect the commercial understanding of the business. A simple shareholder or final user would never imagine that a retailer should book an asset for the use of a store that is clearly and in substance owned by a third party landlord (particularly in shopping mall or high street arrangements). Further the majority of users understand a P&L with "lease expense" as opposed to a "non commercial" presentation of depreciation of a theoretical asset and interest cost.

# **Question 2: Lessors**

Do you agree that a lessor should apply the performance obligation approach when the lease exposes the lessor to significant risks and benefits associated with the underlying asset, and a derecognition approach otherwise? Why or why not? If not, what alternative model would you propose and why?

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

We believe that under IAS 17, a proper accounting model can be applied to both lessor and lessee, based on the transfer of risks and rewards related to the underlying asset.

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

The exposure draft proposes that a lessee or a lessor should apply simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term 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 and loss over the lease term (paragraph 64).
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from short-term leases in the statement of financial position, nor derecognise any portion of the right of use the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit and 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 believe accounting of leasing contracts should be based on the transaction, not on the term. Companies, on the basis of materiality, can exclude certain insignificant contracts from the scope of this guidance.

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

No, as the control criteria stated in the asset definition in the Conceptual Framework are not taken into account. We believe that lessee and lessor accounting should continue to be based on the "risk and reward" concept.

# **Question 5: Scope and scope exclusions**

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

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

As previously noted, we disagree with the current proposed approach, as we believe it will reduce reliability and comparability in financial information while increasing volatility, due to the significance of long-term estimations. In addition, we consider, as mentioned before, that

application of the proposed ED should lead to a better understanding of the business and therefore scope exclusions make sense when this requirement is not met.

## **Question 8: Lease term**

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

As explained before, we strongly disagree with considering the options to extend or terminate the lease in assessing the lease term, but we support its disclosure in the notes with its main features. Additionally, the generally practice of break options in retail business contracts even from the first year on, makes it even more difficult to estimate the lease term.

#### **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 contract should be included in the measurement of lease assets and lease liabilities 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 can only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the lease receivable if they can be measured reliably? Why or why not?

The contingent rents themselves do not meet the definition of a liability at inception because they do not meet the "past event" requirement to be recorded as a liability as stated in the Framework. For example, in the case of payments under contingent rental arrangements based on the performance of the underlying asset (i.e. sales), this would be inconsistent with the Conceptual Framework, as these payments could be avoided by the lessee.

In some instances the contingent payment could be compared to incentives for the lessor or profitsharing schemes which might not be related to the leased asset itself.

An estimate of the contingent payments, especially in those leases which have a long term nature, may lead to arbitrary or complex and difficult to support calculations and therefore the reliability of the estimates could be argued. For example, in the case of a lease of an asset for a 30 years period, the estimate of the contingent rent obligation would be based on the estimate of the sales volumes for the next 30 years, which does not appear a reasonable estimate, taking also into account that for other standards (IAS 36) projections are normally calculated in a 5 year period.

In retail industry, where long term contracts are common (being the average lease term between 15 and 20 years), with break options even from the first year on, and with contingent rents based on PCIs and performance (sales) on a monthly basis, makes it impossible to estimate reliably and make projections for each and every one of the leases (currently for Inditex Group, more than 5,000 stores all around the world being most of them leased).

We believe that contingent rentals (those based on lessee's performance or based on usage) should be booked as an expense when incurred, although we would support giving appropriate disclosures about contingent rentals which may arise in the future, similar to the disclosures presented for commitments.

## **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 obligation

or receivable arising from changes in the lease term or contingent payments since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

The answer to this question is closely related to the outcome of Questions 8 and 9, where we strongly oppose to the proposed approach. Given the significance of estimates and uncertainties in some scenarios, relevant changes could occur in the financial statements between periods. The need for reassessments during the lease term, will lead to high volatility in the financial statements arising in amendments in assets and liabilities and impacts in the profit and loss account, which are not related to the reality of the business. These changes might not be, in many cases, the result of changes in the entities' assets and liabilities, but the result of changes in the entities' operational or marketing strategies, management's views and business. Even estimations on economic cycle would have to be made on a long term basis, increasing the lack of reliability.

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

- (a) Do you agree that a lessee should present its liability to make lease payments separately from other financial liabilities and present right-of-use assets as if they were tangible assets within property, plant and equipment, or investment property as appropriate, but separately from other assets that the lessee does not lease (paragraphs 25-27, 42-45, 60-63 and BC142-159)? Why or why not? What alternative presentation do you propose and why?
- (b) Do you agree that a lessor applying the performance obligation approach should present its 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? 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 residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? What alternative presentation do you propose and why?
- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease separately (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?

As previously explained, we do not support the proposed approach, instead of that we would support giving appropriate disclosures in the notes to the Financial Statements.

# Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and expense separately from other income and expenses in the statement of comprehensive income (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? 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?

As previously explained, we do not support the proposed approach, instead of that we would support giving appropriate disclosures in the notes to the Financial Statements.

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

Do you think that cash flows arising from lease contracts should be presented on 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?

As previously explained, we do not support the proposed approach and, as mentioned in the "General remarks" section, the ED addresses cash flow statement presentation on the financing activities, which could be misleading, particularly in a retail context.

#### **Question 15**

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

- (a) identifies and explains the amounts recognised in the financial statements arising from lease contracts; and
- (b) describes how lease contracts may affect the amount, timing, and uncertainty of the entities future cash flows? (paragraphs 70-86 and BC168-BC183) Why or why not? If not, how would you amend the objectives and why?

As previously explained, we believe an enhance of IAS 17 regarding a better distinction between operating and financial leases, together with qualitative disclosures in the notes about contingent rents, options and similar uncertain items, would provide final users with more useful and transparent information. This would also be consistent with other disclosures that are a combination of quantitative and qualitative disclosures, such as those required by IAS 36 and IFRS 7.

We believe that the resulting Financial Statements will be misleading for the retail industry analysts who will request additional disclosures on real rental expense to be able to follow the business.

#### **Question 16**

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?

Do you think that full retrospective application of lease accounting should be permitted? Why or why not?

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

As previously explained, we do not support the proposed approach. Additionally we would like to remark our concerns about the misleading reduction of lessees' profits during the initial periods due to the asymmetric accrual of financial expense.

#### **Question 17**

Paragraphs BC200-BC205 set out the boards  $\square$  assessment of the costs and benefits of the proposed requirements. Do you agree with the boards  $\square$  assessment that the benefits of the proposals outweigh the cost? Why or why not?

As already explained in the "General Remarks" section, we believe that the *principle of balance between benefit and cost* contained in the Framework for the Preparation and Presentation of Financial Statements is not met in the proposed ED: while the benefits of the proposed approach are strongly arguable, the costs would significantly increase.

There are no doubts about the increase in administrative burden related to the follow up of the lease contracts for accounting, legal and tax purposes. For certain types of businesses, the processes that would inevitably result necessary to account for, perhaps, thousands of lease agreements which would be material as a whole, would require massive efforts in terms of data collection, adaptation of the accounting systems and the budget management, employee training, implementing and monitoring internal controls, etc..

#### **Ouestion 18**

Do you have any other comments on the proposals?

Although we do not support the proposed approach, we believe that there are some issues that should be clarified:

- o Impairment of the right of use
- Determining the discount rate when there is no active market or no information is available from lessor
- Lease incentives
- o Leases linked to a currency other than the functional one of the lessee
- Treatment in case of the exercise of the break option at any time prior to the estimated lease term regarding the generation of relevant impact (income) on the P&L account.
- Lease modifications versus new leases.