

# China Accounting Standards Committee

January 21, 2011

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

Dear Sir Tweedie,

# **Subject:** Exposure Draft on Lease

Thank you for offering the opportunity to the Ministry of Finance of China as well as China Accounting Standard Committee to comment on the IASB exposure draft *Lease* ("The ED").

We appreciate the efforts made by the IASB to improve the lease accounting. Basically we support the purpose and framework of this ED. However, we are very concerned about the following issues:

- (1) Lessee accounting model. We support the basic principle of the proposed right-of-use model for lessee, but we also have significant concerns regarding the guidance for determination of lease term and measurement of complex leases, in particular leases with extension options and contingent rent.
- (2) Lessor accounting model. We do not believe that the proposals for lessor accounting achieve the Boards' objective to develop a consistent model for model for both lessees and lessors and account for economically similar arrangement similarly. We also do not believe that the 'hybrid model' is a significant improvement over the existing lessor accounting model, but will incur great workload and cost if adopted. According to the exposure draft, a lessor shall assess whether a lease is accounted for in accordance with the derecognition approach or the performance obligation approach on the basis of whether the lessor retains exposure to significant risk or benefits associated with the underlying assets. This threshold is essentially the same as that used to distinguish financial and operating lease in current lease standards. Besides, financial leasing is an emerging industry in China and plays a vital role in financial system. The proposed accounting model of lessor will cause a substantial negative impact on Chinese leasing companies. Therefore, in order to minimize the implementation cost and the negative effects on leasing industry, we suggest maintain the current lessor accounting model until the Boards develop a single model

consistent with the lessee accounting model and conceptual framework.

- (3) Contingent rentals. We suggest the accounting treatment principle of contingent rentals should be consistent with IAS 37. The consistency of terminology also should be considered.
- (4) Lease incentives and lease holidays. Lease incentives and lease holidays are common terms in lease contracts but are not addressed in the exposure draft, we suggest the Board address this issue and provide sufficient guidance in the final standard.

We would like to take this opportunity to ask the IASB to reconsider the related issues in lease accounting.

Please refer to the attached file for our detailed feedback on listed questions.

Your Sincerely,

YANG Min

Director-General of

Accounting Regulatory Department

Ministry of Finance, P.R. China

&

Member of

China Accounting Standards Committee

#### **Attachment:**

#### THE ACCOUNTING MODEL

The exposure draft proposes a new accounting model for leases in which:

- (a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.
- (b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29, B22 B27, and BC23–BC27).

# **Question 1** LESSEE ACCOUNTING MODEL

- (a) Do you agree that a lessee should recognize in the statement of financial position a right-of asset and a liability to make lease payments? Why or why not? If not, what alternative approach would you propose and why?
- (b) Do you agree that a lessee should recognize the amortization of the right-of-use asset and interest expense on the liability to make lease payments? Why or why not? If not, what alternative approach would you propose and why?

**Answer 1(a):** We agree that lessees should recognize the assets and liabilities that arise from lease contract and support the basic principle of the proposed right-of-use model for lessee. However, we have significant concerns regarding the guidance for determination of lease term and measurement of complex leases, in particular leases with extension options and contingent rent, as well as differentiation between service agreements and lease agreements.

**Answer 1(b):** We agree that a lessee should recognize the amortization of the right-of-use asset and interest expense on the liability to make lease payments if the right-of-use model is adopted.

#### **Question 2** LESSOR ACCOUNTING MODEL

(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?

**Answer 2:** We disagree with the proposed 'hybrid model' for lessor. We do not believe that the proposals for lessor accounting achieve the Boards' objective to develop a consistent model for model for both lessees and lessors and account for economically similar arrangement similarly. We also do not believe that the 'hybrid model' is a significant improvement over the existing lessor accounting model, but will incur great workload and cost if adopted. According to the exposure draft, a lessor shall assess whether a lease is accounted for in accordance with the derecognition approach or the performance obligation approach on the basis of whether the lessor retains exposure to significant risk or benefits associated with the underlying assets. This threshold is essentially the same as that used to distinguish financial and operating lease in current lease standards. Besides, financial leasing is an emerging industry in China and plays a vital role in financial system. The proposed accounting model of lessor will cause a substantial negative impact on Chinese leasing companies. Therefore, in order to minimize the implementation cost and the negative effects on leasing industry, we suggest maintain the current lessor accounting model until the Boards develop a single model consistent with the lessee accounting model and conceptual framework..

If the Boards were to change the lessor accounting model, we prefer the single derecognition approach. Although there are also practical issues of applying the derecognition approach for certain leases where only a portion of the asset is leased or where the lease term is for a period substantially less than the life of the assets, such as real estate leases and time charter shipping, we considered that the derecognition approach is consistent with the right-of-use model and more accurate and reasonable for lease accounting. Conversely, we believe that the performance obligation approach should be eliminated. The performance obligation approach is not consistent conceptually with the lessee accounting model and results in double-counting of the asset. In addition, the leverage ratios will also be inflated under the performance obligation approach, making it more difficult for lessor to raise funds and reach hurdle rates of regulators.

# **Question 2** LESSOR ACCOUNTING MODEL

(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?

**Answer 2:** Disagree. We don't support the performance obligation approach.

#### **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 elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, 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?

**Answer 3:** We agree with the proposed simplifications for lessors, but we do not believe that the proposals for lessees are sufficient. We suggest that the Boards provide lessees with the same relief for short-term leases as is proposed for lessors, that is the ability to elect not recognize a right-of-use asset and a liability to make lease payment.

### **Question 4** DEFINITION OF A LEASE

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

**Answer 4(a):** We generally agree with the definition of lease proposed in the exposure draft. However, we believe that the Boards need to provide further guidance to assist preparers in applying the definition to their lease contracts, especially in differentiating service arrangements from lease arrangements.

# **Question 4** DEFINITION OF A LEASE

(b) Do you agree with the criteria in paragraphs 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?

# Answer 4(b): Disagree.

We do not believe that the sale/purchase guidance in the lease exposure draft is consistent with the proposed revenue standard, nor it is necessary. Introducing separate criteria to distinguish a lease from in-substance sale/purchase results in complexity and inconsistency. We believe that a transaction that meets the definition of a sale/purchase as set out in the proposed revenue standard is accounted for in accordance with the revenue standard. Otherwise it should fall with the scope of the proposed lease standard. Thus, there is no need to provide new criteria in the lease standard.

#### **Question 4** DEFINITION OF A LEASE

(c) 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?

**Answer 4(c):** We do not believe that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient. Due to significant difference between the accounting for lease under right-of-use model and service, distinguishing between lease and service contracts become a key issue when implementing the proposals in practice. We urge the Boards provide more guidance or example to clarify how to apply these principles, such as for outsourcing contracts.

# **Question 5** 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, leases of 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?

Answer 5: We do not object the scope exclusion for leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. However, we also suggest that the lease of investment property should be excluded from the Lease standard whether it is measured at fair value or cost. We believe that the difference in treatment of leases of investment properties would result in the financial statements of companies engaging in the same leasing business becoming incomparable if the companies adopt different cost bases for their properties. Whether the investment property is carried at cost or fair value should not have any bearing on the leasing activity.

**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?

**Answer 6:** We agree that distinct services components should be accounted for in accordance with the proposal in the Revenue from Contracts with Customers. However, if the service component is not distinct and not significant, we support the accounting approach proposed by FASB, i.e. the lessee and lessor should apply the lease accounting requirements to the combined contract; if the service component is not distinct but represents a significant proportion of the value of the contract, it may not appropriate to be accounted for as a lease, so we would suggest apply the Revenue from Contracts with Customers to the combined contract instead.

#### **Ouestion 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?

**Answer 7:** We disagree. We believe that purchase option is essentially similar to providing renewals that extend over the entire economic life of the lease. Hence the accounting should be similar. Otherwise, significant structuring opportunities will be provided. We also believe that both purchase option and term extention option should be included only when it is virtually certain they will be exercised.

#### **MEASUREMENT**

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

- (a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).
- (b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.
- (c) is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).

# **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?

**Answer 8:** We disagree. It is very difficult to determine the lease term under the requirement of the ED in practice. We propose that the lease term include only those extention periods of which the exercise of an extention option is virtually certain in order to reduce the complexity and subjectivity in practice.

# **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?

**Answer 9:** We agree with the inclusion of residual value guarantees in the measurement of assets and liabilities, but disagree with the inclusion of contingent rentals and expected payments under term option penalties, because the recognition of contingent rentals are not consistent with IAS 37.

We also do not agree with the proposed 'expected outcome technique', as it is unduly

complex and highly judgmental. We support a best estimate approach, which may be based on the most likely outcome or on a probability-weighted calculation depending on the information available to the preparer.

# **Question 9** Lease payments

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?

**Answer 9:** We generally agree with the proposal, but we believe further guidance should be provided around the reliably measured requirement.

#### **Ouestion 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?

**Answer 10:** No comment.

#### **Question 11** 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).

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?

**Answer 11:** We disagree. As in our response to question 4(b) above, we don't support the criteria of distinguishing lease from in-substance sale/purchase. Consistent with our response to that question, we suggest that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the criteria in the proposed revenue standard.

#### **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?

# Answer 12(a): Agree.

# Question 12 Statement of financial position

(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?

# Answer 12(b): Agree.

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

(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?

# Answer 12(c): Agree.

# Question 12 Statement of financial position

(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?

# Answer 12(d): Agree.

#### **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?

# Answer 13: 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?

Answer 14: We agree that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows. However, we do not believe that the requirement for lessees to classify cash payments for leases entirely as financing activities is consistent with the treatment of interest payment on other financings. We also disagree that the requirement for lessors to classif cash receipts from leases entirely as operating activities.

#### **Question 15** DISCLOSURE

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?

#### **Answer 15:** Agree.

#### **Question 16 TRANSITION**

- (a) The exposure draft proposes that lessees and lessors should recognize 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?

Answer 16(a): Agree.

**Answer 16(b):** Yes, we believe that full retrospective application of lease accounting requirements should be permitted.

# **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?

**Answer 17:** Given the significant change and complexity of the proposed exposure draft, we believe that the cost of implementing the proposed requirements will be very high.

# **Question 18 OTHER COMMENTS**

Do you have any other comments on the proposals?

**Answer 18:** There are several issues should also be considered:

- Provide guidance on the accounting treatment of lease incentives and lease holidays
- Provide guidance on the accounting treatment for the period between lease inception and lease commencement
- Provide clarification for 'the rate the lessor charges the lessee' and it's relationship with 'rate implicit in the lease'
- Whether lease modifications should be considered changes of existing lease or treated as an termination of one lease and recognition of a new lease.