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Organisation internationale des commissions de valeurs
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Organización Internacional de Comisiones de Valores

28 January 2011

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

Our Reference: 2011/JE/TCSC1/IASB/5

RE: Exposure Draft: *Leases*

Dear IASB Members:

The International Organization of Securities Commissions (IOSCO) Technical Committee Standing Committee on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for the opportunity to provide our comments regarding the International Accounting Standards Board (IASB or the Board) Exposure Draft: *Leases.*

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1. They are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

General Observations

While we support the overall direction and objective of the project, we have provided some feedback on certain aspects of the proposal where we have some concerns. Our comments below address the specific questions posed by the Board where we have concerns.

Responses to the Board's Questions

Question 1: Lessees

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(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?

We agree with the proposed model for lessee accounting.

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?

Some members believe that it would be preferable to have a single lessor accounting model. These members believe that a derecognition model, developed based on a consistent framework for derecognition across various standards, should serve as the basis for the lessor accounting model.

Other members support the proposed hybrid lessor accounting model, but believe that additional guidance should be provided for whether a lessor would apply the performance obligation or the derecognition model to a particular lease, particularly since this distinction cannot be reassessed (unlike other elements of the proposed model). These members believe that no single lessor model would be appropriate for all leases because neither the performance obligation or derecognition models would appropriately reflect the economics of all leasing transactions. For example, accounting for a lease of an aircraft by its manufacturer for a relatively short portion of its useful life would seem to be more consistent with the performance obligation approach, while a lease of the same aircraft for the majority of its useful life would seem to be more consistent with the derecognition approach. Accordingly, these members believe that the current proposal combined with additional guidance would be an appropriate solution.

Lastly, some members believe that the proposed hybrid lessor accounting model may not represent an improvement over current financial reporting for lessors. These members believe that unlike the lessee accounting model, the current lessor accounting model is not fundamentally flawed, and

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accordingly, believe that the Board should give further consideration to whether lessor accounting issues need to be addressed, or should be addressed through a separate project.

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?

We have no fundamental objection to having simplified requirements for short-term leases. However, it does not appear that the proposed requirements for short-term leases would be a substantive simplification for lessees. Since lessees would be required to track short-term leases to apply the simplified requirements, minimal additional effort would be required to discount the projected lease payments, if discounting were required.

We also believe that the Board should better articulate why lessors (and not lessees) would receive a recognition exception for short-term leases. The factors which argue against providing such an exception (e.g., paragraph BC 43's notation that a large number of short-term leases may give rise to material assets and liabilities) would also apply to short-term leases of lessors, yet the Board proposes a short-term lease recognition exception for lessors without further explaining why in paragraph BC 46.

We also believe that any simplified requirements should be required to be applied to all leases if elected, to prevent selective application with no underlying consistent justification, unless there is a compelling reason why the election can be made on a lease-by-lease basis that is not currently

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articulated in the Exposure Draft. Otherwise, for example, lessors could conceivably elect to apply the simplified requirements to only those leases that would not qualify for derecognition.

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).

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 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?

(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?

We generally agree with the proposed definition of a lease, but are concerned that the guidance in paragraphs B1-B4 for distinguishing between service contracts and leases that was carried forward from IFRIC 4 is insufficient, since the interpretation of this guidance will now result in significantly different accounting treatment depending on whether an arrangement is a service contract or a lease. Issues noted in practice include whether the definition of outputs is limited to physical outputs, or could include other items such as renewable energy credits or investment tax credits. Similarly, clarification of the meaning of a fixed price per unit of output should also be provided. We acknowledge that the Board has requested input from the leases working group regarding the interpretation of this guidance, and we encourage the Board to conduct additional outreach directly to preparers.

We also believe that the Board should clarify whether and under what conditions entities would be permitted or required to reassess the distinction between a service contract and a lease.

Some members believe that the guidance for distinguishing a lease from a contract that represents a purchase or sale should be conformed to the guidance in the revenue project to achieve consistency among standards in applying control-based transfer criteria. Other members believe that the criteria are reasonably consistent between the two exposure drafts, and that the reasons articulated in

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paragraphs BC59-BC62 explain why the leasing exposure draft includes criteria relating to risks and benefits as well as control.

Scope

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 5and 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?

Some members agree with the scope exclusion of leases of intangible assets from the proposed standard, pending the Board's future deliberations on intangible assets, noting that the proposed scope exclusion is intended to be consistent with most existing IFRS practice. Other members agree that it is appropriate for lessees to account for leases of intangible assets using the guidance in IAS 38, but believe that lessor accounting for such leases should be included in the scope of the proposed standard. These members are concerned that no guidance for lessors of intangible assets will exist for some time. This would appear to be a step back from the limited guidance that currently exists, given the proposed changes to the scope of the revenue standard and the absence of derecognition guidance in IAS 38.

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.

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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?

Some members support the FASB's proposed approach, noting that it appears that the circumstances under which revenue could be recognized for non-distinct services that have not yet been provided under the lessor derecognition approach would appear to be limited. Other members support the IASB's proposed approach. We agree that it would be preferable for the Boards to develop a converged approach.

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?

Some members agree with the proposed treatment of purchase options. These members acknowledge that there are valid arguments for other approaches to accounting for purchase options, but believe that the proposed treatment is a reasonable approach. Other members believe that purchase options should be treated in the same manner as lease term extension options under the proposed model, as discussed below in response to Question 8. These members do not believe there is any conceptual difference between purchase options and lease term extension options that would justify different treatment, since both options give the lessee a contractual right to continue to use the underlying asset for an additional period of time.

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.

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(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?

Some members agree with the proposed definition of a lease term. Other members believe that optional lease periods should only be included in the determination of the lease term and resulting measurement of the right-of-use asset and lease liability if they meet a higher threshold than specified in the Exposure Draft, such as "highly probable" or "highly likely." These members are sympathetic to the alternative view expressed by Stephen Cooper, as they believe that recording of a receivable by the lessor for such periods may underestimate the business risk to the lessor, and that the recording of a liability by lessees for the amounts relating to optional lease periods may not meet the conceptual framework definition of a liability. At the same time these members note that, at least from a lessee's perspective, a lease term extension option provides an additional right to use the underlying asset, which may justify the recognition of an asset. These members believe that increasing the threshold at which optional lease periods would be included in the measurement would help to alleviate these concerns.

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?

Some members agree with the proposed measurement of contingent rentals and other contingent payments. Other members do not support including contingent rentals as currently proposed, for the same reasons discussed above relating to optional lease periods.

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Among those members who support the definition of a lease term and resulting measurement of lease payments, some note that the reliability threshold for lessors, combined with the absence of the same threshold for lessees, could be interpreted to mean that the lessee's measurement is not reliable. Accordingly, these members would prefer that different language be used to describe the measurement of lease assets and liabilities by lessors, such as the language in paragraph 25 of IAS 37.

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 agree that reassessment is an integral part of the proposed measurement model. However, we believe that more specific guidance should be provided for when reassessment would or would not be required, as we are concerned that the current wording could be interpreted to effectively require continuous remeasurement of all leases at each balance sheet date, which appears contrary to the Board's intentions. We believe that the Board should carefully consider the incremental benefits of reassessment against the costs which will presumably be borne primarily by preparers (and ultimately by investors).

We believe that the Board should consider ways in which the burdens on preparers could be minimized while maintaining the overall integrity of the reassessment principle. Potentially this may be accomplished by requiring significance to be evaluated in relation to the financial statements as a whole, and by requiring specific reassessment for annual periods only, similar to the approach for remeasuring residual values under IAS 16. In addition, we believe that the language in paragraph BC133 should be included in the standard itself, since it appears to better articulate the Board's intentions.

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).

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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 with the proposed criteria for classification of sale and leaseback transactions.

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 agree with the proposed presentation requirements, but believe that these requirements could be expressed as a disclosure principle that entities could apply based on their facts and circumstances, rather than a series of prescriptive requirements. The potential concern is that the balance sheet

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could become less meaningful for entities that act as both lessees and lessors, in cases where leases are relatively insignificant to the entity's overall business.

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 with the proposed requirements.

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 with the proposed requirements.

Disclosure
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?

We generally agree with the proposed disclosure requirements. Some members believe that the Board should consider including example disclosures, which would illustrate how an entity might apply the disaggregation/aggregation principle in paragraph 71.

Given the importance of the distinction between service contracts and leases, some members believe that the Board should consider whether disclosures of entity's obligations under service contracts, which were not accounted for under the proposed standard but could have been if different judgments had been made, should also be required.

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Transition
Question 16

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

Some members would support full retrospective application being permitted, while other members would not support it because this would reduce comparability among entities. In addition, some members believe that additional guidance should be provided regarding how the transition provisions would be applied to sales-leaseback transactions.

Benefits and costs
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?

We agree that the benefits of the proposed requirements would outweigh the costs, provided that the requirements can be implemented in a manner that balances the incremental improvements in financial reporting against the incremental costs of compliance with the proposed requirements. We encourage the Board to conduct outreach to assess the incremental costs to preparers of applying various elements of the proposed requirements, including using probability-weighted cash flows in measuring the expected lease payments, and applying the reassessment provisions.

Other comments
Question 18

Do you have any other comments on the proposals?

While we support the overall direction of the project, we encourage the Board to consider ways in which the overall complexity of the model and the resulting costs that will ultimately be borne by

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investors could be minimized while maintaining the basic principles underlying the proposed model. Although one of the primary objectives appears to be to require entities to account for rights-of-use in a similar manner as if they had purchased the underlying asset, we note that the proposed model is significantly more complex than the IAS 16 requirements for the acquisition of property, plant and equipment. For lessees, the proposed model would require significant judgments in determining the lease term (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), expected lease payments and contingent rentals (using an expected outcome technique in both cases), and when reassessment would be required. For lessors, such judgments would be based on limited information that may be available, and additional judgment would be required regarding which accounting model to apply. Collectively, we believe that these judgments may be difficult for accounting firms to audit and for securities regulators to enforce in a consistent manner, which may serve to reduce comparability. Accordingly, we encourage the Boards to consider ways in which the overall complexity of the model could be reduced while maintaining its core objectives. We also encourage the Boards to work towards a converged solution in those areas where differences currently exist.

* * * * *

We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at + 202-551-5300.

Sincerely,

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