המוסד הישראלי לתקינה בחשבונאות Israel Accounting Standards Board

September 8<sup>th</sup>, 2013

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

Dear Madam/Sir,

Exposure Draft ED/2013/6 - Leases

The Israel Accounting Standards Board is pleased to have this opportunity to comment on the IASB's Exposure Draft ED/2013/6 *Leases* published in May 2013.

**Question 1: Identifying a lease** 

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

- 1. In assessing whether a contract is a lease or contains a lease, the ED uses the term "control". The term "control" is not defined in the ED and the ED does not refer to a definition of this term in other IFRSs. In addition, paragraph 16 of the ED states "A contract may include clauses that restrict a customer's use of an asset; for example, a contract may specify the maximum amount of use of an asset to protect the supplier's interest in the asset. Such protective rights that restrict a customer's use of an asset would not, in isolation, prevent the customer from having the ability to direct the use of the asset." The reference to "protective rights" seems similar to the reference in IFRS 10. If the term "control" in the Standard is meant to be synonymous with the one in IFRS 10, the ED should cross-reference to IFRS 10. Otherwise, the terms "control" and "protective rights" should be defined in the Standard.
- 2. In the ED's illustrative examples (paragraph IE3), example 5A states that "Customer has the right to control the use of the power plant because of the following:
  - (a) Customer has the ability to direct the use of the power plant. Customer has determined how the plant will be operated by both being involved in designing the plant and appointing the party that operates and maintains the plant. Customer's decision-making rights about the design and maintenance of the plant have given it the ability to make decisions about the use of the plant that most significantly affect the economic benefits derived from use throughout the term of the contract. Although another party might operate the plant on a daily basis, that party would be implementing decisions made by Customer about the use of the plant." (emphasis added)

In contrast, in example 5B Customer was not involved in the design of the power plant and "Supplier designed the power plant when it was constructed some years before entering into the contract with Customer—Customer had no involvement in that design."

According to example 5A, Customer's decision making rights about the design of the power plant give the customer control over the use of the power plant. Example 5B emphasises that a customer must be involved in the design in order to control the use of the asset. In our opinion, this requirement is too restrictive and would result in many contracts being scoped out of the proposed Standard, even though they are contracts that convey the right to use an asset (the underlying asset) for a period of time in exchange for consideration. We believe that involvement in the design of the underlying asset should be an indication of control, not essential for control.

3. The criteria drafted in the ED regarding the determination whether an arrangement is a lease or a service arrangement are clearer than the current guidance under IFRIC 4 Determining whether an Arrangement contains a Lease. However, these criteria put greater focus on the purchaser's ability to direct the use of the underlying asset as compared to IFRIC 4. In particular, the ED requires the purchaser's ability to make decisions regarding the use of the asset (paragraphs 12-14) in order to be scoped in the proposed Standard, as opposed to IFRIC 4's requirements, according to which the right to use the asset must convey the ability or right to operate the asset or direct others to operate the asset in the manner the purchaser determines. In our view, the difference between making the decisions and directing others (which is more general), may lead to different conclusions regarding the assessment of certain types of arrangements that insubstance include leases. In our opinion, the ability to direct others to operate the asset in the manner the purchaser determines should also be included in the above-mentioned criteria in the Standard.

# **Question 2: lessee accounting**

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

1. The leases project was aimed to include as much leases as possible on balance sheet and to eliminate a great part of off-balance sheet leases. It was also aimed to align the accounting for leases to that of acquisition of an asset and an incurrence of an obligation, if the leases are in-substance acquisitions of an asset. We understand that two accounting approaches are necessary for the lessor to account for different leases and that the Boards' intention was to create a mirror approach in the accounting applied by the lessee. However, in our opinion, from the lessee's perspective, there is no economic justification for two different accounting approaches. From the lessee's perspective, both types of leases are rights to use an identified asset that is consumed over the lease term. In our opinion, the asset presented in the statement of financial position should represent the remaining right of use of the underlying asset and the expense recognised in profit or loss relating to the lease should represent the consumption of that asset. In addition, the expense should be presented as if

the lessee had purchased the asset and has incurred an obligation, i.e. the lessee should recognise an interest expense and an amortisation expense (as in Type A lease) for all leases. Therefore, we believe that all leases should be accounted for using the accounting treatment proposed to Type A leases.

- 2. An entity that purchases an investment property with a financial liability, and chooses to measure that investment property using the fair value model, can use the election in paragraph 4.2.2 of IFRS 9 and measure the liability at fair value through profit or loss in order to significantly reduce a measurement inconsistency that would otherwise arise from measuring assets or liabilities on different bases. Paragraph 52 of the ED allows a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model in IAS 40. However, the lease liability stays in the scope of the proposed Standard and is not allowed to be measured at fair value through profit or loss. We suggest that the Boards will allow such lease liabilities to be measured in accordance with IFRS 9 (or IAS 39) in order to avoid an 'accounting mismatch'.
- 3. For our comments regarding leases with variable payments, see our response to question 6.

## **Question 3: lessor accounting**

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Paragraph 92 of the ED states: "In the statement of cash flows, a lessor shall classify cash receipts from lease payments within operating activities." Paragraph BC272 states: "The Exposure Draft proposes that, in the statement of cash flows, a lessor should classify lease payments received as operating activities because leasing is generally part of a lessor's revenue-generating activities." In our opinion, this requirement should not be conclusive, since leasing is not **always** a lessor's revenue-generating activity and the classification in the statement of cash flows should depend on the revenue-generating activity of the lessor. For example, consider an entity in the retail business that has a warehouse that is no longer used by the entity. The entity had made attempts to sell the warehouse, but failed to find a buyer, so instead has decided to lease the warehouse. In our opinion, these kinds of lease payments should be classified as investing activities. In our opinion, the IFRS should require that if a lease is part of the lessor's revenue-generating activities, than the cash receipts from the lease payments should

be classified as operating activities, but if lease is not part of the lessor's revenue-generating activities, than the cash receipts from the lease payments should be classified as investing activities.

## **Question 5: lease term**

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

- 1. Paragraph 25 states: "An entity shall determine the *lease term* as the non-cancellable period of the lease, together with both of the following:
  - (a) periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; and
  - (b) periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option."

The paragraph applies to both the lessee and the lessor. Whilst the lessee has the means to determine whether it has significant economic incentive to exercise an option to extend or to terminate the lease, the lessor has no means to determine whether the specific lessee has significant economic incentive to exercise an option to extend or to terminate the lease. In our opinion, the determination whether a significant economic incentive to exercise an option to extend or to terminate the lease, should be based on assumptions that market participants would use and not on the specific assessments of the lessee. In accordance with paragraph 3 of IFRS 13: "...Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value."

2. If the Boards do not accept our previous comment that the assessment should be made based on assumptions that market participants would use, we would appreciate guidance to the "entity-based factors" that an entity has to consider when assessing whether a lessee has a significant economic incentive to exercise an option to extend a lease or not to exercise an option to terminate a lease. Paragraph 26 states: "At the commencement date, an entity shall consider contract-based, asset-based, entity-based and market-based factors when assessing whether a lessee has a significant economic incentive either to exercise an option to extend a lease, or not to exercise an option to terminate a lease, as described in paragraph B5." The term "entity-based factors" is not entirely clear to us. Does it mean that the lessor should consider specific factors that are different from the factors the lessee should consider? We would appreciate if the Boards could provide examples or guidelines to entity-based factors that should be considered by the lessee and by the lessor. As mentioned

above, we believe that both the lessee and the lessor should assess the significant economic incentive from a market participants' perspective.

#### **Question 6: variable lease payments**

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

- 1. Paragraph 43(a) states: "After the commencement date, a lessee shall remeasure the lease liability to reflect changes to the lease payments as described in paragraph 44 and changes to the discount rate as described in paragraphs 45–46. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset, except as follows:
  - (a) a lessee shall identify the amount of the remeasurement arising from a change in an index or a rate (as described in paragraph 44(d)) that is attributable to the current period and shall recognise that amount in profit or loss...."

Example 18 (paragraph IE11), which illustrates variable payments that are linked to the Consumer Price Index states: "Because the lease payments are variable payments that depend on an index, the lessee adjusts the lease liability to reflect the Consumer Price Index rate at the end of the reporting period, ie the lease liability now reflects annual lease payments of CU 102,400... The lessee's adjustment to the lease liability is the difference between the present value of the revised and the original lease payments, discounted using the rate determined at the commencement date, ie the present value of nine payments of CU2,400 payable at the beginning of the period, discounted at the rate of 8 per cent, which equals CU16,192. The lessee determines that all of the remeasurement relates to future periods and adjusts the carrying amount of the right-of-use asset as follows."

In our opinion, since the remeasurement of the lease liability arises from the change in the Consumer Price Index that occurred during the first year, all the remeasurement of the lease liability should be attributable to the first year and not to future periods and therefore should be recognised in profit or loss of the first year rather than as an adjustment to the carrying amount of the right-in-use asset. This accounting treatment would resemble the accounting for acquiring an asset on credit. The liability to pay the supplier is remeasured each period to reflect the change in the consumer price index and the remeasurement is recognised in profit or loss. No portion of the remeasurement of the liability is attributable to future periods and thus the carrying amount of the right of use asset should not be adjusted for any part of the remeasurement.

2. According to the ED (paragraph 39), the lessee includes in the initial measurement of the lease liability only variable payments that are in-substance fixed payments. In certain industries, the lease payments are variable payments that are based solely on revenue, with

no minimum fixed payments. In our opinion, the exclusion of variable payments that are not in-substance fixed payments, which was meant to ease on the application of the Standard, is inconsistent with the fair value concept in IFRSs (for example, the requirement to recognise and measure the obligation arising from contingent consideration in a business combination on the acquisition date - IFRS 3.39). In such lease agreements, the lease payments are determined as a percentage of the revenues and that percentage is determined based on forecasts of the revenues. Therefore, in our opinion, the lessee should recognise an asset and a liability that would be measured based on those forecasts.

3. Paragraph 71 prescribes that the lessor shall include in the measurement of the residual asset the present value of expected variable lease payments. In our opinion, if the lessor is able to recognise the present value of the expected variable lease payments as an asset, then that amount should be included in the lease receivable rather than in the residual asset and vice versa if the expected variable payments cannot be recognised as an asset, then that amount should not be included in the lease receivable nor in the residual asset. The distinction between in-substance fixed variable payments that are recognised in the lease receivable and other variable payments that are recognised in the residual asset has no justification.

## **Question 7: transition**

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

Generally, we agree to the transition requirements included in the ED. We believe that specified reliefs are necessary when applying the Standard to leases that commenced before the effective date. Paragraph C7(b) states that "an entity may use hindsight, such as in determining whether a contract contains a lease, in classifying a lease or in determining the lease term if the contract contains options to extend or terminate the lease." Usually, use of hindsight is not accepted and inappropriate in accounting standards. Furthermore, it is unclear to us whether the Boards meant that hindsight should be used at the effective date of the Standard or at another date. We believe that the determination whether a contract contains a lease, classifying a lease and determining the lease term if the contract contains options to extend or terminate the lease based on the information on the effective date of

<u>the Standard</u> rather on the commencement date of the lease using hindsight, would be simpler. Such a relief had been given in many IFRSs.

## **Question 8: disclosure**

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We are aware that the Boards are familiar with the "disclosure overload problem" and the need to improve the usefulness and clarity of financial disclosure. In spite of that, the ED includes extensive disclosure requirements, some of which are, in our opinion, overbearing and unlikely to provide users with useful information.

- 1. The last sentence of paragraph 60(a) states: "A lessee shall identify the information relating to subleases included in the disclosures provided above." Since the lessee acts as a lessor in its subleases and is required to apply the disclose requirements of the lessor, we believe that identification of the information relating to sublease is unnecessary. This disclosure adds to the disclosure overload in the financial statements.
- 2. Paragraph 61 requires the lessee to provide a reconciliation of opening and closing balances of right-of-use assets by class of underlying asset separately for Type A leases, Type B leases and right-of-use assets measured at revalued amounts. If leasing is considered to be an acquisition of assets on credit, then the disclosures regarding right-of-use assets should be similar to the disclosure requirements in IAS 16. We see no benefit in segregating the disclosures by lease types.
- 3. In our opinion, the disclosure requirement set by paragraph 104 is unnecessary and not useful for financial statements users.

## Question 12 (IASB-only): Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 *Investment Property*. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property. Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

- 1. Currently, a property interest that is held by a lessee under an operating lease and meets the definition of investment property could either be accounted for as an operating lease or as an investment property measured using the fair value model. That classification alternative is available on a property-by-property basis. As a result, if a lessee chooses to account for the property interest held under an operating lease as an operating lease and not as an investment property, the lessee is not required to provide the disclosure requirements of IAS 40, including the fair value of its property interest. According to the proposed amendment to paragraph 3(a) of IAS 40, IAS 40 would apply to "the measurement in a lessee's financial statements of a right-of-use asset that arises from a lease of property if the property would otherwise meet the definition of investment property." According to the proposed amendment to paragraph 74 of IAS 40: "The disclosures below apply in addition to those in [draft] IFRS X. In accordance with [draft] IFRS X, the owner of an investment property provides lessors' disclosures about leases into which it has entered. An entity that holds an investment property under a lease provides lessees' disclosures as required by IFRS X." Consequently, the disclosure requirements of IAS 40 would apply to a right-of-use asset that is measured in accordance with the new IFRS. These disclosure requirements would require entities to determine the fair value of each right-of-use asset every reporting period, usually using real estate appraisers. In our opinion, there is no need to enhance the disclosure requirements and to burden the financial statements' preparers.
- 2. According to the proposed amendments to IAS 40, paragraph 60A would state: "When a right-of-use asset becomes owner-occupied property in accordance with paragraph 60 and a lessee classifies the lease as a Type B lease, the lessee shall include the difference between the fair value of the right-of-use asset and the carrying amount of the lease liability at the date of change in use as part of the remaining cost of the lease."

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The wording "the remaining cost of the lease" is unclear to us. We suggest that the Boards

clarify their intention.

Other comments

1. According to the proposed amendment to IAS 23, borrowing costs may include the

unwinding of the discount on lease liabilities arising from Type A leases. This means that

the unwinding of the discount on lease liabilities arising from Type B leases is not

considered borrowing costs that can be capitalised. Consequently, a lessee that builds

property on a leased land (classified as Type B) that is measured using the cost model

would not be able to capitalise the unwinding of the discount on its lease liability. We see

no justification for distinguishing Type A leases and Type B leases with respect to

capitalization of borrowing costs.

2. According to paragraph 71 of the ED the residual asset includes the gross residual asset and

the present value of the expected variable lease payments less any unearned profit. We

believe that the subsequent measurement of the residual asset can be simplified by treating

the gross residual asset as a variable lease payment.

We appreciate the opportunity to provide our comments.

Sincerely,

Dov Sapir, CPA, Chairman

Israel Accounting Standards Board

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