



December 15th, 2010

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

Dear Madam/Sir,

Exposure Draft ED/2010/9 - Leases

The Israel Accounting Standards Board is pleased to have this opportunity to comment on the IASB's Exposure Draft ED/2010/9 *Leases* published in August 2010.

General comments

We believe that the practical expedient in paragraphs 64-65 is too narrow. As explained in our response to question 3 (short-term leases), in our opinion, the accounting treatment by both the lessee and the lessor should be as operating lease. We believe that more leases should be treated in accordance with the requirements for operating leases, for example, the lease of a printer for 18 month by a consumer product manufacturer. The costs of identifying, recognising and measuring the assets and liabilities arising from these non-significant leases would outweigh the benefits to users of financial statements. In our opinion, setting a quantitative threshold and not a qualitative one creates structuring opportunities. We encourage the Board to develop a more qualitative criterion for the scope of the practical expedient.

In this comment letter we refer only to the questions regarding requirements that we believe should be clarified or amended. Please find below our detailed comments for these questions.

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).**

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 that the distinction made between the accounting treatment required by the lessor and that required by the lessee is inappropriate. If the Board wishes to make a practical expedient to short-term leases, the accounting treatment by the lessee should be parallel to that of the lessor, ie since the Board proposes that the lessor should treat these short-term leases as operating leases are currently treated under IAS 17, the Board should also permit that the lessee treat these short-term leases as operating leases and not require the recognition of an asset and a liability.

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**

In our opinion the criteria set out in paragraphs B9 and B10 emphasize the legal form rather than the economic substance of the transaction. For example, if the lease term is for the entire economic life of the underlying asset, then in our opinion the contract should be outside the scope of this proposed IFRS and should be treated as a purchase/sale. Another example is renewal options to the entire economic life of the underlying asset that it is reasonably certain at the inception of the lease that such options will be exercised. We believe that there is inconsistency in the treatment of bargain purchase options which will result in treating the lease as a purchase while renewal options are considered only for the determination of the lease term.

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?

Paragraph 7(b) states that a lessor shall apply IAS 40 and not this [draft] IFRS to leases of investment properties that are measured at fair value in accordance with IAS 40. We do not understand the rationale of this scope exclusion. In our opinion, these leases are not different from leases of other assets. The fact that total rental income is an important measure for investment property analysts, does not preclude inclusion of leases of investment properties in the [draft] IFRS's scope. A lessor could be required to disclose the information regarding rental income in the notes to the financial statements.

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 contain service components and lease components (paragraphs 6, B5-B8 and BC 47-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 lease.
 - (ii) A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
 - (iii) A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in *Revenue from contracts with customers*.

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

We agree with the IASB approach, because according to the FASB approach a lessor that applies the derecognition approach might recognise the profit from the service component prior to the provision of the services.

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?

In our opinion, this requirement could be impracticable in several circumstances. These circumstances include rentals that are linked to an index (for example, consumer price index) or denominated in foreign currency. They also include rentals that are contingent on the lessee's revenue. Forecasting of these variables for a lease term that is longer than several years is impracticable in many cases.

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

We do not understand the inconsistency in the requirements for the lessor and for the lessee. The lessor is required to include those contingent rentals and expected payments under term option penalties and residual value guarantees only if they can be measured reliably while the lessee is required to include those amounts regardless if they can be measured reliably.

If, in light of the wording of question 9, the Board believes that expected payments from the lessee under term option penalties should be included in the measurement of the right to receive lease payments only if they can be measured reliably, an amendment is required to paragraphs 35(c) and 52(c), because there is no such restriction on their inclusion currently.

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?

We believe that assets and liabilities arising from leases should not be separated and should be presented on the statement of financial position in accordance with their economic substance ie the liability to make lease payments should be part of the financial liabilities and the right-of-use asset should be classified as property, plant and equipment or investment property, as appropriate, without separation from other financial liabilities or from other assets that the lessee

does not lease. In our opinion, this information should be included in the notes to the financial statements.

- (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, totaling 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?**

We believe that on the statement of financial position, the lessor should present only the net lease asset and should not present the components of that net amount. This information should be included in the notes to the financial statements.

- (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 (paragraph 60, BC154 and BC155)? 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?**

We believe that assets arising from leases should not be separated and should be presented on the statement of financial position in accordance with their economic substance. The rights to receive lease payments should be part of the financial assets and the residual asset should be classified as property, plant and equipment **or investment property**, as appropriate, without separation from other assets. In our opinion, the distinction between assets arising from a lease and other assets should be included in the notes to the financial statements.

Paragraph 60(b) requires the classification of the residual asset as property, plant and equipment. However, if the residual asset is an investment property accounted for under the cost model, it should be classified as investment property and not as property, plant and equipment. Therefore, we believe an amendment to paragraph 60(b) is required.

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 this information in the notes instead? Why or why not?

In our opinion, the presentation in the statement of comprehensive income of the lessee and the lessor should be based on the nature or the function of the income and expense and there should not be a distinction between those items that arise from a lease and other items.

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 (paragraph 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?

1. In our opinion, the presentation in the statement of cash flows of the lessee and the lessor should be based on the nature of the cash flows and the cash flows arising from leases should not be presented separately.
2. According to IAS 7.33 an entity may classify interest paid as either operating cash flows or financing cash flows and interest and dividends received as either operating cash flows or investing cash flows. Paragraph 27 of the proposed IFRS requires a lessee to classify cash payments (principal and interest) for leases as financing activities in the cash flow statement. We believe that requirement precludes the lessee from the choice permitted in IAS 7. Also, the lessee's accounting policy might be to present interest payments as operating activities and application of the proposed IFRS would cause inconsistency in these instances. We believe that the Board should not include specific provisions in this proposed IFRS regarding the cash flow statement, but require the application of IAS 7 for all cash flows arising from leases. The abovementioned applies also to the lessor and the choice in IAS 7 of presenting interest received as either operating cash flows or investing cash flows, that is precluded in paragraphs 45 and 63 of the proposed IFRS.

Question 16 - Transition

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

IFRS 3 requires an acquirer to classify a lease contract of the acquiree on the basis of the contractual terms and other factors at the inception of the contract. However, the proposed IFRS requires lessees and lessors to recognise and measure all outstanding leases as of the date of initial application. In other words, although the lessee is not required to recognise and measure all outstanding leases on the basis of the contractual terms and other factors at the inception of the contract, the acquirer of the lessee would be required to do so. We believe that an amendment to IFRS 3 is required in order to require the recognition and measurement of leases of the acquiree on the basis of the contractual terms and other factors at the date of initial application of the proposed IFRS.

Question 18 - other comments

1. We don't understand to which cases paragraphs 19, 40 and 57 apply. It is also unclear whether the changes to the asset or liability should be disaggregated into two components - the change that arises from changes in the discount rate and the change that arises from changes in the contingent rentals - and each component should be treated in accordance with the relevant requirements (the first in accordance with paragraphs 19, 40 and 57 and the second in accordance with paragraphs 18, 39 and 56). We believe that guidelines and illustrative example are required.
2. In our opinion, Appendix C, amendments to other IFRSs, lacks some of the consequential amendments necessary. For example, there is no amendment to paragraph 6 of IAS 38 *intangible assets*. Paragraph 5(a) to the proposed IFRS excludes leases of intangible assets from its scope and directs to IAS 38. According to IAS 38.6 a lessee should account for an intangible asset held under a finance lease after initial recognition in accordance with this Standard. Accordingly, it is unclear what is the accounting treatment required for the lessee at initial recognition and what is the accounting treatment required for the lessor.

3. We believe that the requirements to apply IAS 36 or IAS 39 in paragraphs 24, 41, 58 and 59 at each reporting period might be misleading. We believe that the Board's intention was that the lessee or the lessor should **assess** at each reporting period whether there is any indication that an asset may be impaired, but not automatically perform an impairment test. We suggest that the Board clarify its intention in these paragraphs' drafting.

4. The amounts of the residual asset in examples 4 and 5 are unclear to us. Examples 4 and 5 are based on the same facts. The only difference is that in example 4 the lease term is estimated to be 10 years at inception and at the end of year 1 the lease term is estimated to be 8 years, while in example 5 the estimated lease term at inception is 8 years. In example 4 the residual asset at the end of year 1 is 241 CU, when the expected lease term is 8 years, while in example 5 the residual asset at the end of year 1 is 895 CU (while the estimated lease term is 8 years, before the change in estimate of the lease term). We believe that this unjustified difference arises from the adjustment at the end of year 1.

We appreciate the opportunity to provide our comments.

Sincerely,

Dov Sapir, CPA, Chairman

Israel Accounting Standards Board