Comments on the Exposure Draft – Lease

By China Banking Association

SUMMARY: Although the purpose of this EXPOSURE DRAFT is to provide more complete information to the public and eliminate the room for off balance sheet financing, the negative impact on leasing industry is very large. Generally speaking, the accounting model proposed in EXPOSURE DRAFT will have the following adverse impacts:

Firstly, the traditional concept of Lease will be changed fundamentally. According to the EXPOSURE DRAFT, current financial Lease will be treated as in-substance sale/purchase. The lease scope will be narrowed to the current operating lease.

Secondly, the Lessee needs to recognize Right of Use assets and liabilities for all leasing transactions. The attractiveness of operating lease will decrease dramatically. From the perspective of Lessee, the transaction substance is different from financial lease. Financial lease and operating lease are two different products. However, the new accounting model in ED will eliminate this choice opportunity.

Thirdly, the EXPOSURE DRAFT propose one accounting model for Lessee, whereas there will be two accounting models for Lessor. Additionally, under the performance obligation approach, the total assets and liabilities of Lessor will be inflated. Thus, the leverage ratio of Lessor will be amplified accordingly, making it more difficult for Lessor to reach the hurdle rates of the regulators and raising funds.

Finally, the accounting model proposed in the Exposure Draft involve too much estimation and forecasting when applied, thus leaving more room for manipulating financial statements. The accounting information quality will decrease.

The following are our answers and concerns to the questions in the ED-LEASE.

ED LEASE - QUESTION1: 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?

(China, Lessor) We disagree with the change in the treatment for operating lease. Under this new accounting model, Lessee needs to recognize assets and liabilities in financial statements even in operating Leasing. The operating lease can be substituted by traditional credit products more easily, making it less competitive. The market share of operating lease will decrease dramatically. In addition, Lessee of operating lease needs this product partly because they have no intention of holding the underlying asset. From the perspective of Lessee, the transaction substance is different from financial lease. Financial lease and operating lease are two different products. However, the new accounting model in ED will eliminate this choice opportunity.

(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?

(**China, Lessor**) Agree. If Lessee needs to recognize the right-of-use asset and liability, we agree with the amortization method.

ED LEASE - QUESTION 2: LESSOR ACCOUNTING MODEL

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

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?

(China, Lessor) We disagree with the performance obligation approach. Considering that there is only one accounting model applied for the Lessee, it will be more reasonable to apply one accounting model to Lessor. In our opinion, the __derecognition approach can book Lease more accurately and reasonably. Under the performance obligation approach, the underlying asset will be booked both in the financial statements of Lessor and Lesee. The underlying asset will be double-counted. The depreciation will also be accrued both in the financial statements of Lessee and Lessor at the same time. 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 regulation agencies.

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?

(China, Lessor) We agree with the boards' proposals regarding the derecognition approach; however, disagree with the performance obligation approach. However, as far as the derecognition approach is concerned, we still have some qualified opinions. Too much estimation and forecasting need to be made when applied, such as lease term, contingent payments, expected payments under term option penalties and residual value guarantees.

ED LEASE – 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?

(China, Lessor) Agree with the standard regarding the Lease term. However, we disagree with Lessee's accounting treatment for the short-term lease. Considering that Lessor need not do any accounting treatment at the inception of the transaction, it is more consistent for Lessee not to recognize assets and liabilities either. Additionally, in the simplified way of Lessee, the right-of-use assets will be booked as the face value, which is greater than the discounted amount. Thus the leverage ratio of Lessee will be greater in the simplified accounting treatment of Short-term Lease.

ED LEASE – 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?

(**China, Lessor**) Disagree. According to the proposed definition, the traditional concept of Lease has totally changed. Current Financial Lease will be booked as In-substance Sale/purchase.

(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?

(China, Lessor) Disagree. According to the new criteria, current financial lease will be regarded as a sale and purchase. However, current financial lease has substantial difference from Sale/purchase. Based on ED, current financial lease will be subject to value added tax, whereas, this product is subject to business tax at present. The tax base and rate will be totally different. The tax load of Lessor will be increased a lot accordingly. So, we suggest that the standard for distinguishing lease from sale and purchase could be the transferring of the legal title of underlying assets instead of that of the economic ownership.

(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?

(China, Lessor) Disagree. We think it difficult to define the percentage of service component and lease under the guidance, thus leaving more chances to manipulate financial statement. In our opinion, the service component can be treated as the lease component, because the services provided are integral to the whole lease transaction. When negotiating with clients, the service charges affect the lease rate.

ED LEASE – 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?

(China, Lessor) Agree.

ED LEASE – 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?

(**China, Lessor**) Disagree. In our opinion, the distinction of service components and lease components will involve too much estimation and judgment. In addition, as we mentioned above, the service components are integral to the whole lease contract. The two parts will affect each other. So, we suggest not distinguishing the service and lease components.

ED LEASE – 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?

(China, Lessor) Disagree. According to the ED, the deal will be booked at Leasing before the exercise of purchase option. However, after exercising the purchase option, the deal will be accounted for as a sale/purchase. In that case, the treatment of the same deal is inconsistent. The purchase option is just one clause of the lease contract and is written into the contract at the inception of transaction. In addition, according to the ED, the whole deal will be subject to two different taxes. Lessor needs to pay business tax and VAT respectively before and after the exercise of the purchase option. In our opinion, exercising the purchase option can be treated as one lump-sum rental receipt.

ED LEASE - MEASURE

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?

(China, Lessor) Disagree. According to the ED, the determination of longest possible term will involve too much estimation and prediction. For the same lease contract, different persons will have different judgment. The same deal will possibly be booked differently by different companies. So it will reduce the consistency and comparability of financial statements. We suggest set the lease term as minimum and definite term.

Question 9: Lease payments. Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease 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?

(**China, Lessor**) We agree with the inclusion of residual value guarantees in the measurement of assets and liabilities, but disagree with the inclusion of contingent rentals, expected payments under term option penalties, because contingent rentals and expected payments can not be measured exactly. It will involve to too much estimation and forecasting.

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?

(**China, Lessor**) Agree. If these payments can be measured reliably, estimation and forecasting can be minimized.

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?

(**China, Lessor**) The answers are based on that to Question 9. In our opinion, we can't re-measure assets and liabilities unless the changes regarding lease term and residual value guarantees can be confirmed reliably.

ED LEASE - 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?

(**China, Lessor**) Disagree. Sale and leaseback is one transaction, instead of two separate deals. It doesn't seem reasonable to require the first step (sale) should be an in-substance sale. According to the

standard proposed in the ED, then the sale and lease back deal will be subject to two turnover taxes: VAT and business taxes in China. The sale step is subject to VAT. And the lease back step is subject to business tax. However, the sale and lease back deal is one transaction. There is no reason to levy two kinds of turn-over taxes on the same deal.

ED LEASE - 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?

(**China, Lessor**) Disagree. We think that the right-of-use asset should be presented separately from property, plant and equipment or investment property.

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?

(China, Lessor) Disagree. As mentioned above, we disagree with the performance obligation approach.

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?

(China, Lessor) We agree to present rights to receive lease payments as financial assets. However, we suggest present residual assets separately from property, plant and equipment.

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?

(China, Lessor) 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?

(**China, Lessor**) Disagree. We suggest disclose lease income and lease expense separately instead of net lease income for the Lessor whose business is to provide finance.

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?

(China, Lessor) Agree.

ED LEASE – 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?

(**China, Lessor**) Disagree. The disclosure should be different for different lessors depending on their principal business. Such information has already be disclosed in the balance sheet or profit and loss, such as initial direct cast. Additionally, if disclosed according to ED, the competitiveness and business secrets will be impaired.

ED LEASE – 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?

(China, Lessor) Agree.

ED LEASE – OUESTION 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?

(**China, Lessor**) No. We think the costs outweigh the benefits. Generally speaking, ED has large negative impacts on leasing industry. And the accounting information seem not to be increased due to too much estimation and forecasting.

ED LEASE – QUESTION 18: OTHER COMMENTS

Do you have any other comments on the proposals?