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Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
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Email: commentletters@iasb.org

Dear Sir

EXPOSURE DRAFT ON LEASES

Sappi Limited is pleased to comment on the International Accounting Standards Board (the "IASB" or the "Board")'s Exposure Draft on leases.

Our primary basis of reporting is International Financial Reporting Standards (IFRS), but we are required to comply with certain filing requirements of the Securities Exchange Commission (SEC) in the United States of America due to our listing on the New York Stock Exchange. We therefore are encouraged by the Board's commitment in converging IFRS with US GAAP while at the same time aiming to produce a standard on leases that would ensure that all assets and liabilities resulting from leases are recognised in the statement of financial position.

We would like to thank you for the opportunity to provide comments on this document. Our detailed responses to the invitation to comment questions are included in Appendix A.

Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

Moses Sekgobela
Group Reporting Manager

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Appendix A: Invitation to comment

General comments

We note that the Board's intention in issuing the ED is to improve the accounting requirements for leases so that financial statements provide users with a complete picture of an entity's leasing activities. We have provided comments on the following specific questions asked by the Board:

Question 1: Lessees

(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 board's proposal on the approach that lessees should apply in accounting for leases. We find that the guidelines that are currently used to distinguish between operating and finance leases can result in different treatments of transactions that are economically similar. The current requirements also result in the same asset being included in two balance sheets by the lessee and lessor.

For practical reasons, the board should consider treating the following leases as operating leases (entities will record an expense and a liability only when they accrue in line with the current requirements of IAS 17):

- Small immaterial (materiality will vary amongst entities) leases (for example motor vehicles and computers); and
- Leases that have a short term – less than 3 years (refer to our comment to question 3) with no option to extend the lease.

This will prevent non-value adding administrative costs to maintain loan schedules for a lot of small low value leases.

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?*

We are of the view that all lessors should apply the performance obligation approach.

According to the boards' definition of a lease liability, the obligation is created by entering into the lease agreement; the retention of significant risks and rewards is not a term of the contract that creates the obligation.

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In both models, the lessor is committed to allowing the lessee to use the underlying asset for the entire lease term. The obligation to permit the lessee to use the underlying asset is a present obligation of the lessor arising from past events that would result in an outflow of economic benefits for the lessor under both models (explained in *Appendix A defined terms* and BC 17). In our view the definition and the BC apply equally to a lessor under the performance obligation and the derecognition approaches.

Whereas the performance obligation is not created by an entity's business model, the boards' propose that entities should use their business model to decide whether the performance or derecognition approach should be applied. Where an entity's business model involves generating a return from active management of the underlying asset, this would be a distinct service that would have to be accounted for separately in line with *Revenue from Contracts with customers*.

The derecognition approach is really a purchase or sale of an asset, the treatment under this approach is not different from current treatment of sales under IAS 18 except for the fact that under the derecognition approach an entity does not derecognise the portion of the asset that is not subject to the sale.

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 agree with the board's proposal on the approach that lessees should apply in accounting for short-term leases. However, in our view, the definition of short term lease should be a lease that at the date of commencement of the lease has a maximum possible lease term (including options to renew or extend) of three years or less. In order to be more practical, we suggest that three years be set as the threshold.

In addition (and in line to our comment to question 1), we believe that management should be able to use judgement in determining that certain immaterial leases be treated under the current requirement of IAS 17 as operating leases. We believe that this will reduce the administrative burden that would be involved in keeping loan schedules for such items.

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We do not believe that treating immaterial leases in this way will impact on the decisions that users make on the basis of the financial statements prepared in this way.

Question 4: Definition of a lease

- (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 agree with the boards proposed definition and guidance.

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?

We agree with the boards' proposal on the scope of the draft IFRS, we also note that the boards' have excluded intangible assets from the scope of the IFRS; while we believe leases of such assets need to be addressed we note the boards' reasons for not addressing such leases.

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?

In line with our answer to question 2 above we believe that the lessor should apply *Revenue from Contracts with Customers* for distinct service components but the lessor should not be applying the derecognition approach as the derecognition approach is effectively a sale of an asset (or a portion thereof).

Question 7: Purchases 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?

We agree with the boards' proposal. When the purchase option is acquired, the substance of the transaction changes from a lease to a sale and purchase transaction.

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?

We do not agree with the boards' proposed determination of the lease term. For long term leases, the impact of taking renewal options into account may result in material overstatement of assets and liabilities. Due to the difficult market conditions that have prevailed in the past years, there will be greater uncertainty as to whether leases will be renewed or not depending on business conditions in the market. For the purposes of the applying the boards' proposed requirements, lease terms should exclude renewal options.

We do note that a longer lease term will result in a higher right of use asset and lease liability as compared to a shorter lease term that is continually renewed.

Renewal of a lease raises new rights and obligations which must be accounted for when they occur. The proposal will result in financial statements relying too much on estimates as opposed to accounting for transactions as they occur.

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?

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We do not agree that an expected outcome approach using probability weighted averages should be used. Entities should determine what the most likely outcome is and base their contingent rentals on these estimates as opposed to an averaging technique.

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 agree with the boards' proposal. We prefer this approach over an expected outcome approach technique that uses probability weighted averages. We note that lessors could in this case use an averaging technique to try and mitigate the fact that the level of uncertainty is high but we believe that contingent rentals, payments under term option penalties and residual value guarantees should only be included in the right to receive lease payments if they can be measured reliably.

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 with the boards' proposal on reassessments.

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?*

Except as mentioned in our response to question 2, we agree with the boards' proposals on the presentation of leases in the statement of financial position.

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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 are of the view that lessees and lessors should present lease income and lease expenses separately from other income and expenses in profit or loss as this provides useful information for decision making.

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 are of the view that cash flows arising from leases should be presented separately in the cash flow statement as this provides useful information for decision making.

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?*

We agree with the boards' proposal.

Question 16: Transition

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

In our view, the simplified retrospective approach would be appropriate as it would not need a lot of investment in time and costs. Entities should be allowed to apply the proposals on a full retrospective basis. However for some entities it the costs of applying the requirements on a fully retrospective basis may outweigh the benefits.

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Question 17: Benefits and costs

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

In our view, the proposed requirements will be beneficial to users of financial statements. For some entities, the costs of complying with the requirements of the standard will be high and it is our view that on certain immaterial leases, entities should be allowed to apply the current operating lease requirements to make sure that the benefits really outweigh the costs.

We do not believe that treating immaterial leases in this way will impact on the decisions that users make on the basis of the financial statements prepared in this way.