International Accounting Standards Board 30 Cannon Street LONDON EC4M6XH United Kingdom

December 15, 2010

Re: Exposure Draft Leases

Dear Sir/Madam,

We are writing to you on behalf of a working group of finance professionals primarily serving in French groups or French subsidiaries of groups that prepare their consolidated financial statements under IFRSs. We welcome the opportunity to comment on the Exposure Draft *Leases*, (the « ED »).

Leases are a very important class of transactions, whereby firms acquire the right to use operating capacity and are offered a source of financing. We are aware that over past years current lease accounting standards have become partly ineffective in depicting the true economics of a leasing transaction. Classification criteria between operating and finance leases have proven fairly easy to circumvent and have allowed companies to structure transactions in order to achieve the desired off-balance sheet accounting outcome. Therefore, we accept the Boards' decision to develop an improved accounting model to replace the existing standards.

In principle, we agree with the single accounting model for lessee accounting. Nevertheless, at this stage, we have several major concerns about the proposals in the Exposure Draft. Our comments are set out and explained in detail in appendix 2. Our major concerns are summarized hereunder:

- Estimated term of the lease: the estimated lease term should not be based on the longest possible term that is more likely than not to occur; in our view, the estimate should derive from a most likely to occur approach
- Contingent rentals and similar payments: amounts due under options and contingent rentals should not be included in the measurement of the lease assets and liabilities based on a probability weighted-average basis; we consider that a most likely outcome approach should be retained
- Short-term leases: as far as lessee accounting is concerned, the actual issue is not addressed by the proposed relief. We believe that, for practical reasons, lessees should be allowed to apply to those contracts the accounting for operating leases in the existing IAS 17
- Purchase options: purchase options should not be treated differently from renewal or extension options
- Contracts that contain both lease and service components: from lessees' perspective, systematically accounting for contracts with non-distinct service components as leases is

inappropriate; the accounting treatment should reflect the predominant nature of the contract as identified through an analysis of its economic substance

- Leases of intangible assets: the proposed scoping out of all intangible assets represents a backward step from the existing IAS 17, with a number of unacceptable implications
- Lessor accounting: the proposed model for lessor accounting has several flaws; the major one being that the performance obligation approach leads to partial double-counting of the same future cash flows.

We consider all those to be major substantive issues that need to be resolved.

Should you have any questions, please do not hesitate to contact us.

Yours sincerely,

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Co-head of the working group

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Appendix 1 Members of the working group

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Appendix 2 Response to questions in the Exposure Draft

General comment

Though we offer some views on the proposals for lessor accounting, we primarily comment on the Exposure Draft from the point of view of lessees.

The accounting model

Question 1 – Lessees - Do you agree that a lessee should recognise a right-of-use asset and a liability for its obligation to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on its liability for lease payments? Why or why not? If not, what alternative model would you propose and why?

We acknowledge that the proposed model has merits and can be supported. Our concerns lie with a number of specific provisions of the future standard.

We agree that the existing model in IAS 17 has limits and generates application issues. We are aware that over past years current lease accounting standards have become partly ineffective in depicting the true economics of a leasing transaction. Classification criteria between operating and finance leases have proven fairly easy to circumvent and have allowed companies to structure transactions in order to achieve the desired off-balance sheet accounting outcome.

Altogether, we support the right-of-use model. We agree that if the right-of-use model is applied, a lessee should recognise amortisation of the right-of-use and interest on the lease liability.

We nevertheless have a number of concerns about specific aspects of the model, the major ones are addressed in our responses to Questions 2 to 18 below.

Question 2 – Lessors – Do you agree that a lessor should apply the performance obligation approach when the lease exposes the lessor to significant risks and benefits associated with the underlying asset, and a derecognition approach otherwise? Why or why not? If not, what alternative model would you propose and why?

Do you agree with the boards' proposals for recognition of assets and 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 not convinced by the hybrid model for lessor accounting. We support a single partial derecognition model for lessors.

In our view, the proposed approach is flawed in three respects.

Firstly, we are not convinced by the argument developed in the basis for conclusions (BC§25) that one approach to lessor accounting would not be appropriate for all leases due to the differences in the economics of the transactions. In our view, the same could be said about lessees.

Secondly, the proposed hybrid model would require lease agreement being classified by a criterion that is very similar to the current distinction between finance and operating leases. Hence, it would result in the same application issues.

Thirdly, the major weakness of the performance obligation approach is that the lessor keeps recognising the full amount of the asset in its books and, in addition, separately recognises a lease receivable. This is equivalent to double-counting part of the future cash flows generated by the leased asset, which is inconsistent.

Since we consider the partial derecognition model as appropriate, we support a single partial derecognition model for all leases.

Question 3 – Short-term leases – The Exposure Draft proposes that a lessee or a lessor should apply simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term 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 and loss over the lease term (paragraph 64
- b) the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-bylease basis not to recognise assets and liabilities arising from short-term leases in the statement of financial position, nor derecognise any portion of the right to use the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit and 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 consider that the proposed relief for lessee accounting is inadequate as it does not address the real issue from the preparer's perspective.

As preparers and primarily lessees, we would like to mention that the main issue of the proposed model for short-term leases is the burden of reviewing those contracts so as to identify and track their expected payments. Since short-term contracts are numerous and mostly managed by local units on a local basis, the cost and efforts implied by such a group-wide data gathering coupled with the cost of adapting software would be exceedingly high. Moreover those costs would be incurred by preparers at no benefit to users since the relevance of financial statements will generally not be improved. In comparison, the cost of identifying the appropriate interest rate in order to discount lease payments is not an issue.

Therefore, we are convinced that the simplification proposed for lessees is not an adequate answer and that the real issue remains unaddressed. Our view is that an exception to the general model should be allowed on practical grounds for short-term leases. In other words, we propose that lessees apply to their short-term leases the current treatment of operating leases under IAS 17. We observe that such treatment will but be symmetrical to the simplified treatment applicable by

lessors. The election of the simplified treatment would be treated as any accounting policy option and as such it should be consistently applied over time to all similar contracts.

As for lessors that decide to use the simplified requirements, we do not see the reason why the choice between recognizing or not recognizing the right-of-use asset and the lease payment liability on the balance sheet should be allowed on a contract by contract basis. This will severely alter the comparability of financial statements. As above-mentioned, election of the simplified treatment should be a global accounting policy option.

Definition of a lease

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 for distinguishing a lease from a purchase or sale in paragraphs B9 and B10? Why or why not? If not, what alternative criteria would you propose and why?
- c) Do you think that the guidance provided for distinguishing leases from service contracts in paragraphs B1-B4 is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

We consider that further guidance should be provided for distinguishing leases from service contracts.

We observe that the definition of a lease provided in the Exposure Draft retains the same principle as the definition of a lease in IAS 17 §2 and that the criteria indicated in IFRIC 4 *Determining whether an Arrangement contains a Lease* have been carried forward to the Exposure Draft.

However, the boundary between leases (particularly "operating leases") and service contracts is often difficult to determine. Under the future standard, the treatment of leases will become very different from the treatment of service contracts. In view of the forthcoming change, we consider that the criteria for distinguishing the former from the latter have to be very robust and that their application must be entirely clear. Hence, we consider that the guidance should be developed and clarified; in addition several real life examples should be provided and analysed.

We agree that a transaction in which title is transferred at the end of the lease term should be treated as a sale or purchase (under French accounting provisions there are indeed treated as such). We do not object to the same treatment being applied to agreements with a bargain purchase option.

Scope

Question 5 - Scope and scope exclusion

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, 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 object to the exclusion of intangible assets from the scope of the proposals

The current IAS 17 only excludes licensing agreements for items such as audio or video recordings, manuscripts, patents and copyrights (IAS 17 § 2(b)). The Exposure Draft proposes to extend the scoping out to all leases of intangible assets.

The proposal represents a backward step from the existing standard, with the following implications:

- lessees of intangible assets would be left with no accounting guidance to treat those transactions;
- lessors of intangible assets would apply the provisions in the Revenue Recognition Exposure
 Draft, which may result in a different measurement of revenue from what it would be under the
 Leases proposals;
- options to purchase or extend the term of the license being treated differently in the Revenue Recognition Exposure Draft and in the Leases proposals, measurement of revenue and of the receivable will differ;
- where lease contracts include both tangible and intangible assets (as is often the case in the IT industry), preparers will have to segment those contracts and apply different requirements to each component. This will create additional complexity.

We object to an exclusion that may lead to a gap in available guidance, a different accounting treatment of transactions that have similar economic substance, and additional complexity.

Question 6 – Contracts that contain both service 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, B6-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not distinct:

The FASB proposes that the lessee and lessor should apply the lease accounting requirements to the combined contract.

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 appropriate? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We disagree with the proposal regarding lessees. We do not offer views on the proposal for lessors that apply the performance obligation approach. We accept the treatment proposed by the IASB for lessors that apply the derecognition approach.

We disagree with the proposal that a lessee should apply the lease accounting requirements to the combined contract where this contract includes both a lease and non-distinct service components. In

order to adequately depict the economic substance of the transaction, the lessee should assess what the predominant component is and then treat the whole contract accordingly.

As we object to the performance obligation approach for lessor accounting, we do not offer views on the proposed treatment of a combined contract under this approach.

We agree that a lessor applying the derecognition approach should always be required to separately account for the lease and for the service components.

Question 7 - Purchase options

The Exposure Draft proposes that a contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus a contract is accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraph 8 and BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options when they are exercised? Why or why not? If not, when do you think that a lessee or a lessor should account for a purchase option and why?

We have reservations about the proposal

We would like to stress that purchase options, extension or renewal options are quite often used as alternatives. Lessees will exercise one or the other given circumstances. Therefore there is no reason why the treatment of purchase options and of renewal options should differ.

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 strongly object to the proposal. In our view, the lease term should be determined on a most likely basis

We agree that renewal options should not be ignored when initially measuring the lease liability. However we strongly object to the proposal that the lease term should be determined as the longest possible term that is more likely than not to occur. This would raise challenges in terms of feasibility and reliability, and relevance in lease accounting would be altered. The proposed approach would be particularly difficult to apply where the lessee legally has an unlimited renewal option as is the case for commercial property leases in France. Paragraph BC 120 of the Exposure Draft states that "a weighted average approach to assess the lease term might be difficult to be measured reliably and may result in a lease term that does not reflect a possible outcome". In our view, the same can be said about the longest possible term that is more likely than not to occur.

Altogether, we consider that the only feasible, reliable and sound approach to determine the lease term is a most likely to occur estimate.

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 contract should be included in the measurement of lease assets and lease liabilities 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 can only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the lease receivable if they can be measured reliably? Why or why not?

We strongly object to the proposal. We support a measurement based on a most likely outcome approach.

We agree that contingent rentals, term option penalties and residual value guarantees should not be ignored when assessing the right-of-use asset and the lease liability. However, we strongly object to a measurement based on an expected outcome technique. For reasons similar to those explained in our answer to the Revenue Recognition Exposure Draft, we consider that in the context of lease accounting the expected outcome approach would raise feasibility challenges, put the reliability of the measurement at risk and hinder both the relevance and understandability of financial statements.

We consider that the only feasible, reliable and sound approach to the measurement of contingent rentals and other contingent payments is an estimate of the most likely outcome.

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 obligation or receivable arising from changes in the lease term or contingent payments since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why not?

We agree with the proposal.

We agree that a reassessment is needed only when facts or circumstances indicate a significant change.

Sale and lease back

Question 11 – Sale and leaseback

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or not? If not, what alternative criteria would you propose and why?

We do not offer views on the proposals for classification of as a sale and leaseback transaction and their accounting consequences.

Presentation

Question 12 - Statement of financial position

- a) Do you agree that a lessee should present its liability to make lease payments separately from other financial liabilities and present right-of-use assets as if they were tangible assets within property, plant and equipment, or investment property as appropriate, but separately from other assets that the lessee does not lease (paragraphs 25-27, 42-45, 60-63 and BC142-159)? Why or why not? What alternative presentation do you propose and why?
- b) Do you agree that a lessor applying the performance obligation approach should present its 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? 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 residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? What alternative presentation do you propose and why?
- d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease separately (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 proposal for lessees as far as leases on tangible assets are concerned. That proposal should be amended to accommodate the case of leases on intangible assets.

Consistent with our answer to question 2, we do not comment on the presentation requirements for lessors that apply a performance obligation approach.

We agree with the proposal for a lessor that applies the derecognition approach.

We generally consider that separate presentation of lease assets and lease liabilities, on the face of the statement of financial position provides useful information. Presentation of right-of-use assets deriving from leases of tangible assets within PPE or investment property is appropriate. Should leases of intangible assets be scoped in the future standard (cf. our answer to question 5), then the resulting right-of use assets should obviously be presented within intangibles assets.

Question 13 - Statement of comprehensive income

Do you think that lessees and lessors should present lease income and expense separately from other income and expenses in the statement of comprehensive income (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? 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 proposal in paragraph 26 of the Exposure Draft.

Consistent with our answer to question 2, we do not offer views on the presentation requirements for lessors that apply a performance obligation approach.

We agree with the proposal in paragraph 61 of the Exposure Draft.

We agree with the proposal in paragraph 26 of the Exposure Draft that "A lessee shall present amortisation of the right-of-use asset and interest expense on the liability to make lease payments separately from other amortisation and interest expense, either in profit or loss or in the notes".

From lessees' point of view, we consider it is important that preparers can elect either to separately present the lease expense on the face of the statement of comprehensive income or to disclose this information in the notes.

We do not offer views on the provisions in paragraph 44 of the Exposure Draft as we object to the performance obligation approach for lessor accounting.

We do not offer views as to the provisions in paragraph 61 of the Exposure Draft.

We disagree with the requirements in paragraph 62. In our view, separate presentation in profit or loss of interest income from leases should not be mandatory. When this would be sufficient to highlight the income that relates to leases, an entity should be allowed to disclose this information in the notes (for instance, where the amounts involved are not material).

Question 14 - Statement of cash flows

Do you think that cash flows arising from lease contracts should be presented on 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 disagree with the proposals in several respects.

We disagree with the proposals in several respects.

In reference to the provisions in paragraph 27 of the Exposure Draft, we object to short-term lease payments being classified cash flows from financing activities. Those short-term lease contracts are entirely operating in nature and their cash flows should be treated as such in the cash flow statement. Only for longer term leases, classification of their cash flows among other cash flows from financing activities is appropriate.

We do not consider the provisions in paragraph 45 of the Exposure Draft as we object to the performance obligation approach for lessor accounting.

We agree that lease receipts should be presented among cash flows from operating activities. However we **object with the requirement in paragraph 63**. Consistently with the answer to question 13, we consider that separate presentation in the cash flow statement should not be mandatory. When this would be sufficient to highlight the cash inflows that relate to leases, an entity should be allowed to disclose this information in the notes.

Disclosures

Question 15 - Disclosures

Do you agree that lessee and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from lease contracts; and
- (b) describes how lease contracts 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 proposed objectives but consider they should be clarified.

We observe that the disclosure requirements of the future standard are significantly more extensive than those in existing IAS 17. Hence, we appreciate the provision in paragraph 71 of the Exposure Draft that "an entity should consider the level of disclosures appropriate to satisfy the objectives in paragraph 70". To prevent endless and useless debates, we consider that the Boards should:

- clearly state that those disclosures should not be regarded as mandatory in all situations
- provide at least two illustrative examples in the application guidance, one for a simple case and the other for a complex and/or large one

Transition

Question 16 - Transition

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?

Do you think that full retrospective application of lease accounting should be permitted? Why or why not?

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

We consider that retrospective application is needed and appreciates the simplification allowed under the future standard.

We consider that retrospective application is needed for comparability sake. However, full retrospective application would be extremely costly, hence we welcome the idea of simplifications being allowed. Their extent and expected effectiveness are almost certainly insufficient given the proposed recognition and measurement requirements in the Exposure Draft. Should those requirements be amended as suggested in our comment letter, then the simplifications would probably become appropriate.

In our view, there are no conceptual reasons to prohibit full retrospective application when entities have the relevant information. Election of full retrospective application should be treated as an accounting policy option (IAS 8§13).

Other transitional issues are addressed in our answer to question 17.

Benefits and costs

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 outweigh the cost? Why or why not?

We consider that implementation costs to preparers will be much more important than those taken into account by the Boards.

We consider that implementation costs to preparers, as assessed by the Boards, are significantly underestimated. Beyond those mentioned in paragraph BC203 of the Exposure Draft, material costs will be incurred by preparers, such as group-wide education, staff training, upgrades of accounting systems, implementation of new processes and controls. We would like to stress that not only financial reporting processes will be affected but internal reporting and budgeting processes, performance-based metrics, and so on, will as well. All this should be taken into account when deciding upon the following aspects:

- the appropriate relief for short-term leases
- the extent of simplification allowed for retrospective application
- the leadtime given to preparers to first apply the future standard

Other comments

Question 18 - Other comments

Do you have any other comments on the proposals?

We consider that the initial measurement of the right-of-use asset and lease liability should be capped by the fair value of the leased asset.

The Exposure Draft proposes that lessees initially measure the lease liability (and corresponding right-of-use asset) at the present value of lease payments discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee. In some cases, the incremental borrowing rate of the lessee will be lower than the implicit rate charged by the lessor. We are concerned that this could result in the present value of lease payments exceeding the fair value of the leased asset. Such an inconsistent outcome could well occur where the estimated term of the lease is long and the difference in interest rates material. We consider that the future standard should provide a cap on the initial measurement of the lease liability similar to the existing one in IAS 17 § 20.