



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

IASB – International Accounting Standards Board
IFRS – International Financial Reporting Standard

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Leases

ED/2010/9

Comments by the European Federation of Financial Analysts Societies (EFFAS) Financial Accounting Commission - FAC

Dear Madam, dear Sir,

The European Federation of Financial Analysts Societies is the European umbrella organization of national analysts' societies. It comprises 26 members, representing more than 14,000 investment professionals in the areas of equity and bond research, asset management as well as investment advice. The European Federation of Financial Analysts' Societies through its Commission on Financial Accounting has reviewed the ED, *Leases*.

A substantial part of investments in property, plant and equipment is financed through leasing. IAS 17 provides information, mainly in the notes, on the amounts involved. Analysts have therefore been able to adjust financial statements in order to show a more relevant picture of leverage. However, not all users are comfortable with doing their own adjustments. The main criticism of IAS 17 is that there is a possibility that financial risks remain unnoticed, especially by the less sophisticated investor. Therefore, after discussions in the Commission, EFFAS supports the issue of a standard on leases based on the exposure draft.

The exposure draft does not however address the broader issue of executor contracts. We recall that when it was decided to start working on a revised IAS 17 the question was raised on how to draw a borderline between such contracts and lease contracts.

Members also expressed concern about several specific ED aspects, such as:

- the absence of a rationale for recognising a contract to rent office space as a lease. We believe that this is a standard executor contract;
- presenting de-recognition as a solution for the lessor, if the lessee doesn't have a mirroring accounting, because the underlying idea is a unique economic approach for each contract;
- a lessening of reclassification and adjustments to the financial statements.

Following several discussions, the Commission would like to present its comments to the ED questions as follows:

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?

Our response

Yes, we support recognition of a liability to make lease payments as this would lead to a balance sheet presentation that better represents the leverage position of the lessee. We also support recognition of a right-of-use asset as a natural consequence and the proposal for amortisation.

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?

Our response

Our understanding is that the possibility for a lessor to apply one of two approaches depending on the circumstances will not lead to a significant change compared to IAS 17. That might be seen as an advantage, as users are accustomed to it. However, if the standard has two approaches for the lessor, we think that it would be logical to have two approaches for the lessee as well. In the absence of such an alternative, we would prefer that only the derecognition shall be available for the lessor.

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?

Our response

The amounts of short-term leases are normally immaterial. Therefore we see no need to recognise them in the financial statements. A note disclosing the contractual payments should provide enough information.

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).

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 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?

Our response

We refrain from answering this question.

Scope

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?

Our response

We see no fundamental reason why intangibles are scoped out.

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?

Our response

In principle we support the fact that services which are distinct are recognised according to the standard on Revenues. However, we realize that it might be difficult to make such a separation. Therefore, a simpler alternative would be to require that the lessee applies lease accounting to the combined contract.

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?

Measurement

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).*

Our response

Yes, we support that a purchase option is considered only when exercised. This view is consistent with how we view options to extend the lease period.

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?

Our response

We do not support the assumption that a lessee or a lessor determine the lease term as the longest possible term. The alternative view as presented in AV2ff is more appropriate. In particular, we believe that options to extend leases should not be considered as they reflect the operational flexibility and the risk management policy of the company.

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?

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?

Our response

We do not support that contingent rentals are included in the measurement of a lease, as they are dependant on future events. We support the alternative view as presented in AV5ff.

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?

Our response

We support that a reassessment is required only when there is a significant change in the circumstances.

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).

Question 11

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?

Our response

Our experience is that sale and leaseback transactions more often than not have been borrowing transactions. The proposals in the exposure draft would not change this. We are in favour of the alternative approach proposed by EFRAG.

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).

Our response

We support this proposal, which we find essential.

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?

Our response

We support this proposal, as we think it provides useful information.

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?

Our response

We think that presenting lease income and lease expense only when the amounts are material should be adequate.

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?

Our response

We think it is sufficient to present cash flows arising from leases separately from other cash flows only when they are material.

Disclosure**Question 15**

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?

Our response

We support the proposals for disclosure, recognising that they are extensive.

Transition

Question 16

(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?

Our response

Although by and large we do not favour options, we believe that if an entity would prefer a full retrospective application this should be permitted.

Benefits and costs

Question 17

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?

Our response

For users, the benefits certainly exceed the costs.

Other comments

Question 18

Do you have any other comments on the proposals?

Our response

No.

Should additional comments be necessary, the Commission will be willing to participate.

Yours sincerely,

Javier de Frutos

Chair Commission on Financial Accounting

EFFAS Financial Accounting Commission

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 26 member organisations representing more than 14,000 investment professionals. The Commission on Financial Accounting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint.

FAC members are Javier de Frutos (Chairman, Spain), Friedrich Spandl (Vice-Chairman, Austria), Jacques de Greling (SFAF, France), Henning Strom (NFF, Norway), Ivano Mattei (AIAF, Italy), Taras Koval (USFA, Ukraine), Jérôme Vial (SFAA, Switzerland) and Rolf Rundfelt (SFF, Sweden).
