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Präsident



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Comment on the *Leases Exposure Draft* by the IASB and FASB

Dear Sir/Madam,

The *Leases Exposure Draft*, presented on 17 August 2010 by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), aims to approve a new standard on lease accounting by mid-2011. The new standard would replace the current IAS 17 and make substantial changes to lease accounting for lessees and lessors. The German Property Federation (ZIA) represents over 130 property companies in Germany. On behalf of these companies, the ZIA would like to take this opportunity to comment on the current draft standard.

The new accounting standard would require lessees to recognise in their balance sheets all rental and lease agreements and the resulting rights of use and liabilities. This would also apply retroactively to contracts that have already been concluded. In addition, the standard intends to make it obligatory to either take direct account of or disclose in the notes any renewal options, contingent rentals, term option penalties and residual value guarantees. Currently, lessees recognise leased assets only if the lease transfers substantially all the risks and rewards of ownership of an asset to the lessee (finance lease). Leases that simply transfer rights of use (operating leases) are, like other services, not recognised in the balance sheet because they represent "pending transactions".

The IASB proposes a laudable exception according to which the new regulations on lease accounting would not apply if the property is considered a financial investment (investment property) and measured in accordance with the fair value model set out in IAS 40. However, the exemption does not apply to businesses that recognise assets at cost, meaning that they are subject to the new standard – and all its problems. This would have a significant impact on the property leasing business. The ZIA sees the following points, which mainly affect lessees, as particularly problematic:

- **Balance sheet extension**

Under the new standard, lessee accounting would involve a considerable increase in balance sheet totals because lessees would have to recognise a larger part of their lease contracts, including options to extend. Within this context it is important not to underestimate the conflict that could arise with auditors when assessing the measurement of term options and utilisation of discretionary powers.

Diverging methods of calculating depreciation on right-of-use assets and lease liabilities would also compound the negative effect on certain balance sheet figures such as equity ratio, which, compared to the current treatment of operating leases, would fall. Requiring lessees to recognise liabilities to make lease payments would increase the declared debt ratio, which could make it difficult to gain access to capital.

Furthermore, the property companies that belong to ZIA and are affected by the new standards are concerned that the regulations would lead companies that are obliged to change their accounting procedures to steer clear of long-term lease contracts so as to avoid the negative effects they would have on their balance sheets. In all likelihood this would cause a move towards shorter lease contracts, which in turn would make the (commercial) property market more cyclical, increasing market lease rate volatility. This is because shortening contract periods would mean more contracts would be up for renegotiation at any given time and, as a result, that recessions and boom periods would have a greater impact on leasing costs.

- **Impact on profit and loss statement**

The proposals foresee replacing operative lease expense with depreciation expense and an interest and amortisation component. The lessee's profit would be lower at the start of the lease contract period than in the subsequent periods. This distortion increases with the contract period and the applied discount rate. It contravenes the matching principle because the consideration is provided in the form of a transfer of use that remains the same over a specific period of time.

The lease equivalents recorded in the profit and loss statement could make shorter contract periods more attractive. Longer usage periods would cause the interest component to have a greater impact at the beginning and would increase the discrepancy between the lease equivalent recorded in the first and last periods.

- **Lease term options and discretionary scope**

ZIA also considers as problematic the fact that lease terms are determined by estimating various probabilities and are to be reviewed on every balance sheet date in future periods. That would make the treatment of lease term options far more complicated in the future. On top of that, the estimation of individual probabilities is dependent on subjective discretionary scope. Constant reassessments would be necessary for a large number of lease agreements. The consideration of optional terms conflicts with the definition of liability, as these terms impose no obliga-

tions on the lessee. In general, the new standard would make financial reporting excessively bureaucratic.

- **The principle of non-inclusion of pending transactions on balance sheets**

Furthermore, the new standard contravenes the principle of non-inclusion of pending transactions on balance sheets. This will open a discussion of whether to include things like employment contracts on the balance sheet.

Lessor accounting, too, will become more complicated under the new regulations. Of the two approaches proposed, the performance obligation approach in particular is to be regarded with scepticism. It favours a contractual obligation approach when the lessor has significant exposure to the specific risks associated with the property. Yet this would activate not only the leased item – such as the property – but also the right to receive lease payments. The intended recognition of liabilities for the right-of-use obligation/commitment to the lessee that would arise from this is not compatible with accounting for the lessee's unconditional right of use. Here again, we have the problem that reassessments of the right to receive lease payments will have to be made in future periods. ZIA favours the uniform application of the "derecognition approach" that complies with right-of-use. Depending on the form the lease takes, a portion of the value of the property is derecognised and offset from the right to receive lease payments. This can lead to the recognition of a profit for the lessor.

The new standard would also have a considerable impact on the leasing of mobile assets such as vehicles or IT systems.

For the reasons stated above, the draft standard has caused market participants a great deal of doubt and uncertainty. It also represents an unjustified intervention in the business models of property companies. The changes it brings about in accounting, reporting and bookkeeping will result in substantial additional costs. ZIA thus rejects the draft standard developed by the IASB and FASB and urges them to avoid implementing it.

Yours sincerely,



ZIA

The Germany Property Federation (ZIA) is a unified lobby group that represents the interests of the German property sector in all its diversity, as befits its position as one of the most important industries in the German economy. The confederation gives its members – some of the best-known companies in the sector – a voice that is heard at the national and European level and within the Federation of Germany Industries (BDI). The chair of the confederation is Dr Andreas Mattner. For more information, visit www.zia-deutschland.de.