



Instituto Iberoamericano
de Mercados de Valores

1850-100
Comment Letter No. 125

Santiago Cuadra
Secretario General

International Accounting Standards Board
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Madrid, 10 December 2010

Exposure Draft ED/2009/6 Management Commentary

Dear Sirs,

Instituto Iberoamericano de Mercados de Valores (IIMV) is pleased to respond to the International Accounting Standards Board's (the IASB's) Exposure Draft ED/2010/4 Fair Value Option for Financial Liabilities (referred to as the 'exposure draft' or 'ED').

IIMV is an organization formed by securities regulators from the Ibero-american area that is committed to the development of the transparency and integrity of the securities markets, improve the knowledge of their structure and regulation, enhance the harmonization and encourage the cooperation between supervisors and regulators. Attached list of members of IIMV.

We support an accounting model to recognise more lease assets and liabilities, and a consistent accounting for both lessees and lessors. On this sense, IIMV agrees with the IASB that the right-of-use model would result in a more relevant and decision-useful information for users than the present one.

Although we agree with the proposed model, we have some concerns on specific issues, in particular some related to the simplified model for lessees and the use of the performance obligation method for lessors, as it will result in double counting of the underlying assets. The boundaries between service and lease contracts are not clear enough and could result in divergent application in the practice, and constitutes a source for structuring opportunities. These and other concerns are explained in more detail in the Appendix.

IIMV also welcome the joint effort made by the IASB and the FASB to develop a new common standard on lease accounting.

Our detailed comments and answers to your questions on the exposure draft along with other comments are included in the Appendix to this letter.

We are pleased of your consideration on the comments included in this letter. If you have any questions concerning them, please contact the General Secretary in Madrid, by email acf@iimv.org or at phone +(34) 91 585 09 01.

Yours sincerely,

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INSTITUTO IBEROAMERICANO DE MERCADOS DE VALORES (IIMV)

The Council of IIMV is comprised of the maximum authorities of the securities market supervisory bodies in Ibero-american countries and a senior representative of the public administration with regulatory responsibilities for capital market affairs. The Council is chaired by the Chairman of the Comisión Nacional Supervisora de Empresas y Valores (CONASEV) de Perú

The current membership are:

- Comisión Nacional de Valores de Argentina
- Comissão de Valores Mobiliários de Brasil
- Autoridad de Supervisión del Sistema Financiero (ASFI) de Bolivia
- Superintendencia de Valores y Seguros de Chile
- Superintendencia Financiera de Colombia
- Superintendencia General de Valores de Costa Rica
- Superintendencia de Compañías de Ecuador
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- Superintendencia de Valores de República Dominicana
- Banco Central de Uruguay
- Comisión Nacional de Valores de Venezuela

APPENDIX

Responses to questions ED/2010/4 Financial Instruments: Amortised Cost and Impairment

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?

Response

It is important that lease accounting should provide users of financial statements with complete and useful information about the leasing activities. The present model has been criticized because it does not provide, for a variety of reasons, a faithful representation of leasing transactions. It has also provided the issuers with a variety of “ad hoc” lease contracts just to take advantage of the sharp bright line between finance and operating leases.

On this sense, IIMV agrees with the IASB that the right-of-use model would result in a more relevant and decision-useful information for users. We also find it relevant for the lessee to recognise amortisation of the right-of-use asset and interest on the liability to make lease payments.

Nevertheless, the proposed model include both recognition and valuation criteria that sometimes could include subjective elements in their calculations, and practical application could be complex in the situations described in the following answers.

Having said that, and in relation to what exposed in BC7 (b), we would appreciate having included in the standard a clearer and more detailed clarification on the fact that a lease is not an executory contract after the date of commencement of the lease, to better distinct between both of them; or if perhaps the problem is whether is was an executory contract but ibn which after the commencement date one party (the lessor) has performed a significant part of its obligation (to convey the possession and right of use of the underlying asset) while the lessee has not discharged significantly its leased payments obligations. In consequence, we ask the Board to clarify its reasoning on the issue.

Although we agree with the proposed model, we have some concerns on specific issues. Please refer to our comments on each answer to the questions presented below.

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?

Response

We think that the use of alternative models should be avoided (i.e., the use of the performance obligation approach when the lease exposes the lessor to significant risks and benefits associated with the underlying asset, or the derecognition approach otherwise). It may be difficult to apply in practice, and present IAS 17 has proved practical difficulties in distinguishing between finance and operating leases.

We consider that the more faithful representation of the lease contracts from the lessor perspective is the one provided by the derecognition model, as it would end in a symmetrical treatment between lessors and lessees. The application of the proposed performance obligation approach will cause the overstatement of the lessor balance: the lessor will record both the underlying asset leased to the lessee and the right to receive payments as a consequence of the lease agreement.

BC7 (b) may also be understood to support the derecognition model given that the lessor's performance obligation could be considered to be satisfied on commencement date of the 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?

Response

We agree that the proposed model for lessors described in paragraph 65 simplifies the accountancy for short-term leases, and in that sense we agree with it. But in the case of lessees, we think that the proposed model does not constitute a simplification compared with the general model, as the discounting task does not seem to be the most complicated one. In consequence, we would propose, in the case of a lessee that has a short-term lease, a model symmetrical to the one proposed to lessors.

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? Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

Response

IIMV is concerned that the criteria set up in the proposed model should be consistent with the ones proposed in the ED *Revenue from Contract with Customers*. While in that ED states in the paragraph 25 that *revenue shall be recognised when an entity has transferred a promised good or service*, paragraph B9 states that *a contract represents a purchase or a sale of an underlying asset, [...] if an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire*

underlying asset. The two differences may be seen as slightly different, so differences in application may arise.

Moreover, it seems to us that both conditions stated in B9 (i.e. control and transfer of risk and rewards) should be fulfilled according to B9, while in B10 it is said that the control is fulfilled when the contract transfers title to the underlying asset or includes a bargain purchase option. B10 examples are focused on the control issue without mentioning the risks and rewards transfer side. In consequence we encourage the Board to clarify this inconsistency between both paragraphs and revisit the drafting of B9 paragraph.

As ED on revenue focuses on the concept of control transfer, it may arise differences with B9 paragraph when the leased asset is subject to contingent liabilities whose existence may deny the transfer of all but a trivial amount of the risks and benefits. This is another reason, from our point of view, to revisit the drafting of B9 paragraph.

Finally, on the distinction from service contracts, we have concerns that the criteria for that is not clear for us, as the line between both is not clear; in consequence, we would encourage the Board to provide more guidance on the issue. On this issue, we think that the Board gives an excessive importance to the underlying asset as the main fact to difference both types of contracts, while we think it would be more appropriate to establish criteria based on the substance of the transaction from the lessee point of view, in a similar way with what is proposed in ED on revenue, on which the selling of assets or the provision of services is analyzed from the client perspective. We are of the opinion that the use of specified assets do not determine the existence of a lease, as there are contracts on which the use of a specified asset is only a way to finish the main transaction (in this situation the “lessee” also controls the access to the specified asset without meaning that a lease contract is agreed).

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?

Response

We do not understand the reason for scoping out the intangible assets from the scope of the ED. By doing so it will create practical problems, for example with the IT licenses. We encourage the Board to reconsider its position on this.

We agree to scope out the leases for biological assets, and leases to explore for or use minerals, oil, natural gas and similar regenerative resources for the reasons explained in BC 34.

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?

Response

We would prefer applying a unique treatment by the lessee and the lessor, based on the symmetry. Our preference is that the lessor accounts for separately the two components. We see a problem in the lessee side, as it cannot always have the information to split them, so it would be more practical for the lessee to account for it assessing the predominant part of the contract and treat the whole contract based on the predominant part. In those rare cases when the predominant part is not evident, the lessee would treat the whole contract as a lease.

Finally, we would like having the same proposal for both the IASB and the FASB, so we encourage them to revisit the issue to get a unique solution.

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?

Response

IIMV thinks there is not a conceptual reason to treat options to extend or to terminate the lease and options to purchase the underlying asset differently. The not inclusion of the options to purchase the underlying asset in the lease agreement would be contrary to the substance of the transaction.

Having said that, we acknowledge the practical difficulties of incorporating those clauses in the calculation of the asset to be recognized.

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).

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?

Response

IIMV disagrees 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, i.e. optional lease periods should not be taken into account. We concur with the AV4 expressed by Stephen Cooper that *the consequence of including all optional lease periods in the recognition and measurement of the lessor's receivable (under both the performance obligation and derecognition models) is that investors may underestimate the business risk of the lessor. In his view the overstatement of the receivable implies exposure to credit risk when the reality is an exposure to underlying asset risk.*

On this sense, the solution proposed by the model could be difficult to apply, in particular in some businesses on which the use of the lease contract is very intensive; the use of optional lease periods is under the lessee decision, and in consequence, the recognition of any additional liability in relation to additional payments during the extension period could not comply with the liability definition.

In addition, we would accept the inclusion of contingent rentals as far as they are referred exclusively to the initial non cancellable lease term; the extrapolation of such contingent rentals to subsequent periods would cause us the same concerns expressed for the optional lease periods dependant on the lessee desire. Moreover, we are not sure if the IASB is proposing different reliability criteria for assessing future events in the proposed ED compared to what stated in IAS 36, in which the use of periods in the estimation of the value in use or recoverable amount exceeding the budgeted period is not allowed unless justified. Admitting that the purpose of these two standards are not the same, the grade of future events estimation that is proposed in this draft is much higher, which will also lead to applicability problems and divergent application.

As explained by Stephen Cooper in AV2, we agree that the inclusion of optional lease periods would only be acceptable when the lease contract includes an incentive to extend the lease period (such as penalties payable on cancellation or reduced rentals in the optional period), or where costs of customisation or installation make renewal likely.

Lastly, we would like the draft to explicitly mention other circumstances that usually are included as part of a lease contract, such as the rental update clauses, or the expenses to incur due to recovery or dismantlement of the leased asset to turn it to the initial condition.

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?

Response

We refer to the views expressed in the previous question. IIMV agrees with the AV5 expressed by Stephen Cooper in the sense that *Reflecting all expected contingent rentals in the measure of the lessee's liability and the lessor's receivable does not provide relevant information about the economics of such leasing arrangements*. In consequence we think 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 based on 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 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?

Response

Although IIMV agrees with the proposal set out in the ED, we have some concerns on the fact that it is not clear the criteria for assessing when there is a significant change. As lease liabilities share some common characteristics with the financial instruments ones, we propose to introduce a similar criteria as those stated in IAS 39.AG62.

The proposed draft seems to look for a simplification of the requirements to reassess a lease contract, with which we agree, but also we are aware that in the practice, and in some business with an intensive use of such contracts (retail and wholesale business, airlines, etc), the use of detailed calculations in a continuous basis will not be prevented, which could sometimes be excessive onerous for some entities.

Lastly, in our opinion the criteria for accounting the impact of the significant change in the lease contract seems clear and easy to apply, except in the situation on which there are significant changes in the guaranteed residual value: changes in that value as a consequence of changes happened between the contract inception date and the present period should be recorded in profit and loss, but it could also be interpreted that as far as the guarantee covers the whole lease period, significant changes should also be recorded against the lease value to adjust it. A clarification on the issue would be welcomed.

Question 11: Sale and leaseback

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?

Response

We refer to our previous answer in Q4 in relation with the interaction with the ED *Revenue from contracts with customers*.

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?

Response

IIMV agrees with the proposed model with the exception of the performance obligation model (see our answer to Q2).

Question 13

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?

Response

IIMV agrees with the proposals set out in the ED.

Question 14

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?

Response

IIMV agrees with the proposals set out in the ED.

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?

Response

We agree with the proposals set out in the ED, although the IIMV is of the opinion that some room for judgment should be left to the entity, depending on the relative relevance of the lease contracts and their impact on the entity's financial position and performance.

Question 16

- (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?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Response

We agree with the proposals set out in the ED.

Finally, we are not sure that these transitional provisions will work adequately in sale and lease-back transactions, so further clarifications will be welcomed.

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?

Response

IIMV, as a securities regulator and enforcers organization, is not on a position to evaluate that.

Question 18

Do you have any other comments on the proposals?

Response

As the new standard would supersede the present SIC 15 on which it was regulated the incentives on operating leases, it would be desirable to include this fact in the new standard. Additional requirements in relation to the accounting of the incentives that were present at the standard effective date should also be desirable.