



BNP PARIBAS

Paris, 15th December 2010

Ms. Leslie Seidman
Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Sir David Tweedie,
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: ED/2010/9– Leases

Dear Ms Seidman,
Dear Sir David,

BNP Paribas is pleased to have the opportunity to comment on the Exposure Draft '*Leases*' published on August 17 2010.

As one of the largest banks in the world, BNP Paribas is present in 84 countries, with a balance sheet of €2 057 billion Euros at 31/12/2009. Our group is active in a wide variety of financial activities, including retail banking, investment banking, asset management, and insurance. We are an actor in all fields of leasing, as shown by our activities;

- as an equipment lessor in 40 countries through our Equipment Solutions division, which wrote over 430 000 new leases in 2009 for an amount of 12.5 billion €, and through equipment leasing activities carried out in our retail banking activities in varying locations
- as a property lessor through our Investment Solutions division, which includes property management and investment activities and property portfolios held by our insurance companies
- as a property lessee for a portion of our retail branches and head office and administrative locations, throughout the world
- as an equipment lessee for a portion of our office, IT and general business equipment.

We are therefore concerned by the Exposure Draft in a range of capacities as both lessor and lessee of both equipment and property, and are pleased to be given this opportunity to comment.



In our response to the Leases Discussion Paper, we expressed a number of serious concerns with the proposals to revise lease accounting. Regrettably, these concerns have in no way been alleviated by the development of the leases project in the period between Discussion Paper and Exposure Draft, and in fact have been heightened by developments in relation to lessor accounting. We summarise these concerns below, and expand further on them in our more detailed responses to the questions contained in the Invitation to Comment.

The exposure draft is built around the concept of right of use accounting for lessees. Whilst we agree that this accounting model can have merits for lessee accounting for a portion of the leasing market, we do not agree with its application as proposed in the Exposure Draft. In particular, we are concerned that its scope of application is not adequately defined;

- we find the distinction drawn between leases and leases that are sales and purchases to be unnecessary
- the guidance for distinguishing between leases and service contracts is essentially unchanged from current guidance and is insufficiently robust given that this will define the frontier between on and off-balance sheet accounting
- the definition of a lease is cast in terms that could encompass arrangements that do not transfer a valuable right of use, such as outsourcing arrangements and those concerning parts of larger assets
- we are not convinced that it is an adequate model for leases of long-lived and non-depreciating assets, where the consumption of the economic value of the asset is limited
- the conceptual differences between leases and other arrangements characterised as executory contracts have not been explored in detail

The application of the right of use model described in the Exposure Draft suffers, in our opinion, from a number of conceptual flaws. The dispositions relating to contingent rentals and extension and termination options lead to the creation of assets and liabilities that do not meet the definition of assets and liabilities, and do not reflect the economic reality of lease contracts containing such features. We feel that the use of probability based measurement techniques leads to extraordinarily complicated accounting rules, which will prove extremely difficult and costly to apply for lessee preparers, and are unlikely to provide clear and useful information to users. The difference between the amortisation and depreciation methods proposed for the subsequent measurement of lessee assets and liabilities will front-end reported lessee costs, and thus depress their earnings, from the date of transition and on a permanent basis for all growing businesses.

We are pleased to note that the boards have concluded that lessee and lessor accounting should be revised contemporaneously, and that different lessor business models may require different accounting models. However, we believe that the Performance Obligation model proposed for some categories of lessor accounting is incompatible with the right of use model for lessees, leads to the creation of unsubstantiated assets and does not reflect economic reality. It should not be retained. The lessor derecognition model proposed for other leases is compatible with the right of use model and would be an acceptable model for a significant part of lessor activity, but the version presented



includes a fundamental flaw in its treatment of lessors' residual assets, which would severely distort the reporting of lessor revenue and distance it from economic reality. As they stand, neither of the lessor accounting models represents an improvement on current lessor accounting models, although we acknowledge that an improved derecognition model could represent a positive step forward.

Perhaps our greatest concern with the proposals lies in the costs, both direct and indirect of their implementation. We are concerned that the boards have failed to recognise the sheer number and the low average value of leases written, which reflect the important and wide-spread use of leasing as a means of ensuring availability of standard business assets. The costs of collecting, analysing and updating the data required by the accounting models proposed have in our view been considerably underestimated. The negative impacts of the proposed reform on net income reported by both lessees and lessors may have unintended consequences on the level of business investment and on the availability of lease finance to the economy. The reform may also have unintended consequences on the requirements for regulatory capital of the banking industry, in its capacity both as lessor and as lessee, according to the status of right of use assets and the regulatory treatment of the Performance Obligation model.

In conclusion, although we believe that both the right of use model for lessee accounting and the derecognition model for lessor accounting are conceptual building blocks upon which a revised and improved lease accounting standard could be built, we do not feel that the case for change has been made. We remain unconvinced that the defects ascribed to current lease accounting are, in the case of IAS 17, as prevalent as is claimed, feel that the models as proposed suffer from too large a number of conceptual flaws for the Exposure Draft to be used as the basis for drawing up a final standard, and believe that the demonstration of the cost/benefit advantages of change remains to be made.

We would urge the boards to give themselves the necessary time to conduct a thorough cost/benefit and feasibility analysis, including field testing of the proposals, and to re-examine and re-expose their proposals in order to address the conceptual weaknesses that have been identified. This will mean that the June 2011 convergence deadline will no doubt be missed, but if this allows for the creation of a conceptually consistent and practicable accounting standard, we feel strongly that this would be a far preferable outcome.

We would like to thank you in advance for the attention that you will no doubt pay to our comments, and would be grateful if you would contact the undersigned if you have any queries or need for further information on these comments

Yours sincerely

Gerard Gil
Deputy CFO



Responses to questions contained in the Exposure Draft 'Leases'

Question 1a: Lessees

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?

We do not agree that the right of use model is appropriate for lessee accounting in all circumstances.

The legal form of a lease is used in a wide variety of contracts, ranging from those that cover a large portion of the economic life of an asset and can be considered economically similar to an asset purchase, to those that cover only a small portion of an asset's useful life, or to those that are essentially service or outsourcing contracts that require the presence of an asset or assets. We do not believe that the lessee right of use model adequately reflects this spectrum of the use of leases.

This arises because the right of use model has been built on the analysis of a simple lease for a significant part of the economic life of the whole of a depreciating asset. In the context of this specific type of lease, we agree that right of use can be an adequate representation of the arrangement.

However, we do not subscribe to the view that more complex contracts are just simple contracts with additional elements such as services, options or contingent rentals. The existence of these elements can change the fundamental economic nature of the arrangement, which can take on the nature of an executory contract whose fulfilment requires, as an accessory, access to an asset or assets. Lessees under such complex arrangements are not simply seeking the availability of a specific asset, they are looking for a convenient and flexible way to fill a business requirement, which may require assets that are fungible and readily substitutable, whilst profiting from asset management expertise and residual value underwriting provided by the lessor. Such arrangements are not a form of asset purchase, the lessee is seeking quite the opposite transaction.

The simple lease used to justify the right of use model concerned the whole of a depreciating asset. We are not convinced that it is readily extensible to parts of assets. Arrangements where the subject of the lease is a portion of a larger asset, and in particular where the leased portion would never be available for purchase, should be considered for treatment as executory contracts. It is counterintuitive that a lessee shows as an asset an item that could never be separately purchased or sold, and that a lessor derecognises something that is incapable of being sold.

These problems of complex contracts and arrangements over parts of assets are linked to the need to better distinguish between leases that could fall under the right of use model and those that are better characterised as executory contracts (see Question 4).

We are also unconvinced that the right of use model translates adequately to non-depreciating or long-lived assets such as land and buildings. In the simple lease example used by the boards, the



lessee is effectively consuming a portion of the asset by using it during the lease, and the asset will have less value when returned to the lessor. In such a case, the conclusion can be drawn that the lessee is effectively purchasing and consuming a part of the intrinsic value of the asset. In the case of leases over property, the consumption of the asset by the lessee is inexistent or insignificant, the asset does not lose value over time, and one can therefore question whether the lessee is actually purchasing and consuming part of the intrinsic value of the leased asset. In these circumstances, the characterisation of rental as a period cost for usage, but not consumption, of the underlying asset would seem a more appropriate presentation. The issue of contracts over parts of a larger asset, such parts not being available for sale, also arises frequently in property related transactions, for example in the case of the lease of surfaces in shopping centres, department stores or airports.

In summary, the question of the validity of the right of use model is intrinsically linked to the definition of the arrangements that it is designed to cover. The ED does not adequately examine this issue.

Question 1b: Lessees

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 do not agree with the proposals for subsequent measurement for lessees.

In most circumstances a right of use asset would be depreciated on a straight-line basis, whereas the liability would amortise on an effective interest or mortgage basis. The effects of this mismatch are significant, as the liability would in most circumstances be greater than the asset, given its greater cumulative amortisation throughout the life of the lease. As compared with current operating leases, costs will be higher in the earlier years of a lease and then lower in the latter years. However total costs to date under the proposed measurement model will always be higher than under a current operating lease, at any point of time in the life of the lease with the exception of the first and last days of the lease term, thus generating:

- a permanent increase in lease costs, and decline in net revenues, for all lessees in the years following transition
- a permanent increase in lease costs, and decline in net revenues, for all lessees whose business is growing, as they will always have a proportionately greater share of recent leases
- permanent creation of book/tax timing differences

We would propose that right of use assets be depreciated on the basis of mortgage-type amortisation. In the case of the vast majority of leases that have even rental payments, lessee assets and liabilities would be of the same value throughout the lease term, absent revaluation or impairment of the right to use asset, thus resolving the problems outlined above. Leases with uneven payment terms would effectively see asset and liability values diverge, correctly reflecting early or late clearance of the



liability.

Question 2a: Lessors

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?

We do not agree with the proposal for a hybrid model for lessors combined with a single model for lessees, as we feel that this cannot lead to coherent and consistent accounting.

We also fail to see how the existence of risks or benefits has any bearing whatsoever on whether the lessor has a performance obligation or not. It is surely the existence or not of a performance obligation that should determine how a lessor accounts for an arrangement, although we would add that an entity that has a performance obligation is clearly providing a service. At that point it is highly questionable that the entity is acting as a lessor, and thus that its client (the “lessee”) is party to anything other than an executory or service contract.

We sympathise with the notion that lessors can have different business models, falling broadly into the families of ‘asset financiers’ and ‘asset managers’. As such, we agree that it is conceivable that each type of lessor adopts a different accounting treatment, but it is inescapable that these different accounting treatments for lessors lead to different accounting treatments for lessees also.

The derecognition approach appears to us (subject to resolution of the fundamental flaw relating to subsequent measurement of the residual asset, described in the response to question 2b below) to be a faithful representation of the business model of many lessors, dividing the lessors assets into the two assets of receivables (asset risk that has been transferred to the lessee and thus converted into credit risk on the lessee) and residual asset (subject to market risk on asset value of lease expiry). It is consistent with the lessee right of use model.

Where a lessor is acting as an asset manager, it is taking operational and market risks associated with the underlying asset, and its major objective is to ensure as great as possible a usage of the asset at the best commercial terms it can find. We would argue that in these cases, lessors are retaining the asset risk, and the lessees of asset managers are simply acquiring a service, the making available of the asset, and that the most appropriate accounting model for both lessee and lessor is either the current operating lease model, or an executory or service contract model. It is certainly not the Performance Obligation model, which we believe to be fundamentally flawed (see Question 2b). Such a model for asset managers is not conceptually inconsistent with the derecognition model, as it would correspond to a situation where the residual asset represented the whole of the asset, and the receivable was of nil or little value.



The proposed dividing line between lessor accounting models is similar to that existing today between finance and operating leases. This reflects the fact that IAS 17 is grounded in economic reality, although its application may be distorted by the importing of numerical bright lines from other jurisdictions. The removal of such numerical bright lines from FAS 13, and reinforced application guidance for IAS17 specifying that the finance/operating lease split is grounded on principles of exposure to risks and rewards and not numerical rules, could very well have been the best way for the boards to achieve their stated aims.

However, if the boards do wish to proceed with right of use accounting, the preferred model for lessors should be derecognition, which caters adequately for lessor accounting in most circumstances, with the exception of short term contracts, as the boards have acknowledged, and contracts on long-lived and non depreciating assets, and on assets that are part of a larger whole, which would be better catered for by the executory model referred to above (see also the answer to Question1 a).

Question 2b: Lessors

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 agree with neither model as presented in the Exposure Draft, although we would be in agreement with the derecognition model, for those leases that warrant right of use lessee accounting, if the subsequent measurement of the residual asset were to be correctly specified.

1) Performance Obligation

We believe the Performance Obligation approach to be contradictory with the Conceptual Framework, with the right of use model, and with economic reality.

The underlying asset subject to a lease produces a single cash flow (the lease payments) that cannot substantiate the value on the lessor's balance sheet of both the receivable and the underlying asset itself. We note that the ED is wholly silent on the question of impairment under the Performance Obligation approach, which is concerning. If the cash flows generated by lease payments substantiate the receivable, the underlying asset would seem to be clearly impaired, for the lessor has no access to any economic benefits flowing from that asset. The situation of the asset would be similar to that of a confiscated or impounded asset (not available to the lessor and no compensating cash flow), which would surely meet the criteria for impairment. A model which would lead to immediate impairment by the lessor of all leased assets cannot be claimed to be appropriate.

Furthermore, it is inconsistent that a lessor continues to carry an underlying asset at its full value when the lessee is recognising the right of use of the same underlying asset on its own balance



sheet. Either the right of use is a valuable asset, and the lessor should recognise that it no longer has control of this valuable asset, or else the lessor surrendering this right of use is not disposing of part of the value of his asset, and the lessee therefore has no asset to recognise. This contradiction alone disqualifies, in our opinion, the Performance Obligation model.

The Performance Obligation liability that balances the proposed lessor accounting has no grounding in reality, as the boards themselves say that *'the lessor cannot prevent the lessee from using the underlying asset.....without causing a breach of contract'* (BC7b). We do not believe that an obligation not to breach a contract represents a liability, nor do we recognise any performance obligation resting on the lessor once he has delivered the leased asset to the lessee.

The net presentation of assets and liabilities under the Performance Obligation model may reduce the visible impact of the model on balance sheets, but certainly does not make the model any less contradictory with the Conceptual Framework, with the right of use model, or with economic reality.

Derecognition model

As stated above, we believe that the derecognition approach for lessors is consistent with the right of use model for lessees. When correctly applied to arrangements suited to the right of use model, it reflects the transfer by the lessor to the lessee of the control of the use of the underlying asset, caters for a receivable that matches the liability of the lessee to make rental payments, and translates the exposure of the lessor to the value of the underlying asset at lease expiry.

Derecognition is capable of application to a significant portion of lessor accounting, and certainly much more widely than is proposed in the Exposure Draft, where its application would be limited to the narrow category of leases where the lessor retains more than trivial but less than significant exposure to risks and benefits of the underlying asset. Beyond the obvious application difficulties of 'more than trivial but less than significant', derecognition is a more conceptually robust model than Performance Obligation and should be more extensively applied than is proposed in the ED.

However, the model as presented in the Exposure Draft is fundamentally flawed in its treatment of the lessors residual asset, which should not be frozen as proposed, but should accrete interest so that its value at lease termination, save impairment during the life of the lease, is equal to the assumption of value of the asset at lease expiry that was initially projected.

This treatment can be justified by an analysis of how equipment lessors price leases. Rentals are priced using 4 elements:

- Lease term and payment frequency
- Initial value of the asset
- Assumption of asset value at the end of the lease
- Rate of return required from the lease



Rentals are then calculated from these elements, such that a constant rate of return is made by the lessor on his outstanding, the initial value of which is the initial value of the asset, and the final value of which is the assumption of final asset value, or residual value. The residual value being part of the lessors outstanding, it is therefore interest bearing during the term of the lease.

If market conditions dictate lower rentals for a given term and initial asset value, the lessor can achieve this by lowering the rate of return required, or by accepting a higher assumption of residual value, and thus a higher level of asset risk, but neither of these actions changes the interest-bearing nature of the residual value.

Given that, at the interest rate inherent in the lease, the present value of lease payments plus the present value of the residual must, by definition, equal the initial value of the asset, the amount of the asset that remains after derecognition is the present value of the residual assumed at lease termination. It is thus inherent in the nature of this residual asset, which is treated as the final cash flow in current lessor finance lease accounting, that it should accrete interest over the life of the lease. This reflects the fact that with the passing of time, the initial discounting should unwind.

The need for this treatment is also precisely explained in the alternative view of Mr Stephen Cooper in the Basis for Conclusions.

This is an essential change that is required to the derecognition model, and without which the model would be unworkable. The effect of the freezing of the residual asset, as currently proposed, would be to radically reduce, or even completely cancel, lessors' reported profits.

Let us assume a lessor working to a 6% rate of return on leases, with funding costs of 3% and overhead and risk costs totalling 1.8% of outstandings. His net margin would therefore be of 1.2% of outstandings. On a lease with a residual asset equal to 10% of the asset's initial value, freezing the residual would deprive the lessor, in the first year of the lease, of 6% interest on the residual of 10%, ie 0.6%, which equates to 50% of his net margin. The loss of income would rise further in the following years. At a 20% residual, the lessor would break even in the first year and then report losses in subsequent years. In both cases the lessor would report a 'wind-fall' gain on lease expiry, when the non accreted interest on the residual would be realised through the sale or secondary lease of the asset. It is thus perfectly feasible that the ED could lead to lessors no longer reporting any profits until they began unwinding their leasing book by not writing new leases to replace expiring ones.

Such a business model (in terms of reported income) would be untenable and completely disconnected from the economic reality of leasing. It is highly unlikely that users would wish to see lessor financial reporting that is to this extent disconnected from their business model of generating a constant return on assets.

If derecognition is to be the lessor accounting model, it is an absolute requirement that this flaw in the



model be corrected.

Other lessor accounting models

We note that the boards also propose to maintain the lessor accounting model for investment property under IAS 40, but propose to limit its availability to those lessors that have taken the fair value option. We do not agree with this distinction. IAS 40 functions to the satisfaction of preparers and users in the investment property industry, and the availability of the fair value and historic cost options allow property lessors to retain the option that best reflects their business model. Accounting for investment property should be left unchanged.

Question 3: Short-term leases

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?

The treatment accorded to lessees for short term leases does not represent a significant simplification as compared to that proposed for longer leases. We would also question the relevance of applying the right of use model, whether with discounted or non discounted rentals, to short term agreements, which are akin to service contracts.

Given that the boards propose to maintain the current operating lease accounting for lessors under short term contracts, it would be logical, and would ensure the internal consistency of the proposals, that lessees also apply operating lease accounting to these contracts.

Question 4a. Definition of a lease

Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

We do not feel that the definition of a lease as proposed in the ED is sufficiently focussed to be consistent with the lessee accounting model proposed, or with the lessor derecognition model that is coherent with right of use accounting.

The definition of 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” is sufficiently broad that it may encompass all forms of lease, but also a whole variety of other arrangements that are not suitable for right of use accounting. The terms making up the definition would benefit from additional detail to tighten the scope of arrangements that would enter this definition.

As explained in the response to Question 1, a right to use may not necessarily be a valuable asset. If the usage of the underlying asset does not equate to a consumption of a part of its economic



substance, because the asset is long-lived or non-depreciating, we are not convinced that the lessor has conveyed an asset of sufficient value for it to be considered as an asset in the hands of the lessee. The right to use the asset must also be an essential, rather than accessory, element of the arrangement. A service or outsourcing arrangement that happens to require the availability of an asset or assets in order to fulfil the service is not an arrangement that is in itself aiming to transfer the right to consume the economic substance of the asset, the consumption of the asset is a by product of the provision of service.

The notion of specified assets should also be tightened. Many outsourcing contracts contain references to specific assets, identified by serial number or other means, not because these particular assets are essential to the provision of the services, but simply for ease of identification of the assets and protection of the legal ownership of the assets by the lessor or service provider. Where these assets are fungible or readily exchangeable, they should not be considered as being specified, as any asset of a similar type could readily fulfil the service function that is being demanded of them.

The notion of conveyance of the right of use remains relatively vague. It contains no notion of control, or a degree of control, of the underlying asset, and no notion of exclusivity of this right of use. If the right of use conveyed is only a partial or shared right of use, then it is doubtful that anything more than a service is being rendered.

The period of time for which the right of use is conveyed is also of key importance. If the period of time is insubstantial as compared to the economic life of the underlying asset, consumption of the economic substance of the asset will be insignificant and the right to use the asset for the agreed period of time may not be of value. This notion underlies the generally accepted view that short term leases should benefit from simplified accounting that better reflects their status as quasi-service contracts, but can also be applied to long-lived assets that are subject to leases for relatively short parts of their economic life.

We believe that the definition of a lease is inextricably linked to the accounting treatment or treatments that are proposed for arrangements that fall into the definition. Either the definition is drawn widely, as in the ED, and more than one lessor and lessee model is required to adequately cope with the variety of contracts that will fall within the definition, or the definition is drawn tighter such that one lessee and lessor accounting model will provide satisfactory accounting. This second alternative implies acceptance that some arrangements currently considered and/or documented as leases are not treated as such, but as some other sort of arrangement, which will generally be service contracts.

Question 4b. Definition of a lease

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?

We do not agree with the notion that it is necessary to distinguish leases that are “in-substance” sales



or purchases, and find that this distinction serves no useful accounting purpose.

The distinction between a lease and a sale and purchase contract is a matter of fact, that can be ascertained by analysing whether legal ownership passes or not. We do not dispute that some current finance leases are extremely close to sale and purchase contracts, but this does not mean that they **are** sale and purchase contracts, it means that they should receive an accounting treatment that is very similar to that of sale and purchase contracts. This would be the case without the presence of this definition.

Under the lessee right of use model, a lease that allows the lessee to consume all but a trivial part of the economic substance of the underlying asset would generate a right of use asset for the lessee that would be of virtually identical value to a fully owned asset. Under the lessor derecognition model, the lessor's receivable would represent virtually the whole of the initial value of the underlying asset, and the residual asset would be of trivial value. The accounting would therefore be nearly identical to that for a sale and purchase, with financing provided by the lessor, but with the advantage that the important difference in legal substance between a sale and a lease would be recognised.

Our interpretation is that this distinction was felt to be needed by the boards at a time when the Performance Obligation model was the only lessor model being considered, which would have prevented manufacturer lessors from recognising manufacturing margin on production that was directly leased. Given that the boards have now introduced the derecognition model, which would apply to those contracts that are the closest to sales and purchases, and which allows for revenue recognition for manufacturers, we believe that this definition of leases that are to be considered as sales and purchases is simply not required.

Although the definition is not required, it has the merit of revealing a use of the notion of 'control' in 'Leases' that is inconsistent with its use in other Exposure Drafts, and notably *Revenue from Contracts with Customers. Leases*, in paragraphs B9 and B10, defines a sale as the transfer of control and all but a trivial amount of risks and benefits. It would seem from this definition that the sole transfer of control would not constitute a sale, or conversely, that one can transfer control whilst still retaining more than trivial risks or benefits. Neither of these situations is coherent with *Revenue from Contracts with Customers*, which implies that the meaning of control is different between these two Exposure Drafts. Given the importance of the notion of transfer of control (of the underlying asset or of the right of use) in determining the correct accounting treatment in *Leases*, and in *Revenue from Contracts with Customers*, we would suggest that this fundamental concept must be defined in an identical manner in the two draft standards.

Question 4c. Definition of a lease

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?



The guidance in paragraphs B1 to B4 is imported with little change from IFRIC 4, and is not sufficient to provide a robust frontier between leases and service contracts.

Difficulties of interpretation can arise today, which have limited consequences, as the IFRIC 4 guidance will in the majority of cases be used to distinguish between an operating lease and a service contract, which will receive, whatever the decision made, a very similar accounting treatment. As this frontier, will, under the proposed models, represent the step from on-balance sheet to off-balance sheet accounting, it is inevitable that this guidance will be placed under greater stress than in the past.

Elements that need more robust definition are:

- the notion of a specified asset. This issue has arisen in our response to question 4a, where we explained that the identification of an asset may be more orientated towards the protection of the lessor's title to the asset than towards the specification of an asset whose presence is essential. We believe that an asset that is fungible with other assets and is readily exchangeable should not be considered as meeting the definition of a specified asset. In this respect, we find the guidance contained in B2 and B3 hard to follow. B2 says that an asset is specified if the lessor can substitute it but rarely does so, whereas B3 says that a contract that permits substitution does not contain a lease because the asset is not specified.
- The notion of control, as explained above, which does not seem to have the same meaning as in *Revenue from Contracts with Customers*. The notions of control of the underlying asset, and of control of the right to use the underlying asset, must be clearly defined.
- Interpretations of contracts that provide for the use of assets that are part of a larger whole. This concerns the interpretation of capacity-type leases, of leases of floor-space in larger assets such as department stores, shopping centres or airports, where the question to be resolved is whether the lessor is leasing a part of the asset to the lessee, or whether he is using his fully owned asset to provide a service to his client. This issue is particularly acute where the underlying asset is not separable from a larger asset and would never, in normal circumstances, be capable of being separately sold.
- Whether the asset is the essential subject of the contract or if it simply a part of a larger service being provided. This distinction of key importance in distinguishing between leases and outsourcing contracts which may take the form of full service leases. In such contracts, the customer is seeking above all a service that provides a solution to a business requirement. This service may entail assets being available, but is not viewed by the customer as an alternative to purchasing assets, it is an alternative to managing, maintaining and upgrading assets using internal resources, with all the risks that such activities entail.

This distinction between leases giving rise to a right to use asset, and executory or service contracts,



may prove to be the point of greatest tension in the application of the revised lease standard if it is brought into force. As outlined above, we feel that the notion of the consumption of the economic substance of the asset, rather than the simple right to use an asset, should either figure in the definition of a lease, if there is to be a unique lease accounting model for lessees and lessors, or should be used to distinguish between types of leases, if there is to be more than one model.

Question 5: Scope exclusions

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 do not agree with the exclusion of those intangible assets that are today covered by IAS17.

Such assets would be left in an accounting vacuum, which is particularly regrettable when the software component of physical assets (either embedded or as an essential complement to the asset) is of growing importance, and when software itself is increasingly also leased as an underlying asset.

Question 6: Contracts that contain service components and lease components

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?

We do not agree with the various approaches defined for accounting for leases that contain lease and service components.

Once a contract has been defined as being either a lease or a service contract in accordance with the guidance discussed in Question 4 above, entities will be faced for accounting for contracts that have met the definition of a lease, but which may contain some service elements. We feel that all entities, whether lessor or lessee, should separate the service components from the lease components. Lessors should always be able to do so, as it is difficult to imagine how a lessor could price a lease if it was unaware of the value of the services that would be provided. We are therefore sceptical that the notion of non-distinct services in leases is a viable concept. Lessees may have greater difficulty in separating lease and service elements, but should be required to do so to the best of their ability.

If lessees are not required to separate service and lease elements, they might find themselves in the position of generating a right of use asset that is of greater value than the underlying asset itself. Upon outright purchase of an asset, there is no requirement to capitalise future service costs that this asset may induce in order to insure or maintain it. We see no valid reason why such service costs should be capitalised as forming part of a lease.

Question 7: Purchase options

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?



Yes, we agree with this treatment, which should be extended to renewal options and contingent rentals.

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, and believe that the lease term should be the term to which the lessee is committed.

The approach proposed by the boards is extremely complex to apply in practice and will lead to the recognition of assets and liabilities that are not consistent with the Conceptual Framework. The method proposed by the boards requires both lessees and lessors to assess the probabilities of exercise of options to end or terminate the lease. We do not believe that lessees have this information available to them with a sufficient degree of statistical validity. Once these estimates have been made, the method used, be it the most probable outcome, the weighted average outcome, or the longest term more likely than not to occur, does not remove the fact that accounting would be based on estimates of future events. We do not believe that a potential obligation to make payments, based on the estimate of the probability of the occurrence of a future event (the exercise or not of an option), is a valid basis upon which to conclude that a lessee has a liability.

In the case of lessor accounting, the boards' proposals seem to be even more dangerous. One of the pitfalls of leasing, of which all leasing professionals learn to be wary, is the financing of non-existent assets, colloquially known as 'thin air'. This can take, for example, the form of financing services that are to be provided in the future by the asset supplier or a third party, of financing over-optimistic assessments of usage based rentals, or aggressive assumptions of lease renewals. Past failures of leasing companies have in many cases been generated by overstatement of assets, and we find it surprising that the boards would envisage lessors considering as receivables anything other than contractually committed rentals.

We appreciate that the boards have determined against the use of a components approach to lease accounting, on the grounds that the necessary information for valuation of lease options is not available. However, the position taken, which is in effect to value options at the present value of future lease payments that would arise if an option is exercised, is totally removed from economic reality. An option over an asset (in this case the right to use an underlying asset) can never be worth the value of the asset itself. We note that the application guidance in B16 takes this erroneous valuation of options even further by including implicit options, including those given effect by the operation of law, in the lease term. In a certain number of legal systems, including France, tenants of commercial property benefit from security of tenure through the right that is given to them by law to renew a lease at the



then prevailing market rent. An option to renew at market rent has no significant value, and yet the boards' proposals would lead to the creation of very significant assets and liabilities corresponding to this option.

The proposals also fail to lead to transparency and comparability of accounts. The proposals would ascribe the same value to a 2 year lease with a 2 year extension option judged to be probably exercised, and to a 4 year fixed term lease. Yet the position of lessor and lessee under these two arrangements are far from identical. The lessee of the 2 year lease has a lower commitment than that of the 4 year lessee, as he has negotiated flexibility for the following 2 year period, and the lessor of the 4 year lease has a more secured position than that of the shorter-term lessor, who will be exposed to an earlier and greater market risk on the value of the underlying asset. The cause of transparency is not served by ascribing the same value to these arrangements.

The reliance on the quality of estimates of probability will not further the aim of comparability, arrangements with identical contractual conditions will receive different accounting treatment according to the probability assumptions made by both lessees and lessors.

We would also point out that options will be priced into the rentals, or other committed cash-flows, of leases. Whilst this is not generally done by using option pricing techniques as for financial instruments, prudent lessors will ensure that their asset risk exposure at the end of the lessee's committed term is acceptable to them. Rentals will therefore be higher on leases that include exit options (or on shorter leases with extension options) than on longer fixed term leases. The value of the option, being included in the rental payments, will thus be included in initial measurement. Although the right of use model for lessees, or the derecognition model for lessors, will lead to this option value being subsequently amortised over the life of the lease rather than being separately valued, we believe that this is a far more acceptable approximation than the boards' proposal which ascribes to the option a value which is equal to the right of use potentially available through exercise of the option.

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?



We do not agree with the proposed treatment of contingent rentals.

The notion of contingent rentals, as used in the Exposure Draft, and as was the case in the Discussion Paper, suffers from a defective definition. Rentals that are dependent upon an index, a rate or any other element external to the usage of the leased asset or the performance of the lessee, are not contingent in nature, they are simply variable in amount. Rentals (or that portion of rentals) that are due only in the case of a future event such as asset usage or lessee performance, are truly contingent.

Variable rentals, ie those whose amount is linked to an index, rate or other element that is not within the control of the lessee, do in our opinion meet the definition of a liability for the lessee and an asset for the lessor. Their payment is certain, it is simply the amount to be paid that is not known with certainty. We therefore agree that they should be included in the measurement of assets and liabilities. However, we find that it is unnecessarily complicated to use an expected outcome technique, or a futures strip, in order to measure their value.

Contingent rentals, ie those whose very existence is dependant upon a future event, do not meet the definition of an asset for the lessor or a liability for the lessee. We therefore see no valid reason for these rentals to be included in lease assets and liabilities, by an expected outcome or indeed any other technique.

We are aware that the boards may be concerned that the exclusion from lease assets and liabilities of contingent rentals may provide scope for structuring, leading to some market participants seeking to negotiate wholly contingent rentals, such that the lessee's right of use would be calculated to be of nil or extremely low value. We do not believe this to be a valid reason for the inclusion in assets and liabilities of amounts that do not meet the appropriate definitions in the Conceptual Framework definition. Were a lessor to agree to provide a right of use to a lessee against payments that were wholly contingent (for example a percentage of turnover with no contractual minimum) we would question whether the agreement was actually a lease and not some form of partnership or joint venture. Where a lease contains a certain level of committed rental and an additional layer of contingent rental, we believe that the combination of right of use accounting for lessees and derecognition for lessors would provide an adequate translation of the economic reality of the arrangement. Lessors who accepted lower fixed rentals in exchange for potential gains of higher contingent rentals would derecognise a smaller portion of the underlying asset and show higher residual asset levels, reflecting their greater exposure to asset-related risk. Lessees who succeeded in negotiating such arrangements would show lower right of use assets and lease liabilities, reflecting the additional flexibility that they had obtained. Contingent rental payments that arise under such agreements should be recognised in profit and loss in the period in which they arise.

Concerning residual value guarantees, we do not see a justification for departing from their current treatment under IAS 17, provided that only residual value guarantees that become payable



immediately following the expiry of the minimum contractual term of the lease are taken into account. In particular, we find the exclusion, for the purpose of lessor accounting, of third party provided residual value guarantees to be illogical. A lessor who has obtained a residual value guarantee has effectively exchanged market risk (on the future value of the leased asset) for credit risk (on the guarantor. This change in nature of the risks taken should be reflected, under the derecognition model, in a reduction of the residual asset and an increase in the receivable.

We note that the Exposure Draft incorporates the notion of term option penalties, of which we were unable to find a definition. However, if these refer to sums to be paid by a lessee in order to exercise an early termination option, we feel that these should be included, for their full amount, in lessee liabilities and lessor receivables, if they are required to be paid for the lease to terminate at the expiry of its committed period. This would ensure consistency between the cash flows taken into account and our suggestion of the lease term being the term to which the lessee is committed.

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?

Given our position on lease term and contingent rentals, we believe that remeasurement is only necessary when the committed term or the committed rentals of the lease are amended through a contractual change. This will also remove the effects of earnings volatility and pro-cyclicality which would inevitably arise if the reassessment methods proposed were to be applied.

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?

We do not agree with the proposed criteria.

We subscribe to the view expressed by EFRAG in its draft comment letter, that in a sale and leaseback transaction, the lessee is retaining the right of use of the underlying asset and is transferring to the buyer/lessor the residual asset that would appear under the derecognition approach.

It should be noted that some lease transactions are initiated as a sale and lease-back transaction on a new asset recently purchased by the seller/lessee. The treatment outlined above should also give



satisfactory results for such transactions.

Question 12a: Presentation - Statement of financial position

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?

We are not opposed to this presentation, although we feel that right of use assets are sufficiently different from PPE and investment property to warrant a distinct asset class.

We agree that right of use assets should in all circumstances be presented separately from owned assets, in order to reflect the very different legal status of the underlying asset.

In our opinion, the decision as to whether this presentation should be on the face of the statement of financial position or in the notes should be left to the discretion of the preparer, according to the significance of the amounts concerned.

Question 12b: Presentation - Statement of financial position

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?

We do not believe the Performance Obligation model to be a valid accounting model, whatever the manner in which it is presented.

Question 12c: Presentation - Statement of financial position

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?

We believe that the presentation proposed above is acceptable only for entities whose activity as a lessor is a marginal part of their overall activity, and presentation in the notes could be left to the discretion of the preparer.

For significant lessors, we believe that lease receivables and residual assets related to leases should be separately presented in a “leases” category. In particular, we do not feel that residual assets should be presented with the PP&E of the company.



Question 12d: Presentation - Statement of financial position

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?

We agree that the distinction should be made, but the decision as to presentation on the face of the statement of financial position or in the notes should be left to the discretion of the preparer.

Question 13: Presentation - 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 agree with this proposal. Given the extent of changes in accounting that would occur if a right of use model was to be adopted, it is essential that its impact on income be capable of being clearly identified. Once again, presentation in the notes or on the face of the statement of comprehensive income should be for the preparer to decide, in function of the significance of the numbers.

Question 14: Presentation - 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 agree, for the same reasons as outlined in Question 13, and with the same remark on presentation in the notes.

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 do not agree with the proposals, because, as explained in answers to previous questions, we do not agree with the lease accounting model proposed.

We would comment that the disclosure requirements contained in the ED are extremely heavy, which we find curious for a proposed standard that is intended to improve the quality of the information shown on the face of the financial statements.



Question 16a 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?

We do not feel that these proposals are appropriate.

Lessees will be faced with significantly increased costs in the years following transition as all leases other than existing simple finance leases will be effectively treated as if they were new leases, thus generating the front loading of costs indicated in our answer to Question 1b. The adoption of mortgage-based amortisation of right of use assets would solve this issue.

We do not comment on transition arrangements for lessors using Performance Obligation as we do not believe the model to be valid.

For lessors using the derecognition method, we agree with the proposal for calculation of lease receivables, and believe that residual assets should be calculated by discounting the residual value determined at inception, using the rate charged in the lease determined at the date of inception of the lease, subject to any adjustments required to reflect impairment.

Question 16b Transition

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

We believe that in the current state of the boards proposals, full retrospective application may be essential for some preparers and should therefore be permitted, but believe that if the amendments to the lease accounting model that we have suggested are adopted, it may not prove to be necessary.

Question 16c Transition

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

Under the lessee model as currently proposed by the boards, we believe that lessees under current 'non-simple' finance leases will revalue their new right of use assets to a level greater than current net book value, thus effectively reversing past depreciation charges.

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?

We do not agree, and indeed completely disagree, with the boards' assessments of the costs and benefits of the proposed requirements.

Beyond the conceptual flaws in the proposed accounting models, we are convinced that the proposed requirements do not meet user requirements and that the burden placed upon preparers in order to prepare accounts under these requirements has been largely under-estimated.

Leasing is a widely used arrangement whose essential utility is to enable businesses to ensure themselves of the availability of standard business assets in a convenient and flexible manner. We feel that the boards have placed excessive emphasis on the occasional structuring of operating leases to achieve off-balance sheet treatment of significant assets. Many leases are operating leases, but we would refute the contention that operating leases as a category are structured leases. Businesses that seek to ensure the availability of standard equipment at a level period cost, do not wish to take residual value risk on these assets, and may also wish not to be responsible for the insurance, maintenance and repair of these assets, turn to lessors to obtain these services. Almost by definition, such arrangements will today be classified as operating leases, but this does not mean that these agreements have been deliberately structured to avoid on-balance sheet accounting.

We recognise that users routinely adjust published accounts for the effects of operating leases, using disclosures in the notes to the financial statements, and that users would effectively find it simpler for the adjusted figures to figure on the face of the financial statements. This could be a benefit of the reform of lease accounting, but presupposes that all users carry out the same adjustments with the aim of finding the same numbers. We do not believe this to be the case, and see no evidence in the Exposure Draft that the boards have ascertained that this is the case. We believe that users are seeking different goals through their adjustments; some will be seeking to identify committed cash-flows, others to identify likely future cash flows, others to identify the value of assets used in the productive processes of the preparer. The provision of maximal asset and liability values for both operating and finance leases, based on necessarily subjective assessments of probabilities of the exercise of extension options and likely levels of contingent rentals, is unlikely to satisfy any significant population of users, and may well prove to be confusing and opaque to the majority of users. We also feel that the incorporation of all forms of lease, including contracts for standard types of business asset that are routinely rented, does not necessarily correspond to user requirements. The vastly expanded series of disclosures that is contemplated by the proposals is in itself an indication that the numbers provided on the face of the balance sheet need even more extensive explanation and justification in order to be useful.

The distortions to the income statements of lessees, through the front-loading of costs following transition, and in the early years of all leases, are unlikely to be welcomed by users, and the reduction in lessors' reported income, and absence of a constant rate of return on leased assets, due to the



freezing of residual asset values, will impose a complete revision of the analysis methods used to examine the accounts of lessors.

We are thus sceptical as to the reality of benefits that the proposed reform would bring to users of accounts.

The cost burden placed upon lessee preparers by these proposals will be considerable. The information required to correctly account, under the proposals, for current operating leases, goes far beyond the information that is necessary for correct accounting and disclosure under IAS 17. This additional information will need to be collated, centralised and interpreted for the millions of leases that will be concerned by the proposals. Carrying out this process will involve creating asset registers and accounting systems specifically for right of use assets, training staff in the interpretation of lease documentation for lease accounting purposes, and implementing and maintaining organisational and computer systems capable of assessing and recording probabilities to be used in asset and liability measurement, and scanning lease portfolios to assess them for changed circumstances that would warrant reassessment of right of use assets. The 2009 figures of new leasing business in Europe must be borne in mind in any analysis of costs; 5 million new leases for an average amount of €27 000 were written in a year that was historically a poor year for leasing activity. The sheer volume in numbers, and low average size of lease, is a significant pointer to the logistical costs that would be involved in preparation for initial application of these proposals, and to the ongoing administrative costs that would be generated.

In conclusion, we do not agree with the boards' analysis of costs and benefits, and would urge that fully fledged field testing of the proposals should take place before any further steps towards implementation are taken.

Question 18 Other comments

Do you have any other comments on the proposals?

We have made all the comments that we wish to make in our responses above.