

POSITION PAPER Reima Letto 15.12.2010

International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

### FASB / IASB EXPOSURE DRAFT ED /2010/ 9 - LEASES

Dear Sir/Madam,

The Federation of Finnish Financial Services (FFFS) is a member of Leaseurope and European Banking Federation. While supporting the views put forward in these responses, the FFFS submits the following comments.

#### 1. General remarks

- Our position on the ED is that only minor development in a better direction has been conducted since the consultation of Discussion Paper in summer 2009 The ED is still unnecessarily complex and its costs are disproportionate to the gains for the users of accounts.
- We believe that the proposed approach will result in accounts that are less understandable and comparable than today because greater proportion of subjective factors has been introduced. Against this background, the aim to increase the transparency in accounting will not be met.
- The proposed performance obligation model for lessors is inconsistent with the right of use model for lessees and does not reflect the economic reality of leases.
   Moreover, lessors are faced with 5 different methods for accounting for existing lease contracts creating unjustified complexity and reduced comparability as lessors of similar leases will have very different accounting.
- As a consequence of requirement to hold more assets on balance sheets, lessees
  that represent regulated industries (like banks), may be required to hold additional
  capital despite their risk profile remaining unchanged. Moreover, the performance
  obligation approach could have substantial capital impacts for lessors. Particularly
  considering the overall impact of the whole ongoing financial regulatory package
  (Basel 3, bank tax and levies etc.), this would have a significant impact on business
  activities and cost of lending.
- The proposal on subsequent measurement of leases will lead to significant effects
  on a lessee's income statement. To avoid such impacts, we propose a
  measurement approach that reflects the specificities of leasing by recognising the
  linked nature of asset and liability. The lessees right of use asset should be measured
  on an amortised cost basis using mortgage based amortisation and liability
  amortised according to the same method.



POSITION PAPER Reima Letto 15.12.2010

- No cost/benefit analysis of the new model has been conducted. The impact
  assessment would ensure that the proposed rules are appropriate and proportional to
  their purpose. This is of particular interest for lessees, which amongst other, would
  need to make probability assessments of their various intentions under leasing
  contracts. They would have to reassess these and make estimates regarding e.g.
  service payments included in the lease. This would increase the create volatility in the
  lessees' accounts.
- Furthermore, it is important to note that the majority of leases are small ticket transactions that are in fact very different to the sophisticated, structured big ticket leases that are the focus of standard setters' concern. The ED in its present form makes the supply of financing more difficult and companies instead would prefer other forms of financing. Leasing is also crucial as it is often accessible to businesses, such as SMEs or startups, when other means of financing assets are not available.
- We believe that **exempting leases of non-core assets** from the new standard would go in better direction to achieving a well balanced standard that meets the needs of both the users and prepares of financial statements.
- The proposed **transitional requirements will have significant impacts** for both lessee and lessors and need to be reconsidered.
- We don't consider the ED provides a sufficient basis for moving forward before substantial improvements to the content have been made. The mid-2011 deadline for publishing final standard should be postponed and new version of the ED send out for comments after in- depth reassessment (including cost/benefit analysis) and simplification of proposals.

# 2. Comments to the specific questions contained in the ED

#### **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?

We believe that the IASB/FASB should take the current IAS 17 as a starting point and improve its principles. The weaknesses identified by the IASB/FASB in the current standard could be remedied by increasing the disclosure requirements. If the Boards however do prefer a right of use model, it is necessary to significantly simplify the model by limiting its application to amounts that lessees are contractually committed to pay under a lease in order to mitigate the costs of its implementation for preparers.

The nature of the right of use asset should also be clarified. The ED implies that a lessee's asset is an intangible asset, for instance by cross-referencing to IAS 38. Nowhere however does the ED clearly state what the nature of this asset is. This is a crucial issue for lessees in regulated industries such as banks.



**POSITION PAPER** Reima Letto 15.12.2010

In more detailed recommendations, we refer to the position paper by the Leaseurope.

(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?

We understand that the proposal will in practice be required to amortise the right of use asset on a straight-line basis. This creates a number of problems for lessees and the users of their accounts, like a lack of comparability between lessee accounts, permanent increase in lease costs and mismatch between lease costs and cash rentals paid.

Against this background, we believe that subsequent measurement should be done on an amortised cost-basis but reflecting the fact that a lessee's asset and liability are intrinsically linked.

### **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?

We don't support the proposed hybrid model for lessors. The performance obligation model does not reflect the economic reality of leases. The cash flows of the lease contract cannot simultaneously support both a lessor's receivable and the physical asset it is required to hold at the same carrying value as if there was no lease. The result is that lessor's balance sheets become artificially grossed up. Moreover, the performance obligation model is inconsistent with the right of use model for lessees.

If the Boards however do intend to transfer the existing finance/operating lease principle into the new standard, at least this should be made clear as preparers are familiar with and understand this concept. The ED principle, together with its list of unclear indicators, will just create confusion for preparers, auditors and users.

(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?

No. We refer to our answer to question 2 (a). It should also take into account that in case lessors sustaining credit institution status would have to apply to performance obligation, a significant increase in regulatory capital could occur, in spite of their risk profile remaining unchanged. This is because lessors using this approach have to recognise two different assets for the lease, whereas today they only recognise one.

# **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?



POSITION PAPER Reima Letto 15.12.2010

We believe that the proposals for short term leases do not go far enough as the only simplification made in the ED is the omission of a present value calculation. We consider that lessees of short term leases should be allowed to continue to apply existing operating lease accounting. The Boards should also clarify in further work, whether the short-term leases approach would apply both lessors and lessees.

# **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?

No. We believe that the definition provided in the ED is too broad since this definition has simply been imported from the existing leases standard without adequate consideration as to whether it remains applicable in the context of the new accounting model. The current approach is not appropriate due to the fact, that under the new standard much more strain will be placed on making the determination between what is a lease and what is an executory contract as the accounting for these two types of contracts will be very different. Today however there is no such strain as the accounting for an operating lease and for a service contract are very similar, to the extent that it is possible that many do not consider "rental" contracts to be leases but rather "service" contracts.

For alternative definition, we refer the proposal defined in the Leaseurope's position paper.

(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?

No, the proposed distinction is unclear and creates new classification between different kind of leases. The new concept is not fully consistent with the Revenue Recognition ED which only requires the transfer of control as a condition to recognize a sale.

(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?

No, we do not think that the proposal is sufficient but additional guidance is needed to make the determination between a lease contract and a service contract. We refer to the comments on "specified asset" and "control" in the Leaseurope's position paper.

# Question 5:

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 believe that leases of intangible assets should not be excluded from the scope of the new standard as the exclusion would increase the complexity for preparers particularly in case contracts involve both tangible and intangible assets (e.g. where equipment is provided together with software).



POSITION PAPER Reima Letto 15.12.2010

We also believe that property leasing (relating to e.g. premises) is specific types of contracts where the proposal for accounting for lessees in the ED is not appropriate. These contracts should be excluded from the standard or treated as current operational leases.

With reference to the leasing of non-core assets, we refer our comment above under point 1.

# **Question 6:**

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 proposals as many lease contracts contain service elements in addition to the right to use the leased item. Particularly in cases where lessee effectively outsources all asset-related needs and costs to the lessor in exchange for a single, convenient invoice, it would be extremely burdensome for preparers to identify and separate service and lease components. These type of contracts should not be defined as leases.

For more specific proposal to treat service components, we refer to the Leaseurope's position paper.

# Question 7:

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?

We do agree with the proposed treatment of purchase options but think that purchase options and renewal options should be treated consistently. We find it more appropriate that information about purchase options should be included in the disclosures of the financial statements.

# **Question 8:**

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?

No. We think that this approach unlikely provide users of accounts with better information and increase complexity for preparers. The subjective requirements for assessments which the ED provides would complicate analysis if financial information for analysts as the information is not comparable.

Concerning the treatment of options, we refer to the Leaseurope's position paper.

# Question 9:

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



POSITION PAPER Reima Letto 15.12.2010

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 ED. As a starting point, current wording of IAS 17 regarding variable payments should be retained, i.e. they should not be included in any lease payments. Against this background, there is no need to separate different categories of contingent rentals. Moreover, residual values should be treated in the same way as today.

If current treatment is not possible, we refer to the alternative models proposed in the Leaseurope's position paper.

### **Question 10:**

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?

No. We consider that these requirements are simply a consequence of an inappropriate approach to lease accounting.

The alternatives suggested by the Leaseurope in its position paper should be considered by the Boards as they deal effectively with the rights and commitments of lessees and lessors, without requiring burdensome reassessments such as those currently proposed.

### **Question 11:**

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

No, as a whole we question the need for a specific rules on sale and leaseback transactions. As a starting point, the sales should be defined in the context of the revenue recognition guidance and not in the leases standard. The sale component of a sale and leaseback should be determined in reference to the revenue recognition definition.

# **Question 12:**

(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



POSITION PAPER Reima Letto 15.12.2010

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 believe that leases should be shown on a separate line of the balance sheet, on both the asset and liability side. However, taken into account the principle of materiality or in case of non – core assets, it should be possible to disclosure the information in the notes.

As pointed above, we believe that the nature of the lessee's right to use asset should be clarified. The current proposals amount to presenting an intangible asset together with tangible assets. The distinction is important as it could have impacts on the capital requirements of lessees operating in the banking industry

(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?

As mentioned above, we do not support the performance obligation model for lessors and consider that the presentation issues that arise under this approach are a clear indication that it does not reflect economic reality. We see no rationale on performance obligation approach, which is based on mixing assets and liabilities on the same side of the balance sheet.

(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?

We believe that leases should be treated as a separate category for lessors too.

(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?

We propose the standard providing scope for freedom of choice on this issue, i.e. presentation in the statement of financial position or disclosure in the notes.

# **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



POSITION PAPER Reima Letto 15.12.2010

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?

Yes, as a starting point. We note however that an principle of materiality should have the role in the assessment. If the lease income and lease expense are material items in the entity's activity, we consider it reasonable to have requirements for separate reporting from other income and expense in P&L in a legal entity, but in the consolidated accounts a requirement for disclosure in the notes may be sufficient as the assessment of materiality may differ trom the assessment in the legal entity.

#### 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?

We believe that this issue should be discussed within the FASB/IASB project on "Financial Statement Presentation". As a whole, suitability of cash flow statement to financial institutions has been questioned by many stakeholders and there is a need to wait development in this project before adopting a position on how leasing should be handled.

### **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?

No. We believe that the consequence of the model is that the disclosure requirements are simply too complex and burdensome for preparers. As pointed out above, this information is less understandable and comparable than today because greater proportion of subjective factors has been introduced. Not only will preparers be required to go through a significant additional number of decisions, judgments, calculations and accounting steps to come up with a balance sheet number, they will have to give much more information, far exceeding existing requirements, in the notes.

### **Question 16**

(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?



POSITION PAPER Reima Letto 15.12.2010

We do not agree. Particularly in the context of the de-recognition model a modified version of the simplified retrospective approach is unclear and needs more specific guidelines e.g. about the term "fair value" in paragraph 95 (b). Also a long transition period for both lessors and lessees is necessary.

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

Yes, the preparers should have the option to adopt full retrospective approach.

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

We urge a long transition period for entities to adapt to the new standard not only due to the complexity of the ED but it should be noted that according to the IAS1 a history of three years is required in conversion of the items in the statement of financial position.

#### **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?

As stated above, we feel that the ED adds complexity of accounting for leases and therefore not agree with the Boards' assessment of the costs and benefits of the proposed requirements. We believe that the advantages of the proposals do not outweigh the drawbacks associated with the proposal.

The Boards should take the current IAS 17 as a starting point and improve its principles and remedy weaknesses by increasing the disclosure requirements, if necessary.

The critical views expressed during the DP have been confirmed in the survey of European preparers conducted by the Leaseurope/PwC survey. We note that also EFRAG has expressed the view that "implementing the Board's proposals could be very costly, beyond the satisfaction of a reasonable cost/benefit trade- off".

#### **Question 18**

Do you have any other comments on the proposals?

Leaseurope has in its response developed an alternative simplified right of use model applying to all leases. It is important that the Boards take in- depth analysis of this model together with performing and publishing a through cost/benefit analysis.

FEDERATION OF FINNISH FINANCIAL SERVICES

Helena Laine Head of Banking and Finance Regulation