CONFEDERATION OF FINNISH INDUSTRIES EK

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Exposure Draft ED/2010/9 on Leases – answers to the specific questions

General remarks

Dear Sir/Madam

We thank you for the opportunity to provide comments to the Exposure Draft on Leases. Confederation of Finnish Industries is a lobbyist organisation representing Finnish listed companies as well as SME’s.

We are of the opinion that the proposals in the exposure draft are problematic and if implemented will change the use of leases fundamentally. The proposal to recognize all assets and liabilities arising from lease contracts on the balance sheet of the lessee causes unnecessary burdens. Moreover, the proposals fail to simplify and enhance the financial information to be provided to users.

The majority of proposals endanger the functionally of leasing as financing instrument and are thus not promoted. The Board should take into consideration that lease contracts that are made in order to lease ordinary office equipments, such as copy machines or equivalent should be excluded from the scope of the proposed standard.

It is also to be pointed out that the proposals are not considered as necessary amongst lessees. Not only because the lessees do not recognize the need to change the accounting methods as regards leasing but also because there has never been an indication from the users or investors side to receive such information which is now proposed in the ED. In addition, many companies representing both lessees and lessors are of the opinion that the costs of the proposals compared to the benefits are excessive.

The accounting model

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?
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?

We provide our general level answers to the questions 1 and 2.

We do not consider that a lessee should always recognize a right-of-use asset and liability to make lease payments. The right-of-use model should be further developed in a way that the lease is defined and that the application of the right-of-use model is limited so that not all assets and liabilities arising from lease contracts would be recognized on the lessee’s balance sheet.

It should be taken more into account that the companies have different reasons for usage of leasing and we are of opinion that the proposed model fails to recognize the differences between different types of lease contracts. We are of the opinion that the current IAS 17 recognizes appropriately the different types of leases and that the distinction between operating leases and finance leases should be maintained. Should this proposal however be pursued further, the accounting for sale, purchase, finance leases and rentals should be specified in the standard.

It is also to be pointed out that we do not agree that the proposal that lessors should have two models for lessors. Further, the argumentation which is based on the existence of “significant risks or benefits” does not seem to be clear and it will presumably lead to different interpretations. We recommend the use of a single, partial derecognition approach with the retention on the balance sheet of a residual asset representing the risks and benefits that the lessor retains.

We would also like to point out that the revisions proposed to IAS 17 are not revisions that are welcomed by companies. The vast majority of companies we have interviewed have pointed out that the proposals will have many adverse consequences for the companies in terms of more complicated technical accounting issues.

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 recognize lease payments in profit or loss over the lease term (paragraph 64).
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(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?

As a general comment, companies do not use lease terms that are shorter than a year.

We think that this option will not provide help to the lessees as they still have to go through a massive amount of short term contracts in order to identify the lease terms and payments. We are of the opinion that the lessees should be allowed to apply the existing operating lease accounting.

However, we agree with the proposal towards the lessor and suggest that a similar option should be provided also for lessees.

Definition of a lease

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 think that the definition in the ED is too broad and it should be defined. The definition should at least exclude service contracts – a situation where the lessee enters a service contract in order to obtain a certain service, not because of the use of an asset.

(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?

We do not agree with the proposal. This distinction is not necessary. Further, the sales of goods and services are to be defined within the revenue recognition project and these issues should not be tackled in different standards as this might result in inconsistency between the standards.

(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. The guidance is not sufficient. We suggest that the Board examines further this issue in order to determine and define which arrangements could be excluded from the scope of the standard and be accounted for as service contracts. The contents of the paragraphs B1–B4 are not clear and self-explanatory but rather confusing. One option could be to use the concept of control with reference to the Revenue Recognition project in order to define the status of the contract.
Scope

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

We do not agree that leases on all intangible assets should be excluded from the scope. This might lead to very problematic and complex situations in practice, as there would not be any guidance for the proper arrangements as regards intangible assets. Additional problems might arise from contracts that contain tangible and intangible assets. We are of the opinion that all arrangements, including intangible assets need to be covered in the standard also in the future, but as an exception leases to explore for or use minerals and similar non-regenerative resources shall be excluded.

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?

We think that the proposals will weaken few of the best qualifications of leasing, i.e. its flexibility and simplicity. One reason for the usage of leasing is that it is rather easy and quick way to finance or outsource certain operations of the company. The proposed suggestions would result in unwanted administrative burden for companies as they would be obliged to e.g. estimate their service payments and to account them differently.

We suggest that lessee should be able to determine whether the contract is a service contract or not and to account the whole arrangement based on that judgement.
It is very difficult to specify or separate the lease part and the service part from the leasing agreement. One good example of this difficulty is cars that are leased for the company as the lease agreements contain both of these parts. It should be specified in more detail in the standard that how this difficult issue could be dealt with.

**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?*

We agree with the proposal on the treatment of purchase options. However, if the option can be measured reliably and if it is material, the option itself should be accounted for.

**Measurement**

**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 with this proposal. This might lead to a situation where the lessee would have to recognize nonexistent assets and liabilities and the lessor would have to recognize nonexistent assets and revenue.

Should this option be continued by the Board, we suggest that the measurement based on the "longest possible term that is more likely than not to occur" should be replaced with something else that better reflects the actual situation. The users need to understand the definition of the measurement term as precisely and clearly as possible. The definition should make difference between machines and other assets that are used rather quickly and between assets that are not used quickly, e.g. buildings.

According to the standard the length of the lease contract period should always be estimated. This kind of estimation or judgment is always very subjective in nature and as a result the balance sheet would contain values that are based merely on subjective estimates. This would have a negative effect on the balance sheet and it would weaken the value of the balance sheet and the possibility for the users to analyze it properly. We therefore suggest that the balance sheet would only include the contract but no estimates of the length of the contract period.

**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?

No. We do not agree with the proposal for accounting for contingent rentals and expected payments under residual value guarantees. This option does not take into account the differences within the contingent rentals. We think that obligations that depend on a future decision by the lessees' management can not qualify as liabilities to be recognized.

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?

No. We do not agree with the proposal. We think that this kind of mandatory reassessment only produces unwanted burden and complexity towards companies. This is another obligation towards the wrong direction in terms of keeping the leasing an interesting option for companies. The proposal would result in a situation where the companies would have to assess whether there has been a change in facts or circumstances and what is to be considered "significant". However, the reassessment as regards the length of the period should be possible.

Sale and leaseback

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?

We generally agree with this proposal.

Presentation

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?

The leases are distinct instruments and they should be presented in detail in the notes. They should not be in the balance sheet since it would add unnecessary length to it.
In addition the assets should be separate from the assets that are owned by the lessee. There should be a clear distinction between the assets owned by the lessee and the assets owned by other parties outside the company. The company management should be able to decide whether to present the lease items separately from the non-lease items.

(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?

We do not promote the performance obligation towards lessors and therefore do not agree with the above proposal.

Should this option however go forward we are of the opinion that the underlying assets, rights to receive lease payments and lease liabilities should not be presented gross but net value in the statement of financial position.

(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?

No. These rights should be presented using net value.

(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?

No. We refer to our previous answer.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

No. We are of the opinion that the users are merely interested in the depreciation and therefore this kind of separate presentation as suggested is neither requested by users nor necessary for them. Further, a breakdown of interest and repayments of the rent together with the amount which has been capitalized is not to be specified in the profit or loss account.

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?
No. Should this option however go forward, we suggest that the present way should also remain as an option to be used.

Disclosure

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognised in the financial statements arising from leases;

and

(b) describes how leases may affect the amount, timing and uncertainty of the entity’s future cash flows

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

No. We do not agree with the proposals.

Our opinion is that these requirements just are too burdensome for companies and they do not bring any additional value towards the users as it might be that this type of information is quite difficult to analyze at the users end. We think that the decision on the level of detail provided should be made by the management of the company depending on materiality.

Transition

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?

We agree.

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

We do not generally have anything against this as long as this stays optional, not mandatory for companies.

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

In the event that the Board continues with its proposal using retrospective approach, they should consider how sale-leaseback accounting achieves clarity and understandability in transition date. The guidance in the ED is silence related to transition provision of sale-leaseback accounting.
Benefits and costs

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We do not agree with the Boards’ assessment of the cost and benefits of the proposed requirements. According to a survey conducted this year amongst European preparers, the majority of respondents were of the opinion that the cost regarding the proposed new standard exceeds the benefits for preparers.

Another way forward with this issue could be to develop the notes. Better and more informative notes could provide as much improvement towards the users as would the proposals as regards the standard.

Other comments

Question 18

Do you have any other comments on the proposals?

We suggest that the effective date of this revision should be changed to be the year 2015.

Yours sincerely

Confederation of Finnish Industries

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Director