Information

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15.12.2010

Subject
IASB Exposure Draft ED/2010/9 'Leases' - Comment Letter BMW Group

Dear Sir David,

The BMW Group is one of the most successful manufacturers of automobiles and motorcycles in the world with its BMW, MINI and Rolls-Royce brands. As a global company, the BMW Group operates 24 production facilities in 13 countries and has a global sales network in more than 140 countries. In the financial year 2009 we achieved a global sales volume of approximately 1.29 million automobiles and over 87,000 motorcycles. Revenues totalled Euro 50.68 billion. At 31 December 2009, the company employed a global workforce of approximately 96,000 associates.

The BMW Group is listed in the German Stock Index (DAX 30) as well as in EuroStoxx50 (Europe’s leading Blue-chip index for the Eurozone) and prepares its consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union.

We are pleased to respond to the International Accounting Standards Board’s (IASB) and the Financial Accounting Standards Board’s (FASB) Exposure Draft (ED) on Leases.

Overall, we support the Boards’ efforts to improve lease accounting. We acknowledge that the current model for lessees has long been criticised for failing to meet the needs of financial statement users. We agree with the Boards’ objective to report relevant and representational faithful information to users of financial statements about the amounts, timing and uncertainty of cash flows arising from leases.

However, we do not believe that the proposals fully meet this objective in a number of key areas, which should be reconsidered by the Boards.
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These key areas include:

- The ED does not meet its objective of improving transparency in accounting for leases and does not faithfully present the effects of leases in financial statements.

- The burden for lessees and lessors will be increased as a result of complexity of the proposal.

- The subjective components of measurement requirements for options to extend the lease term, contingent rentals, term option penalties and residual value guarantees add too much complexity to the accounting for leases.

- We consider that it is necessary to validate - based on a cost / benefit analysis - that the proposed new rules will lead to substantial improvements in comparison with retaining and revising the current standard.

- We believe that the proposed standard for both lessees and lessors should start from the contractual aspect. Only contractual obligations should therefore be recorded and it should only a single accounting model for lessees and lessors.

Please find our detailed comments on the questions raised in the ED in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact us.

Sincerely,

Dr. Thomas Wittig
Senior Vice President
Group Reporting

Elmar Schramm
Vice President
Financial Statements,
Periodic Reporting

Enclosure
Appendix: Answers to the questions raised 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?**

Generally, we agree with the Boards' view that a lessee should recognise a right-of-use asset and a lease liability.

Based on our understanding this should only be the case if and only if the criteria of an asset / a liability are met. We consider them fulfilled if the unconditional right-of-use and obligation to make lease payments exists already at inception of the lease.

In our view this is only the case, if the rights and obligations resulting from a lease have a binding character, e.g. a contractual arrangement exists.

Therefore, we would encourage the Boards to establish more specific indicators/guidance for the definition of a lease (especially in combination with contracts, e.g. supplier contracts).

However, our support for recognising leases on balance sheet is conditional on establishing a more practical approach for measuring the right-of-use asset and liability than that proposed in the ED (see comments on Question 1 (b)).
We do not agree with the proposal and prefer a linked approach.

The proposed model would lead to a mismatch between the recognition of the financing expense and the economic benefit realised from the lease due to the front-loading effect of the lease expenses.

The subsequent measurement proposed in the ED will lead to dramatic increased costs for lessees in the earlier parts of the lease contracts (front-loading effect).

As referred to above, annuity based recognition of interest expense is inappropriate. Renting equipment is an operational decision, not financial, and the expenses related thereto should be so treated. The new model will not clearly depict the operating expenses or operating cash flows for leases.

In our view, this neither does match the parties' intent (represent a true and fair view of the economics of the lease), nor does it reflect the actual cash flows of a lease, where the payments are level throughout the lease term and the leased asset is intended to be returned upon the lease's conclusion.

Therefore, the subsequent measurement should be the same as at the time of commencement of the lease and should reflect the fact that the lessee's liability to make lease payments and the right to use leased assets originate from the same contract.

From our perspective the subsequent measurement based on a straight-line, amortised cost-based approach for both the right-of-use asset and the lease liability better reflects the economic reality of the lease and leads to more decision usefulness for the users of financial statements.
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 and why not? If not, what alternative approach would you propose and why?

We disagree with the Boards’ proposals for lessor accounting.

We do not agree with the proposal that the lessor should assess the appropriate approach based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term.

Furthermore, we question the application of a risk and benefits model for determining which approach should be applied – and therefore, for determining whether a gain or loss is recognized on the transaction – when the Boards’ Exposure Draft Revenue from Contract with Customers proposes to move away from a risk and rewards model to one premised on the transfer of control.

As a consequence, we believe the proposed criteria for determining which model to apply will be difficult to use in practice.

In addition, with the proposal in the ED the problems of the classification based on a risk and rewards approach which have been heavily criticized with the current IAS 17 (regard to the distinction between finance leases and operate leases) will persist (with regard to the distinction between performance obligation approach and derecognition approach).

In our view, a single lessor approach is preferable because it would increase the comparability of financial statements, reduce the opportunity to structure transactions and avoid undue complexity.
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(b) Do you agree with the boards' proposal for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why and why not? If not, what alternative model would you propose and why?

We generally agree with the proposed treatment. But as mentioned, we prefer the usage of a single model approach for lessor accounting.

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 the lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of the 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 profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise lease payments in profit or loss over the lease term (paragraph 65).

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?
We support the proposed simplifications for the short-term leases of lessors.

We believe that simply permitting operating lease accounting also for lessees would likely provide users with adequate information regarding the short-term leases and would maintain consistency in the lessee and lessor models.

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?

We would encourage the Boards to elaborate more in depth the definition of a lease.

(b) Do you agree with the criteria in paragraph B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why and why not? If not, what alternative criteria would you propose and why?

We believe that the Boards should provide additional application guidance clarifying various aspects of the definition and identification of a lease.

(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?

Given the different accounting proposed for lease contracts in comparison to non-lease contracts, the Boards should clarify this guidance as much as possible.
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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 agree with the scope exclusions of leases of biological assets and leases to explore for or use of minerals, oil, natural gas and similar non-regenerative resources.

We also agree with the proposal to exclude the intangible assets as a pragmatic short-term solution and recommend discussing the potential inclusion in a future project about intangible assets.

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?

**Lessor:**

We agree to separate the service components based on the proposals in ED/2010/6 Revenue from Contracts with Customers if the service is distinct. Further application guidance regarding the definition of 'distinct services' is highly appreciated.

If a service is not distinct then we do not agree with the different treatment among the performance obligation model and the derecognition model. This would lead to less transparency which does not support decision-usefulness. Therefore, we highly recommend to follow the FASB proposal.

**Lessee:**

We agree to separate the service components based on the proposal in ED/2010/6 Revenue from Contracts with Customers if they are distinct. In case of non-distinct service components we agree with the IASB proposal. The lessee should apply the lease accounting requirements to the combined contract.
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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 proposed treatment regarding purchase options.
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Question 8: Lease Term

Do you agree that a lessee or a lessor should determine the lease term as the
longest possible term is more likely than not to occur taking into account the
effects 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 disagree with the proposed lease term definition from both a conceptual and a
practical application perspective.

We believe that the lease term should only include optional lease periods that are
reasonably certain to be exercised.

We view this threshold as higher than ‘more likely than not’ and consistent with the
threshold used under current accounting regulations.

Under this approach, only optional lease periods for which a lessee is reasonably
certain to exercise its extension should be included in the lease term (e.g. the
existence of a significant economic incentive to renew or penalty for non-renewal).

We also note that the current definition of a lease term is clear today and works well
in practice and we see little benefit in moving to the definition proposed in the ED.
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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 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.

Under the proposed approach the measurement of assets and liabilities arising from a lease using an expected outcome technique would put management in a position to make judgement on a large number of leases. The management would be forced to estimate the effects of uncertain future effects which can significantly affect the amounts reported in the financial statements. These estimations at the end of each reporting period can have a significant risk in material adjustments of assets and liabilities arising from a lease in future reporting periods.

To include contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease into the measurement of assets and liabilities arising from a lease by using an expected outcome technique would lead to minor decision-usefulness information about enterprise resources (assets), claims to those resources (liabilities and equity), and changes therein. Furthermore, it will create lack of symmetry between lessees and lessors accounting for the same contract as well as lack of comparability among lessors and lessees.
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Nevertheless, if the Boards stick to their proposal we agree to include contingent rentals and expected payments under term option penalties and residual value guarantees only if they can be measured reliably. Therefore, additional application guidance is absolutely necessary to be provided in the future standard.

Furthermore, the final standard should remove the given inconsistency within the Exposure Draft between lessor and lessee accounting concerning the treatment of contingent rentals, expected payments under term option penalties and residual value guarantees.

From our point of view, both lessor and lessee should only take into consideration contingent rentals and expected payments under term option penalties and residual value guarantees if they can be measured reliably.

Question 10: Reassessment:

Do you agree that lessee and lessors should re-measure assets and liabilities arising under a lease when changes in facts and 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?

We only agree that lessees and lessors should re-measure assets and liabilities arising under a lease when changes of contractual conditions (i.e. options to extend the lease exercised) indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments.

For all other kind of changes we disagree that the lessee and the lessor should conduct a re-measurement. Therefore, we recommend that further application guidance is needed to specify when a significant change of contractual conditions occurs.
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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 do not consider that there is a need for any special rules on sale and leaseback transactions. We believe that the determination of whether or not a sale of the underlying asset has occurred should be based on the principles and guidance included in the revenue recognition proposals and not a separate set of criteria and rules.

To the extent that a seller-lessee has met the appropriate criteria from a revenue recognition perspective, the seller-lessee should account for the sale of the asset in accordance with the applicable guidance for revenue recognition and separately account for the leaseback in accordance with the right-of-use model. To the extent the seller-lessee has not met the appropriate criteria from a revenue recognition perspective, the seller-lessee should account for the sale and leaseback transaction as a financing transaction.
Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143-BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(c) Do you agree that a lessor applying the derecognition approach should present liabilities to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Lessee:

We agree that a lessee should present liabilities to make lease payments separately from other financial liabilities in the statement of financial position.
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As pointed out in Question 1 (b) our proposal would lead to a different accounting treatment of the obligation to make lease payments under a lease in contrast to other financial liabilities.

Therefore, a separate presentation on the face of the statement of financial position is necessary. Solely a disclosure in the notes would not be sufficient.

Right-of-use assets should be presented 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.

Lessor:

As explained in our response to Question 2, we do not support a ‘hybrid’ approach for lessors. The reasons behind this position are partly conceptual and partly administrative due to the high complexity of the Exposure Draft.

However, if the Boards decide that the performance obligation model should be applied by lessors we believe a net presentation in the statement of financial position best reflects an entity’s asset/liability position. Underlying assets, rights to receive lease payments and the performance obligation should be disclosed in the notes.

If the Boards decide that the derecognition model should be applied by the lessor, we believe that presentation of the residual asset within property, plant and equipment in the statement of financial position and disclosure in the notes differentiating residual assets from other assets included in property, plant and equipment is sufficient. We do not believe that separate presentation of residual assets in the statement of financial position should be required.

Sublease:

We believe that disclosure in the notes will be sufficient to distinguish assets and liabilities that arise under a sublease from those that arise in other lease contracts.
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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 within profit or loss (paragraph 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why and why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We believe there is sufficient guidance in IAS 1. We believe that an entity should decide whether separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality.

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 and why not? If not, do you think that a lessee or lessor should disclose this information in the notes instead? Why or why not?

We believe there is sufficient guidance in IAS 1, in conjunction with IAS 7 ‘statement of cash flows’. We believe that an entity should decide whether separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality.

We do not believe that lease cash flows should necessarily be classified entirely as financing. In practice, entities enter into leases for many reasons sometimes as an alternative source of finance but in our business environment mainly for operational reasons. Therefore, in our business environment the cash flows should be classified as operating activities.
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 and why not? If not, how would you amend the objectives and why?

We note that the requirements in the ED for the recognition of leasing are far-reaching, not just with regard to presentation in the statement of financial position and statement of comprehensive income, but also with regard to the requirements for supplementary disclosures.

We agree with the general principle for disclosures set out in paragraph 70. But the list of disclosure requirements in paragraph 73 to 86 is very extensive. The current wording in par. 71 – ‘an entity shall consider the level of detail necessary to satisfy the disclosure requirements in par. 73 to 86’ - gives the impression that all of these requirements are mandatory. The IASB should clarify that it is not mandatory to disclose all of these items. Preparers should exercise judgement in determining which of these disclosures are required to meet the overall principle for disclosures.
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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 and why not? If not, what transitional requirements do you propose and why?

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

We agree with the simplified retrospective approach as the leading principle. In addition, the Boards should allow as alternative option the full retrospective application for preparers. Even if a simplified retrospective approach will in many cases lead to results which are not comparable with a full retrospective application regarding the asset base and subsequent earnings effects.

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

None.
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Question 17

Paragraphs BC200-BC205 set out the boards' assessment of the cost 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?

In the absence of the Boards making significant improvements to the ED, we do not agree that the benefits will outweigh the costs.

We estimate that the costs to be incurred for implementing the proposed accounting regulations for leases will be very significant.

We are not sure if the additional information given in the statement of financial position and in the statement of comprehensive income will lead to significantly better decisions taken by the users of this information.

The implementation of the new proposed methodology will be expensive in terms of costs due to the need to adjust company-wide IT solutions and financial processes. In addition, the future reporting processes for preparers of financial statements will lead to higher costs.
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Question 18

Do you have any other comments on the proposal?

Given the scope and complexity and the high costs with which the ED is associated, a long transition period of at least 24 months is required for entities to adapt to the new standard.

Nevertheless, from our point of view the effective date for this proposed standard should not be later as 2015.

In respect of the proposed leasing standard and the complexity associated with, we believe the Boards should question how reasonable the requirement stated in paragraph 39 in IAS 1 is. According to our understanding of paragraph 39 in IAS 1 and the requirements stated there, a history of three years is required in conversion of the items in the statement of financial position.