

### UNION PROFESSIONNELLE DU SECTEUR IMMOBILIER

**RUE DE LA VIOLETTE 43 - B-1000 BRUXELLES** 

TÉL. 02 / 511.47.90 - FAX: 02 / 219.71.99 - BANQUE 390-0522120-24 www.upsi-bvs.be - e-mail:info@upsi-bvs.be

Brussels, 14.12.2010

Dear Sirs. Madam,

### **Re: Exposure Draft Leases**

On behalf of the Union Professionnelle du Secteur Immobilier (UPSI), I am writing to comment on the Exposure Draft, Leases (..the ED"). UPSI represents the entities active in Real Estate in Belgium, mainly property owners and therefore lessors. While some UPSI members account for investment properties at fair value, others have opted for the cost model and would therefore be impacted by the application of the draft IFRS. While we support and understand the overall objective of the exposure draft is to improve the information towards the users of the financial statements, and financial analysts in particular, UPSI is very concerned about the impacts of the implementation of the new standards may have on its members and their tenants in terms of financial information and business. We detail hereafter our answers to the questions raised.

### **Appendix : Response to questions in the Exposure Draft**

#### Question 1. **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?

UPSI: We believe that the new accounting model generates inconsistencies with the current recognition of assets and liabilities.

- Contingent assets and contingent liabilities (for example, purchase commitments) are not recognised in the statement of financial position according to the current provisions of IAS37.
- The exposure draft proposes that the present value of the lease payments includes an estimate of contingent rentals payable.
- The exposure draft proposes that the present value of the lease payments is based on the lease term determined by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease.
- Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the (b) liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

UPSI: The exposure draft proposes that the amortisation of the right-of-use asset is based on the provisions of IAS 38.





















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When a linear amortization would be used, the amortization would be inconsistent with the initial measurement of the right-of-use asset, which is based on the measurement of the liability to make lease payments, including contingent rentals. As a consequence, the cumulative cost linked to the contingent rentals would be spread evenly over the entire lease term, which we believe does not reflect the economic reality of the contract and can be contrary to the matching principle of revenues and expenses.

If for instance the lease of a retailer foresees a fixed payment plus a contingent payment based on a percentage of annual turnover, the exposure draft recommends to project turnover growth to incorporate the contingent rent into the liability and hence the right-of-use. By doing so and if the expected growth materializes the future additional sales revenues will no longer be matched with the increase in rent. To the contrary net income in early years will be penalized and that in late years flattered.

Similarly if the contingent component of lease payments is linked to a consumer price index as is common. inflation will most often be projected in the initial measurement but inflation will probably also entail revenue growth for the lessee's business. Matching revenue growth and higher rents over time may have been fundamental in the lessee's decision to enter into the lease. We believe eliminating the deliberate match may misrepresent the true intention of the lessee.

#### Question 2. **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?

#### **UPSI:**

- We believe that conceptually, the real estate lease contracts cannot qualify as financial assets (receivables). Major risks inherent to the real estate sector remain with the lessor (e.g. maintenance, refurbishment, market risk) during the lease period. The amortization of the financial asset according to the effective interest rate method, generating decreasing interest income, is also not consistent with the costs incurred by the lessor, which tend to increase over the lease term.
- The lessee accounting and the lessor accounting should be similar. We do not agree with different approaches or models for lessor accounting, but believe only one model should be used, consistently with the proposed lessee right-of-use model.
- The distinction between the performance obligation approach and the derecognition approach is based on exposure to significant risks and benefits, while limited guidance is provided on the definition of 'significant'.
- 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?





















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### **UPSI:**

- We believe that in most cases, the performance obligation approach would be applied by our members active in the real estate industry. The application of the propositions in the exposure draft will result in complex accounting treatments, while not generating added value for the users of the financial statements.
- As for lessee accounting, we believe that for lessors, the new accounting model generates inconsistencies with the current recognition of assets and liabilities. See our reply to question 1 (a).

#### **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?

UPSI: We do not have specific comments.

#### Question 4. **DEFINITION OF A LEASE**

- Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative (a) definition would you propose and why?
- 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?
- Do you think that the guidance in paragraphs B1-B4 for distinguishing leases from service contracts (c) is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

UPSI: We do not have specific comments.

#### Ouestion 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?

UPSI: The exposure draft would be applicable to any lease contract, whatever its amount. We do not believe that accounting for new assets and liabilities for immaterial amounts (e.g. copying machine) would bring any added value to the users of the financial statements, while the costs to prepare the information will be material. We believe the standard should include a materiality threshold, for example, a percentage of the total balance sheet, under which it would not be applicable.





















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# 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?

UPSI: We do not have specific comments.

### **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?

UPSI: We do not have specific comments.

### **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?

UPSI: We do not agree and believe that the lease term should be the uncancellable period of the lease, based on the current IAS 17 provisions for determining the minimum lease payments.

We have observed that some lessees already take into account the potential impact of the exposure draft during lease negotiations, tending to reduce the lease terms. A tendency to a reduction of lease terms resulting from the application of the norm would create more uncertainty and volatility which may be prejudicial for all parties in the real estate business. We believe the exposure draft could have a significant economic impact. Furthermore, we believe the exposure draft introduces significant judgment in determining the lease term, therefore allowing deliberate underestimation of the lease term (and therefore of the liability recognised by the lessee).

With respect to the lessors in particular:

The lease term will impact the estimation of the financial asset and of the performance obligation, but also the period over which the cost of lease incentives (e.g. rent-free period, share of the moving or refurbishment costs of the lessee) is currently spread.

Significant judgment will have to be exercised, based on subjective interpretations. We believe the assumptions used in determining the lease term will be difficult to be justified by management or to be audited.





















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Additionally, the cost to determine the most probable lease term for each individual lease contract will be significant, while the impact is probably not material to the financial statements (the lease incentives spread in particular, in aggregate, is generally not significant to the lease revenue for the lessor).

With respect to the lessees:

We believe the principle of determining the lease term based on the most probable period, instead of the uncancellable period, is inappropriate.

- As for the lessors, this generates significant subjectivity in the estimates made by the lessees.
- Different estimates of the most probable lease term by the lessor and the lessee, if made public, would be sensitive commercial information.
- The lessee does not have any obligation after the uncancellable period of the contract, as the contract can be ended, and as a consequence, no liability should be recorded for subsequent periods. Some court decisions in lessor/lessee litigations also evidence that even an uncancellable period, if very long compared market practice, can be considered We therefore believe probability should not be used in determining the amount of the liability for lease payments.

#### **Ouestion 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?

UPSI: We do not agree that the contingent rentals should be included in the measurement of assets and liabilities arising from the lease.

- We believe the currently proposed definition of lease payments leads to significant subjectivity in the estimates recorded in the financial statements, both in terms of amounts (see next point) and in terms of probability of each possible outcome.
- For the buildings in particular, the contingent rentals are based on indexation of the lease payments to the inflation. There are no market expectations available, but only rough estimates by economists or the Belgian State. The assumptions used in measuring the lease payments, and the contingent rentals in particular, will therefore not be reliably estimated in most cases.
- As also discussed in our comments on Question 2 (b), this leads to spreading over the lease term the impact of the future increases in the lease payments, which is economically not justified.
- We believe the current definition of minimum lease payments in IAS 17 should be further retained, therefore excluding contingent rents.





















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### 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?

UPSI: The fact that the financial asset (lessor) or liability (lessee) should be remeasured again introduces subjectivity in the measurement of the amounts recorded in the statement of financial position. Furthermore, the yearly reassessment of the estimated lease term, contingent rentals ... will lead to significant costs for the preparers of the financial statements.

We believe the interest rate used in determining the amortised cost of the financial asset or liability will not be easily determined for the real estate sector. The interests rates applicable to comparable loans under similar terms & conditions, would not take into account the risks linked to the building.

### Question 11. SALE & 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?

UPSI: We do not have specific comments.

### **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?
- 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?
- 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,





















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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? 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?

UPSI: Conceptually, we do not agree with the fact that under the performance obligation approach, both the underlying asset, and the financial asset corresponding to the right to receive lease payments, would be recognised in the statement of financial position. We believe the lessor and lessee accounting should be consistent.

We agree with the separate presentation of assets and liabilities arising from a lease contract, apart from other (financial) assets and liabilities.

#### **Ouestion 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?

UPSI: We do not have specific comments.

### **Ouestion 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?

UPSI: We do not have specific comments.

### **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
- 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?





















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UPSI: We do not have specific comments.

### **Question 16. TRANSITION**

- 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?
- Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- Are there any additional transitional issues the boards need to consider? If yes, which ones and why? (c)

UPSI: The proposed accounting treatment will have significant impact on the financial statements totals and

- We believe the EBITDA would be decreased, while the debt ratios would be increased.
- How will the comparability with previously published financial statements be ensured?
- We believe that banks or insurance companies, that traditionally own important property portfolios, would be significantly affected as their debt ratios would deteriorate.

### **Question 17. BENEFITS & 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?

UPSI: We do not agree and believe that the costs associated with the proposed lease accounting will range to 20% of accounting personnel costs.

- The administrative work associated with the proposals should not be underestimated in terms of IT (lease contracts database to be created) and of personnel (all contracts to be recognised, estimates to be reassessed, each time involving significant judgement).
- The number of lease contracts can range up to 1,000.

Significant judgment is involved for each individual contract, which leads to important costs, but also might deteriorate the comparability of the financial statements from one period to another

We do not believe benefits are expected from the proposed new accounting. For properties, while the users of the financial statements (including financial analysts) understand the lease revenue generated by the contract, or the value of a property recognised in the statement of financial position (at historical cost or at fair value), we believe that accounting for those revenues partly as financial income (interests on the financial asset accounted for the lease payments receivable) and partly as gain on derecognition of the value





















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of the property at the beginning of the lease (derecognition model) or as income from satisfying the obligation to put the property at the disposal of the lessee over the lease term (performance obligation model) will bring confusion. Furthermore based on IAS 17, quite a lot of information about rental amounts and duration are currently disclosed in the financial statements.

#### **Ouestion 18. OTHER COMMENTS**

Do you have any other comments on the proposals?

#### **UPSI:**

- While we support and understand the overall objective of the exposure draft is to improve the information towards the users of the financial statements, and financial analysts in particular, we believe this could be reached through additional information disclosed in the financial statements, rather than through the recognition of additional assets and liabilities in the statement of financial
- The draft IFRS proposes that the investment properties that are accounted for at fair value under IAS40 are excluded from the scope. We agree with this approach as fair value depends on the existing lease contracts and the important residual values at the end of the lease contracts. With respect to revenue recognition, we believe IAS40 should be amended to prescribe how the lease income should be recognised over the lease term. We do not believe it is appropriate to take the most probable lease term into account, instead of the uncancellable lease term as currently, to recognise the lease incentives (see also the comments on Question 8)

We believe that further involvement of valuation experts will be required to determine the residual value of the underlying asset, after derecognition of the part representing the right-of-use granted to the lessee. This involvement might generate additional training costs and practical implementation delays, but also inconsistencies in the valuation methods (based on financial asset valuation methods.

Kind regards.

#### **Laurent Wille**

Administrateur Délégué \*



Rue de la Violette 43, 1000 Bruxelles Tel +32 2 511 47 90 Fax +32 2 219 71 99 \* Crivi sprl

















