1850-100 Comment Letter No. 736

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

15 December 2010

Exposure Draft, "Leasing"

Dear Sir/ Madam

The Roche Group has a turnover of CHF 49.1 bn. (EUR 32.5 bn.) a year derived from our worldwide healthcare business - pharmaceuticals and diagnostics - and employs 80,000. As at December 2009, we had a market capitalisation of CHF 151.3 bn. (EUR 101.1 bn.). We have been preparing our consolidated financial statements in accordance with IFRS/IAS since 1990 and therefore have a substantial interest in how these will develop.

We generally support the decision of the IASB to review the accounting treatment currently in place for Leases. As a company, our diagnostics business has a strong presence in the leasing of medical instruments and thus, we would welcome opportunities to participate in outreach activities on this topic in order to provide valuable insight on the business operations in our industry as the proposals would have a significant effect on our business.

However, from the perspective of a business which makes decisions to lease-in or out assets rather than buy / sell, the proposals of the new ED would require that a lessee / lessor would hire staff to execute the proposals of the ED, collect related data for thousands of lease agreements it has entered into (or plans to enter into), modify its IT systems, internal control processes etc, which may well effectively dissuade a business from entering into lease agreements.

In our view the hybrid model proposed for lessors is not consistent with the lessee approach and does not provide robust enough principles for when the different models should be applied. The

basis for applying the lessor models hinges on whether the lessor retains significant exposure to the risks or benefits associated with the underlying asset transferred. This is very similar to the current application for distinguishing between Finance and Operating Leases. With reference to the performance obligation model, we believe that it is confusing that the Board suggests that a lessor could transfer a right-of-use asset to a "lessee", retain significant risks and benefits associated with the underlying asset transferred, and still have a performance obligation to "deliver" the asset when the "lessee" effectively controls the asset once the asset is at the lessees' location. Further, the Board has not provided any guidance as to what constitutes retention of risks and benefits. This omission would make the proposals extremely difficult to apply consistently in practice, and will inevitably result in similar lease transactions being accounted for very differently – a failure of one of the objectives of the Board. It is also noted that no guidance has been provided on how the lessors' physical asset should be accounted for when an impairment event occurs if the lessor adopts the performance obligation model.

With reference to the derecognition model, BC26 suggests that where the lessor does not retain exposure to significant risks and benefits associated with the underlying asset transferred, then it should derecognise from its books the asset transferred to the lessee. It however does not provide any rationale as to "why" this is the case.

Whilst we appreciate the Board's proposals re: reflecting leased assets in the books of the lessor and the lessee, we are not convinced that the proposals in the ED have been comprehensively thought through. We note that the proposed standard seeks to recognise in the financial statements rights and obligations with reference to contingent rentals and potential renewal and termination options, which in our view do not fully comply with the assets and liabilities concept as defined in the Conceptual Framework.

In addition to this, we note that the current IAS 17 proposes 2 lease accounting models – Finance and Operating Leases - which the Board suggests decreases comparability and provides opportunity for companies to obtain assets of significant value which are not reflected on the face of the financials. We acknowledge and agree that the proposals of the Leases ED combat this issue. However, we do not believe that the elimination of the ability to **expense** at contract inception, lease contracts which are immaterial or whose economic substance justifies that such items be expensed (minor items of a business) is the way forward.

One of the objectives of the Board is to ensure that the financial statements contain information which is deemed relevant to their users. In our view, reflecting every single lease agreement entered into on the balance sheet, regardless of the economic substance of the transaction, would result in increased complexity for users in understanding the Leases number(s). This complexity would not be reduced where 2 models exist for accounting for leases by the lessor. The ED in our view does not

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represent an improvement to IAS 17 but would in fact worsen matters, as there are even more distinctions to be made without bright lines, and the benefits promised for users could be equally well achieved at much lower cost through disclosure.

We note that the ED specifically excludes intangible assets from its scope. Whilst we welcome this exclusion, we are concerned that the Board might at a later date, seek to include intangible assets within the scope of the Leases ED and therefore, strongly suggest that the Board comprehensively consider the impact of the proposals in the Leases ED simultaneously with its implications on intangible assets which by nature meet the criteria for being "right-of-use assets" when out-licensed to partners. Given this, we strongly recommend that the Board defer the conclusion of the Leases project until it has had time to fully consider its impact on intangible assets.

Additionally, in our view, the proposals in the ED fail to provide clarity on what factors distinguish leases from service contracts

Our detailed responses to the questions set out in the ED are reflected in appendix to this letter. Our comments should be read in the context of existing IFRSs on PP & E – IAS 16, Leases - IAS 17 and IFRIC 4.

Sincerely,

F. Hoffmann-La Roche AG

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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?

We accept that the current leasing standard has its limitations and in certain instances, does not appropriately reflect the economics surrounding the leasing of assets in business operations, which in turn fails to provide a firm basis for providing useful information to the users of financial statements. However, we believe the proposals of the ED will require significant clarification in order to aid applying the proposals to business scenarios.

Leasing contracts generally take various forms and purposes, the nature of which could be:

- i. Hire-purchase contracts which provide a form of financing for the purchase of assets. These, we presume should be accounted for as a purchase and the leasing ED would <u>not</u> apply;
- ii. Contracts involving rentals and thus within the scope of the leasing ED;
- iii. Contracts involving the use of an underlying asset as a basis for the provision of services, e.g. telecommunication companies giving customers "free" handsets and subsequently providing the customer with network subscriptions;

Each of the lease structures mentioned above have very different economic substances / business rationale and accounting for these should reflect this.

With reference to our diagnostics business, it is customary for our customers to enter into reagent rental agreements in which the customer agrees to buy unspecified quantities of reagents (substance or mixture for use in chemical analysis or other reactions) over a specified period of time. As part of such reagent rental agreement, the customer receives an underlying instrument (s) which it uses together with the reagents quantities ordered, to run diagnostic tests. These instruments could in some instances, be received at a discounted value or free-of-charge.

Transactions of this nature are principally <u>contracts</u> to supply reagents over a period specified in the contract. This element of the contract is accounted for by applying the proposals in the ED – Revenue from Contracts with Customers in the books of the instrument provider. However, it can be argued that the sales price of the reagents may include amounts which act as "compensation" for the cost of the underlying instrument which was placed at a discounted value or for free at the customer's location.

The proposals of the ED suggest that in the scenario presented above, the customer will be required to recognise a right-of-use asset in its books which is then amortised over the lower of the useful life of the instrument or the reagent rental period; and a liability recorded to acknowledge the need to make lease payments to the instrument provider. However, given this scenario, the following questions arise:

- On what basis would the customer be expected to recognise a "right-of-use asset" in its books since it has received an asset at its place of business and it has the right to control this asset when it uses reagents to run diagnostic tests using this instrument? It should be noted here that the quantities to be ordered by the customer cannot readily be determined at contract inception.
- Given that the customer only pays a fixed price for reagents ordered (and thus this transaction is accounted for applying the proposals in the Revenue ED), on what basis does the customer allocate this price to the "performance obligation" associated with placing the instrument at its location?

We are not clear as to whether the amount attributable to the cost of the asset, should be the fair value of the asset or the present value of potential lease payments (which in the above example cannot be readily identified by the customer).

Secondly, we note that the concept of the right-of-use model for lessee accounting suggests that the lessee has an <u>unconditional right</u> to use the asset for the term prescribed in the lease contract, which gives rise to a liability to make lease payments over such lease term – BC 7(b). BC18 suggests that the lessor continuously satisfies the obligation to permit the lessee to use the underlying asset, and thus the lessor would recognise revenue continuously over the term of the lease. However, the lessor would have fulfilled its obligation to grant the lessee the "right to use" the asset from contract commencement / inception. Given this, the lessor would have no future obligation to perform following the transfer of the "right of use" to the lessee at lease inception, and thus, the use of the performance obligation model in principle, would not be applicable.

These two statements – BC7(b) and BC18 are contradictory, especially given the fact that the Board states that a simple lease is <u>not</u> an executory contract. We suggest that the Board clarifies its intention.

For the lessee, we note that B4(c) states that – "...if the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the entity is paying for a <u>product or service</u> rather than paying for the right to use the underlying asset". This may pose a problem for our Diagnostics business as the wording in this text suggests that only the ED on Revenue would be applicable. Would this mean that the instrument provider accounts for all amounts received from the sale of reagents in revenue or more appropriately, would the instrument provider be required to identify the various performance obligations inherent in the contract – duty to supply reagents and "lease" a right-of-use asset to the customer with the later being accounted for as a lease?

In addition to the comments above, given that most lease contracts often incorporate a "provision of services" element, we would strongly recommend that the Board in its ED on Leases improves its definition of a lease. There should be clear distinguishing factors between leases (accounted for applying the proposals in Leases ED) and service contracts (accounted for applying the proposals of the Revenue ED).

Whilst the Board acknowledges that different lessors have different business models to reflect the differences in the economic substance of lease transactions, this same principle has not been applied to lessee accounting and hence we suggest that the Board considers introducing the concept of expensing immediately in the books of the lessee, "leased-in" minor assets, not used in business operations of the lessee, in the same way that small items of property, plant and equipment are expensed on purchase if they fall below a defined capitalisation limit.

In conclusion, we believe that where an underlying asset obtained, <u>directly as a result of the need to gain access to the use of such asset in the entity's business operations</u>, then, we agree that the lessee should recognise a right-of-use asset in its books. We also agree that the lessee should, in those circumstances, recognise amortisation of that right-of-use asset, as well as interest payable on the liability to make lease payments over the term of the lease.

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?

The ED proposes two very different accounting treatments for lessor lease accounting based on whether or not exposure to the risks and benefits associated with the underlying leased asset are retained by the lessor. Given that the existing leases standard also has two models in place, we fail to see much improvement in the current proposals which justifies the significant cost, changes in business systems, etc. which would be required to implement the proposals. We believe most of the shortcomings of IAS 17 in its current state could easily be overcome with adequate disclosures. This would meet the needs of users who require a full reflection of the asset and those who focus on the partial, right-of-use approach as proposed in the ED.

In our opinion the intention to align lessee accounting with lessor accounting for the same asset is not met, as the lessee is required to measure the asset at the present value (PV) of lease payments, discounted using the lessees incremental borrowing rate or the rate the lessor charges the lessee if this can be determined. The lessor measures the asset at the sum of the PV of the lease payments discounted using the rate the lessor charges plus any initial direct costs incurred by the lessor.

The proposals in the ED suggest that when the lessor retains exposure to significant risks and benefits associated with the underlying asset, the lessor applies the performance obligation model, otherwise, the lessor is required to apply the derecognition approach.

Given the principles above, we are unclear as to which lessor model to apply in the following circumstance:

A customer obtains a machine from a manufacturer for a 5 year period. The machine has a useful life of 5 years (so one would assume the derecognition model applies here) and the customer is required to purchase active ingredients for use with this machine over a specified period of time say, 5 years. The customer does not make any specific payments for the machine received, but pays the provider a fixed price for quantities of active ingredient ordered for use with this machine.

Scenario 1 - Where the customer orders a minimum quantity of active ingredient (as specified in the agreement) over the defined supply period, this provides compensation to the manufacturer who is presumed to have no asset risk – risk that the cost of the asset would not be covered by the supply of active ingredient.

Scenario 2 - Where the customer fails to meet the minimum order requirement or the contract specifies no minimum order quantity, the manufacturer may still <u>retain</u> significant risk and benefit associated with the asset even though the asset has been transferred to the lessee for all of its useful life.

With reference to scenario 2 we are unclear as to whether the lessor in this situation would derecognise the asset as it effectively transfers the asset to the lessee for all of the assets useful life or retains the assets on its books as it retains asset risk.

In the scenario above, we strongly recommend that the Board provide comprehensive guidance as to what constitutes "retention of exposure to significant risks and benefits" so that preparers apply consistently, the accounting principles as intended by the Board.

We are of the opinion that the performance obligation model permits the lessor to keep the underlying leased asset on its balance sheet and also recognise a lease receivable, which forms a part of the future cash flows generated from asset. This in our view constitutes a "double-counting" of the underlying asset in the books of the lessor, though the ED counters this inadequacy by showing a corresponding lease liability on the face of the balance sheet in the books of the lessor.

We note that the derecognition approach proposed is not a full derecognition of the related underlying asset but a **partial** derecognition of the portion of the carrying amount of the underlying asset that represents the lessees' right to use the underlying asset during the term of the lease. Our reference to the derecognition model in this paper refers to the "partial derecognition model" hence forth.

Given that BC7 (b) suggests that leases are not executory contracts following the commencement of the lease, the lessor effectively transfers the right to use the asset to the lessee who recognises this asset in its books. The lessor on the other hand, would have no further performance obligation re: transferring the right to use the asset to the lessee, and thus could recognise revenue – lease income, interest income and gains at inception in line with the proposals contained in the recent Revenue ED.

Paragraph B16 of the ED defines the lease term as the longest possible term that is more likely than not to occur. Paragraphs 47(c) and (d) of the ED require the lessor to recognise in profit and loss:

• lease income and expense upon any reassessment of the lease term required by paragraph 56(a)

• any changes to the right to receive lease payments resulting from the reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees as required by paragraph 56(b).

We do not support the proposal to define the lease term as the "longest possible term". This, in our view, neither reflects the reality of the transaction nor provides useful information to the users of the financial statements. We believe the lease term should be the period over which the lessee secures actual control and use of the asset. Any option to extend or renew the lease should only be taken into consideration when such option is exercised. This would provide clarity as to how long the lease term actually is in reality, and negate the need to conduct unnecessary reassessments.

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?

We believe that the proposals do not provide much relief to lessees. In accounting for lease contracts, the proposals in the ED require lessees to identify, determine and continuously measure, the value of lease payments over the lease period, for each lease agreement executed. Applying this to short term leases, the effect of not discounting leases with lease terms no greater than twelve months would be immaterial and potentially of no significant influence to the decision making process of investors. The proposal to not discount lease payments does not provide meaningful relief to lessees.

We would propose that the Board adopt a more simplified model when accounting for leases with a maximum term not exceeding 12 months, such as adopting the current IAS 17 treatment for operating leases, which requires that relevant amounts be expensed, especially since the amounts relating to such leases are likely to be immaterial on the one hand, and probably are associated with assets which are incidental to the core business operations.

We note that the Board is of the opinion that short-term leases could be used as an instrument enabling lessees gain access to assets which are not reflected on the lessees' balance sheet. We do not believe this suggestion holds true as no lessor would seek to lease high value assets e.g. Buildings over a 12 month period and risk having to incur significant costs to extend or re-lease such assets.

In situations where short-terms leases are cancellable in the short term, we would recommend that the costs associated with such leases be expensed.

At present, the only premise for defining short-term leases relates to time. We would also propose that the Board clearly define what characteristics give rise to short-term leases and even incorporate

text which would permit the application of the current accounting for operating leases for immaterial non-core minor assets.

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?
- (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?
- (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?

We do not believe that a lease has been defined appropriately. The definition in the ED states that "a lease is a contract in which the right to use a specified asset is conveyed for a period of time, in exchange for consideration". In our Pharmaceuticals business, licenses are granted to potential alliance partners, conveying the right to use such licenses over a period of time (for example during research and/or development phases), for consideration specified in the agreement. This circumstance could quite easily fit the lease definition. However, intangible assets have been scoped out of the Leasing ED without any clear rationale as to why this is the case.

We support the Board's decision to exclude intangible assets from the scope of the Leases ED. However, we are particularly concerned that the proposals in the current Leases ED could at a later date, become relevant for leasing of intangible assets without future deliberation. Given this, we would propose that the Board, before the conclusion of the Leases project, address the effect of the proposals as relates to intangible assets and following this, come up with a comprehensive ED which has been fully deliberated on all levels.

Secondly, we believe the criteria for identifying a lease as outlined in B2-B4 re: the ability or right to "operate the underlying asset", "control physical access to the underlying asset" or "obtain all but an insignificant amount of the output" are too broad to aid effective determination as to whether a lease exists. With specific reference to B3 - the ED states that a contract that permits or requires the supplier to substitute other assets only when the specified asset is not working properly <u>may</u> be a lease. This statement is not helpful.

In our view the wording of IFRIC 4 has been incorporated into the proposed ED without sufficient consideration. We believe comprehensive guidance is required to clarify what the Board means when it refers to the use of a "specified asset". Is this term still valid when the lessor can replace the asset placed at the lessee's location if such an asset proves to be faulty or damaged or does it merely relate to the lessor being able to provide "an asset" to enable the lessee meet its needs?

With reference to our Diagnostics business, in some cases we grant our customers a right to use an underlying asset which is often received at a discounted value or free of charge, together with a requirement to purchase reagents (substance or mixture for use in chemical analysis or other reactions) to run diagnostic tests using an underlying instrument. However, the sale price of the reagents typically includes amounts which act as "compensation" for the cost of the underlying asset which was placed for free, at the lessees' location and a fee for the maintenance of the asset provided.

In our view, this arrangement has 2 components:

- the sale of reagents accounted for applying the Revenue ED; and
- provision of a leased asset accounted for applying the Leases ED

Often times, we place several instruments with the same customer who is obliged to order reagents for use with these instruments. The same reagents may be used inter-changeably on the different machines and customers will typically order a batch of reagents for use on the various instruments placed at their location. In other words, reagents ordered cannot be linked to a single machine.

Additionally, business models may be such that customers such as hospitals may be required to pay for reagents' use and instrument placement via such payment structures as:

- costs per test run on the instruments
- costs on each kit used with the instruments
- cost per reportable test run on the instruments (costs reimbursed from government agencies)

Given that these structures may give rise to revenue streams (for the lessor) which cannot be reasonably determined and reliably estimated, we propose that any lease receivable recognised by the lessor be amortised on a straight-line basis, based on the useful life of the instrument and not based on the various reimbursement structures. This would represent the only comprehensive basis for releasing the lease receivable in the books of the lessor. A similar approach would also work for the lessee as regards the lease liability.

With regards to question b), the proposal provided in B9 makes sense in our opinion. However, B10(b) automatically assumes that the customer will exercise a bargain purchase option just for the sake of the "bargain" and totally ignores the fact that a customer may not exercise a bargain purchase option if it has no need for the asset in question. An argument exists that if the lessee had no intention of purchasing the asset, then the bargain purchase option would not feature in the agreement. This is not necessarily the case.

The paragraph 25 Revenue ED suggests that revenue can be recognised when <u>control</u> of the asset has been transferred to the customer. However, B9 of the Leases ED suggests that a sale can be assumed to exist, if at the end of the lease term, <u>control of the asset</u> is transferred to the customer as well as, <u>all but a trivial amount of the risks and benefits associated with the entire underlying asset.</u>

We strongly recommend that the Board takes steps to ensure that the principles contained in the Revenue and the Leases ED are mutually consistent and consistent with all other relevant Board pronouncements as necessary.

Conversely, where lease contracts seek to gain access to PP&E used in business operations e.g. Buildings as office space, then we agree that such assets should reflected as assets on the balance sheet of the organisation.

Question 5: Scope exclusions

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

We note that the licensing (leasing) of intangible assets has been excluded from the scope of the Leases ED without any clear rationale as to why this is the case – BC36. Given this, lessors that outlicense intangible assets are expected to apply the proposals of Revenue ED. No clear guidance has been provided for lessee's who effectively obtain a right to use such intangible assets.

We support the Board's decision to exclude intangible assets from the scope of the Leases ED. However, we are particularly concerned that the proposals in the current Leases ED could at a later date, become relevant for "leasing" of intangible assets without future deliberation. Given this, we propose that the Board, before the conclusion of the Leases project, address the effect of the proposals as relates to intangible assets and following this, propose a comprehensive ED which has been fully deliberated on all levels.

Further, we believe that if the Board intends to apply the proposals in the revenue ED to intangible assets, then this needs to be stated explicitly in the Revenue ED in order to ensure that all intangible assets are accounted for in a consistent manner.

As proposed in our answer to question 4, we would again propose that where the value of assets not essential to the operations of a business (non- core minor assets) are immaterial, such amounts should be expensed in line with the current practice applied to accounting for operating leases. We do agree that if such non-core assets prove to be material, then they should be reflected on the balance sheet as appropriate.

Question 6: Contracts that contain service components and lease components

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We believe that when a lessee enters into an arrangement which has both, a service component and a lease component, the lessee is better placed to determine whether the arrangement was entered into based on its need to obtain a service or lease an asset, and thus, the lessee should account for the arrangement based on the most dominant element.

We acknowledge that where services obtained are not separable and cannot be purchased separately in an open market, the lessee would not be able to allocate payments to such service components. As mentioned in our Revenue comment letter, the Board needs to provide better guidance as to what the term "distinct" really means. We also stated that an entity should consider its <u>own</u> business practices when unbundling performance obligations identified.

We do not agree with the proposal in BC50 which suggests that if the lessor applies the performance obligation model, non-distinct service components of an arrangement should be accounted for as a lease. On the one hand, lessors would be able to unbundle performance obligations which include the lease of an asset and the provision of non-distinct services. The lessee would not be privy to this information. This creates an inconsistency in accounting for the same transaction in the books of the lessee and the lessor.

It may be worth considering stipulating in the ED the need to clearly outline performance obligations inherent in lease contracts which also include service components so that lessees are better able to determine what the right-of-use asset number should be.

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?

We agree that purchase options should not be accounted for as part of a lease. They should be accounted for as a purchase by the lessee, and a sale by the lessor, when the purchase option is exercised.

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?

As stated in our response to question 2, we do not support the proposal to define the lease term as the "longest possible term". This neither reflects the reality of the transaction nor provides useful information to the users of the financial statements. We believe the lease term actually committed to should be the lease term. Any option to renew or terminate the lease should only be taken into consideration when such option is exercised. This would provide clarity as to how long the lease term actually is in reality, identify the actual cash flows associated with the actual term committed to, and negate the need to conduct unnecessary reassessments of lease terms, lease income, interest income, contingent rentals etc.

In practice, lease contracts often have clauses which give the lessee the option to extend the lease at the end of the lease term or purchase the asset.

Option to Extend Lease

Where the lessee opts to extend the lease, the proposals in the ED suggest that the lease extension should be taken into account at lease inception. Thus a 10 year lease with an option to extend for another 5 years would be accounted for as a 15 year lease term. We disagree with this approach. We believe the lease extension should be taken into account only after the option to extend the lease term has been exercised, and where this is material. Where this policy is disclosed in the notes, then this should provide relevant information to users concerning the value of potential liabilities.

Option to Purchase

Conversely, if the lessee exercises an option to purchase the asset at the end of the lease term, then the right-of-use asset and the value of the lease rentals at lease inception would be based on the period representing the lease period prior to exercising the option – 10 years.

The scenarios presented above, give rise to two very different accounting approaches with the lessee recognising higher lease payments and right-of-use assets if it extends the lease and lower lease payments and right-of-use assets, if it purchases the asset. We would suggest that the Board review its position on these points.

If the proposals in the ED are adhered to, lease agreements would have to be reassessed, given changes in lease terms/conditions and this would be unduly burdensome for preparers. This would also increase volatility in the financial statements and reduce comparability as entities with very similar lease terms may account for them in different ways based on subjective assumptions. We are not convinced that such reassessments would necessarily provide useful information for users.

In addition to this, we do not believe that lease renewals qualify as obligating events as per IAS 37 until they are actually exercised. Lessees would only extend or otherwise, at their discretion. In our opinion, it would be difficult for the lessor to recognise a right to receive lease payments until the lessee actually exercises the option and communicates this to the lessor. Prior to the lessee exercising the option to extend, rent receivable cannot be classed as assets as defined in the Conceptual Framework. Also, with reference to the Revenue ED, the lessor cannot really recognise revenue until he has actually transferred to the lessee, the right to use the asset during the extended period.

Whilst we acknowledge the Boards position in BC 123 - the effect of not reflecting contingent rentals in the measurement of a liability could give rise to a significant understatement of right-of-use assets and the right to receive lease payments, we urge the Board to rethink its position on this point in order to develop proposals that are meaningful to users and practical for preparers. In our opinion adequate disclosures should be sufficient. We believe contingent rentals depend on the circumstances surrounding the transaction. For example where a lessee leases shop space and the rent pattern depends on a percentage of sales generated, then, if the sales pattern can be predicated based on historical data and this can be measured reliably, we agree that contingent rentals of this nature should be included in the PV of lease payments calculation.

However, contingent rentals associated with lease extension and renewal options should not be included in the PV of lease payments until such options are exercised.

We believe contingent rentals should be recognised only when their values can be reliably measured, based on predictable future cash flows.

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 believe the Board needs to provide more guidance as to what constitutes contingent rentals from the lessors' perspective. Appendix A of the ED defines contingent rentals as:

Lease payments that rise under the contractual terms of a lease because of changes in facts and circumstances occurring after the date of inception of the lease, other than the passage of time.

Scenario:

A customer obtains a machine from a provider (lessor/seller) for a 5 year period. The machine typically has a useful life of 5 years (so one would assume the derecognition model applies here) and the customer is required to purchase active ingredients for use with this machine in its manufacturing process, over a specified period of time. The customer does not make any specific payments for the machine received, but pays the provider/seller a fixed price for quantities of active ingredient ordered for use with this machine.

It is unclear to us whether the payments to be made by the lessee to the lessor which are dependent on varying factors depending on the reimbursement business model in place as outlined in our response to question 4, meet the definition of a contingent rental. In certain cases, the contingency is based on events such as the number of reagent quantities ordered, tests run on the machines, amounts reimbursed by government agencies for successful test, kits used during the testing process, etc.

Given the scenario above, we would welcome the opportunity to meet with staff members via outreach activities to better explain our business models and how the ED in its current form is impractical to apply.

Generally, we do not believe that contingent rentals dependent on the lessee's future behaviour with regards to usage and performance of an asset and expected payments under term option penalties

(prior to such options being exercised) meet the definition of a liability as defined in the Framework. In this respect, we support the dissenting views of Stephen Cooper. The inclusion of such contingent rentals will not, in our view provide decision useful information to users as the underlying economics of the transactions would not be adequately reflected in the financials. Furthermore, residual value guarantees cannot be recognised in the books of the lessor prior to such amounts being reliably estimated based on the most likely amount. Excluding contingent rentals of this nature in our view would provide useful information to users.

On the other hand, any payments to be made by the lessee to the lessor based on events not controlled by either party such as changes in the retail price index or other related index could be included in the measurement of the obligation of the lessee to the lessor (and vice versa) if they can be reliably estimated.

The proposals in the ED give rise to differences in the approach between IAS 37 and other IFRS's. Applying IAS 37 strictly would give rise to an understatement of right-of-use assets by lessees and the right to lease receivables by lessors as per BC 125. It could be seem that the Board is deviating from prescribed accounting standards at will, when this appears to be convenient for the Board and this cannot be acceptable. Accounting standards need to be applied consistently.

We would welcome the opportunity to meet with staff members via outreach activities to better explain the business model of our Diagnostics business and how the ED in its current form is impractical to apply.

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?

Whilst we note that the Board proposes to effect reassessments of lease agreements following material changes to the facts and circumstances surrounding such lease agreements, we would not support the mandatory reassessment of lease payments, receivables, assets and liabilities on a periodic basis for reasons already outlined in questions 8 and 9 above. This would be extremely costly and cumbersome to implement.

Where the Board actively considers our proposals in response to these questions (8 and 9), we believe the need to reassess the impact of changes in the facts and circumstances surrounding lease agreements would be infrequent, and would certainly not be on a periodic basis as proposed in the ED.

Again, we welcome the opportunity to discuss these points with staff members via out reach activities.

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?

B9 suggests a sale occurs if control of all but a trivial amount of risks and benefits associated with the underlying asset is transferred;

B10 suggests that a sale exists if there is (i) an automatic transfer of the title to the asset at the end of the lease term OR (ii) when transfer of control includes a bargain purchase option. As mentioned earlier, we do not support the conclusion that the inclusion of a bargain purchase automatically guarantees that the lessee will purchase the asset.

B31 prescribes additional criteria which determine whether or not an underlying asset has been purchased or sold.

It appears to us that the additional criteria prescribed in B31 suggest that a higher hurdle(s) need to be fulfilled in order to designate a sale and subsequently leasing of the related underlying asset as a "sale and lease back" transaction. We would suggest that if this is not the intention of the Board re: additional hurdles, then the criteria stipulated in B31 are included in B9 or B10 as appropriate.

We believe that the determination as to whether a sale and lease back transaction exists should be considered with reference to the facts and circumstances surrounding the commercial substance of the transaction in order to determine whether or not the sale and lease back event can be linked.

We also believe that where a transaction has been deemed as sale and lease back transaction, then

i. The asset sold should be derecognised from the books of the original seller who recognises a gain or loss on sale of the underlying asset; the purchaser would recognise an asset in its books;

- ii. Where the original seller subsequently leases back a portion of the sold (derecognised) asset from the purchaser, then, the original seller (now a lessee) recognises a right-of-use asset being of that portion of the asset leased back in its books, based on the PV of the lease payments.
- iii. The original purchaser, being the lessor, would then recognise a right to receive lease payments for the portion of the asset subsequently leased back to the original seller and derecognise the portion of the asset leased by the original seller.

The above principles would be consistent with the partial derecognition approach. Contrary to the views of the Board, we believe the application of the derecognition approach is quite logical and not more complex.

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?

We believe that there are merits to making a distinction between owned assets and leased assets in the financial statements of the lessee. However, this may well give way to an overly complicated balance sheet. The Board should consider permitting management to consider how best to present this information to users.

(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 would support the proposal to present this information on a net basis on the balance sheet, with the necessary disclosure in the notes to financial statements. Including this information separately on the face of the balance sheet would result in an over-complicated presentation.

(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 would support the proposal to present this information in the notes to the financial statements. Including this information separately on the face of the balance sheet would result in an overcomplicated presentation.

(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 note that BC 160 suggests that one entity (the lessee) transfers an asset it owns to another party (the lessor) and then lessees back the same asset.

We would suggest the text be reworded, replacing the word "(the lessee)" in the above text, with the word "the (seller)" to avoid confusion.

We agree with the proposals to distinguish assets and liabilities arising from subleases as separate from regular properly plant and equipment and "head" lease agreements in the financial statements, but we believe that this information should be given in the notes to the financial statements and not as a required separate line item on the face of the balance sheet.

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?

With reference to lessee accounting, we support the separate presentation of the leased asset amortisation expense arising from the right-of-use asset and interest expense payable on the liability to make lease payments, as separate from other amortisation and interest expense arising from non-leased assets. We believe that this information should be given in the notes to the financial statements and not as a required separate line item on the face of the statement of comprehensive income.

In respect of lessor accounting using the **performance obligation approach**, the presentation proposals in the ED - lessor recognising interest income on the right to receive lease income, interest income and depreciation of the underlying asset held in its books - would in our view make sense.

With reference to lessor accounting using the **derecognition approach**, with reference to paragraph 61 of the ED, it may be helpful if the wording were clarified as follows:

"A lessor shall present lease income arising from assets leased out to lessees and lease expense arising from assets subsequently leased back from lessees via sub leases

Also, with reference to pp 61 (a), the statement that "many manufacturers and dealers regard the lease of an asset as equivalent to selling an asset" in our view is not helpful. The accounting guidelines in the ED, taking into account a lessors' business model, should permit the lessor to classify a transaction as either meeting the criteria for qualification as a "lease" as defined in the ED or a "sale". Where the Board seeks to incorporate this "lease equivalent to a sale hybrid", then this should be accommodated in the ED and accounting guidance specific to this model prescribed.

This point also highlights our point raised in question 1 where we suggest the business model of the lessor be taken into account in order to determine whether a lease arrangement constitutes a basis for facilitating the sale of products via a service agreement or whether a lessee seeks to purchase an asset via a financing arrangement with lessors.

Barring these observations, we support the presentation proposals contained in the ED.

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?

Generally, we agree with the proposals of the ED. However, we note that in some cases, the lessee may be justified in presenting cash payments for leases and interest expense as operating activities in instances where the lessee obtains assets mainly as a means of gaining assess to property, plant and equipment for use in its business operations rather than obtaining assets under a financing arrangement which is more related to the purchase such assets.

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?

With reference to the disclosure requirements for lessees and lessors we support the Board's stance re: permitting entities to consider the level of disclosure detail which they see as appropriate to enable users obtain useful information about the entities' operations. We note that the disclosure requirements as outlined in paragraphs 73-86 are extensive and cumbersome to collate and thus, would recommend that the board expressly state that this list is intended to be a guide as to the nature and magnitude of disclosures to be made.

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

The full retrospective application of the proposals contained in the ED will be extremely time consuming – ability to locate original contracts, and restate as necessary – and, expensive to implement, especially in relation to active long-term leases.

The Board has suggested that a simplified retrospective approach should be applied from the beginning of the earliest period presented. In our view, the fact that every single "active" lease agreement would have to be located, reviewed, re-assessed based on the measurement proposals contained in the ED, etc. would prove to be extremely cumbersome, amongst other cons and we are not convinced that the costs to implement the proposals out weigh the benefits.

Benefits and costs

Question 17

Paragraphs BC200-BC205 set out the Board's assessment of the costs and benefits of the proposed requirements. Do you agree with the Board's assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We have not conducted a cost/benefit analysis on the proposals and the potential impact. However, from a preparer's perspective, we are not convinced that the proposals in the ED and the steps to be taken to implement those proposals would really prove to be more beneficial than the existing standard, especially with respect to lessor accounting. Given the lack of clear guidance to facilitate implementing the principles contained therein, a lot of judgement will be required to apply these principles and with no guarantee that similar transactions across different businesses, in different industries would be accounted for consistently.

Generally, lease agreements would have to be located, reviewed, reassessed, and accounted for under the proposals of the ED. Staff would need to be trained, accounting systems re-configured or replaced, and new internal control processes developed to ensure that accounting for leases, which would predominantly lead to recognition of assets and liabilities in the financials, are correct.

Following the recognition of more assets and liabilities, this would lead to significant deviations in impact, with reference to financial ratios, thus affecting an entities ability to obtain capital amongst other things.

Other comments

Question 18

Do you have any other comments on the proposals?