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International Accounting Standards Board
30 Cannon Street
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EXPOSURE DRAFT - LEASES

Dear Sir / Madam,

In response to your invitation to comment, and as a preparer of financial statements under International Financial Reporting Standards, I am pleased to attach our comments on the above mentioned Exposure Draft (ED).

Yours Faithfully,

James Halliwell
Group Financial Controller

GENERAL COMMENTS

We welcome the publication of the ED on Leases and appreciate that the board has identified this project as high priority with the aim of issuing the final IFRS by June 2011. The existing leases standard IAS 17 has long been criticised for having bright lines between finance leases and operating leases thus leaving structuring opportunities. We support the decision of the board to remove the distinction between those two forms of lease accounting. The board has performed commendable outreach activities to gather views of various stakeholders in this project.

We support the decision to require capitalisation of a 'right of use' asset related to leases which are treated as operating leases under IAS 17. However, we do not support the board's decision to require the recognition in the statement of financial position of leases with a lease term shorter than 12 months. As further explained in our reply to question 3, we do not believe the relief from discounting in the measurement of lease payments for such short term leases addresses the issue identified by most preparers of financial statements.

We support the proposal to require recognition of options and contingent rentals within the measurement of the lease asset and the lease liability. However, we believe that requiring a most likely/best estimate approach for measuring the liability for lease term related options together with a probability weighted approach for measuring contingent rentals and residual value guarantees would make the proposal very complicated. We note that in the light of comments received, the Board has decided to redeliberate the proposals in the IAS 37/Liabilities project which would have prescribed probability weighted method measurement for those items. We would support the most likely/best estimate approach for measuring all uncertain components of lease payments in order to keep the requirements consistent and simple.

Finally, we agree with the inclusion of IFRIC 4 into the ED and would prefer that the requirements of this ED which interact with the requirements of ED "*Revenue from Contracts with Customers*" should be aligned as certain aspects of the two EDs are not consistent. This is further explained in our reply to question 4.

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?*
- a) We agree that a right-of-use asset and a liability to make lease payments should be recognised as an asset and a liability because they meet the definition of an asset and a liability contained in the Framework.
- b) We agree that lessees should recognise amortisation of the right-of-use asset to reflect the change in the recoverable amount of the asset on a systematic basis. We also agree that interest should be recognised on the lease liability to reflect the time value of money.

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?*

Generally, we do not support accounting choices as they reduce the comparability of financial statements. We support the proposal of two approaches for lessor accounting and related recognition of assets, liabilities, income and expenses because we do not see this as a free accounting choice. Each lessor has to assess their own circumstances and make a judgment as to which approach is more appropriate for their leases. We note that significant judgment will need to be exercised by lessors in determining the approach they apply since the board has not defined the term "significant" in relation to risks and benefits.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

- a) *At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).*
- b) *At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).*

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 strongly believe that the relief provided by the board in relation to short term leases does not address the issue identified by most of the respondents to the discussion paper. Large corporate entities can have from hundreds to thousands of small short term lease contracts which are currently classified as operating leases. Under the existing standard the lease payments for these contracts are recorded in profit or loss on a straight-line basis. The simplified approach proposed by the ED would require all these contracts to be recognized in the statement of financial position.

We want to reiterate that the issue here is not the efforts required to discount the minimum lease payments for these short term contracts. It is the tracking and recognition of asset and liability amounts for a large number of lease contracts. This would be extremely burdensome for many preparers. We would also question whether asset and liability recognition for these leases will really give users a improvement in the quality of financial information available which is sufficient to justify imposing that cost on preparers. If short term 'right of use' lease assets and corresponding liabilities are recognized, they would presumably need to be classified as current assets and liabilities in order to be consistent with the IAS 1.66 and 1.69 guidance, although the ED does not specifically mention this point. Neither an entity's fixed capital nor its net current assets will therefore change.

We would also reiterate the point we made in our comment letter on the March 2009 Discussion Paper: an analogy to the IAS 16.6 definition of Property, plant and equipment as "*items ...that are expected to be used in more than one period*" would suggest that it is acceptable to expense as incurred the costs of short term leases.

It can also be argued that most of the payments for such short term lease contracts are in many cases made in exchange for services rather than for the use of an asset. Leases of photocopying machines might be one common example of this point.

From a conceptual viewpoint it has been argued, in our opinion convincingly, that leases which would be accounted for by a lessor under the performance obligation model, which would include almost all short term leases, should be accounted for by the lessee in the same way as executory contracts. The ED would not consider the lessor to have performed any of its obligation under these leases at the commencement of the lease. We do not see how the lessee can be considered to have a liability to the lessor at that date for lease payments in respect of the same, still to be performed, obligations.

In our opinion a short term lease should be defined as a lease where the longest lease term which is more likely than not to occur does not exceed one year, in order to be consistent with the ED proposals on measuring lease term. This will ensure that there is no overlap between short term leases to which the exemption applies and long term leases to which the lease accounting model applies. We suggest that the current operating lease model should be retained for short term leases which meet this definition.

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?*
- a) We agree that a lease is defined appropriately in the ED.

- b) The proposal for the distinction between a lease and a contract that represents a purchase or sale encompasses two conditions, the transfer of control as well as all but a trivial amount of risks and benefits associated with the entire underlying asset, whereas the ED on “*Revenue from Contracts with Customers*” proposes the transfer of control as the sole condition for recognition. We do not understand the reason for this difference and suggest the alignment of the two EDs in this respect. We note that if a lessor provides a warranty or guarantee to the lessee, or has a profit-sharing relationship with the lessee with respect to future income from the asset, the transaction could be considered as a lease under the ED “*Leases*” but also as a sale according to the ED “*Revenue from Contracts with Customers*”.
- c) Under the existing standard, the accounting treatment of operating leases and non-lease executory contracts is usually similar and therefore no significant efforts are made to distinguish between the two. Under the proposed model, the accounting treatment of leases and executory service contracts is significantly different. We understand that the distinction between the two can be made using the criteria mentioned in current IFRIC 4. However, we believe more detailed guidance is required considering the impact this will have on various existing contracts.

Scope

Question 5: Scope exclusions

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

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

We agree with the proposed scope of the ED as it would predominantly apply to leases of property, plant and equipment.

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?

As leasing is a joint project under the memorandum of understanding with FASB, we would prefer the differences between the FASB proposals and the IASB proposals to be eliminated. Considering that one of the main objectives of revising lease accounting is to achieve simplification of accounting requirements, we propose that the contracts that contain service components as well as lease components should be accounted for as either service contracts or lease contracts based on the predominant nature of the contract unless both lease and service components are material and the respective amounts of each can be reliably measured. Applying lease accounting to a short term hybrid contract that is predominantly a service contract, for example a short term lease of a photocopying machine, would not be conceptually correct.

Regardless of the Board's eventual decision on this point, we believe that maximizing consistency of recognition criteria across the proposed lease and revenue recognition IFRSs will help to minimize any accounting problems associated with hybrid contracts from the viewpoint of all affected stakeholders.

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 that an option to purchase a leased asset at market value at the end of lease term should be accounted for by the lessee as a purchase contract when such option is exercised. This is because until the date of exercise of such option, it is not certain whether the option will be exercised and the transaction is avoidable from the lessee's viewpoint. However, we believe such an argument would not hold true for bargain purchase options for which it is probable that the option will be exercised. For such lease transactions the present value of the option exercise price should be reflected in the right-of-use asset and lease liability. In this respect we agree with the alternative view expressed in paragraphs AV2-AV4. We suggest this distinction should be clarified in the final standard. As mentioned in our answer to question 4(b), we reiterate that the criteria for sales/purchase transactions should be aligned between this ED and ED "Revenue from Contracts with Customers".

Measurement

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We agree with this proposal because we believe this would address the serious issue of structuring. We also support the use of the most likely outcome/best estimate approach to determine the longest possible lease term as it is simpler than the probability weighted approach.

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 agree that contingent rentals, 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 to address the serious issue of structuring. However, we strongly disagree with the board's decision to require the use of the expected outcome technique for determining such amounts. We believe this would not only make the process very complicated but also inconsistent with the way such amounts are determined for lease term related extension or termination options. We would support the use of the most likely outcome or best estimate approach for contingent rentals, expected payments under term option penalties and residual value guarantees that are specified in the lease. For example, a lessee may have an obligation to pay contingent rentals based on sales derived from using the leased asset, for example a commercial building. Such a lessee could measure its right of use asset and the liability which it records for these contingent payments consistently with its most up to date sales forecasts approved by management. This might be considered as its best estimate of that liability. This will also ensure consistency with its application of the IAS 36 impairment testing requirements to the right of use asset.

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?

We agree with the proposal because we believe that remeasuring assets and liabilities as a result of changes in related facts or circumstances would result in a fair presentation of the substance of these transactions.

Sale and leaseback

Question 11

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

We agree with the proposal, however, we would draw the board's attention to our answer to question 4(b) where we have pointed out that the criteria for identifying sale/purchase transactions contained in this ED should be aligned with those in ED "Revenue from Contract with Customers".

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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 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?*
- (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 agree that assets and liabilities related to lease transactions should be presented in the statement of financial position as proposed in the ED.

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?

In our opinion, it should be sufficient to present the amortization of right-of-use asset and interest expenses relating to lease liabilities in the notes to the financial statements.

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?

We agree that cash flows arising from leases should be presented separately from cash flows from other types of financing activities.

We further suggest that presentation requirements for cash flows arising from leases should be finalised in cohesion with the Financial Statement Presentation project. As per the latest staff draft of these proposals, the operating category of the statement of financial position will be further segregated into operating and operating finance subcategories. We believe that an operating finance subcategory should also be developed for the cash flow statement and cash flows arising from leases should be presented in that subcategory.

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?

We agree with most of the disclosure requirements but there are certain disclosures which in our opinion will not be of interest to the users of financial statements. Under the proposals of the ED, the number of leases that will be recognised in the statement of financial position will be significantly higher than in the past. We believe the requirements contained in paragraph 73(a) (i) to (iv) relating to disclosing the terms of options and contingencies in lease contracts are very burdensome and unnecessary. We believe the users of financial statements will not benefit from a detailed disclosure about the terms of each lease contract and a summarised description would tend to become a 'boilerplate' disclosure. Therefore we suggest that this requirement is removed or at least restricted to lease contracts which are individually material to the financial statements.

Transition

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?*

We agree with the proposed transition approach to recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach. We believe full retrospective application would be extremely burdensome considering the number of lease contracts which will need to be recognised in the statement of financial position under the proposed model of lease accounting. A large number of lease contracts are made valid for many years and it could be extremely difficult to gather data relating to those prior years if full retrospective application is required.

As highlighted in our answer to question 3, we believe it is going to be very burdensome to recognise hundreds and thousands of short term lease contracts in the statement of financial position, with little benefit to users of financial statements. If the Board insists on including short term leases in the scope of its proposed right of use model, it should at least allow prospective application of the new requirements to such leases.

Benefits and costs

Question 17

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

Leases Preliminary views – Discussion paper

We agree with the board's assessment that the benefits of the proposals would outweigh the costs. In our opinion the cost/benefit balance would be significantly improved if short term leases are exempted from the right of use model.

Other comments

Question 18

Do you have any other comments on the proposals?

We have no further comments.