



The Voice of Leasing and Automotive Rental in Europe

Sir David Tweedie, Chairman
International Accounting Standards Board

Ms Leslie F. Seidman, Acting Chairman
Financial Accounting Standards Board

Brussels, 15 December 2010

Dear Sir David,
Dear Ms Seidman,

Leaseurope, the trade association representing the European leasing and automotive rental industry, welcomes the opportunity to provide the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) with its feedback on the Exposure Draft Leases (ED/2010/9) published on 17 August 2010.

Leaseurope remains concerned that the Boards' focus in developing a new accounting model for leases has been on a marginal sub-category of lease transactions that are very different from the vast majority of leases that businesses enter into. Instead of concentrating on sophisticated, high-value, structured deals, we urge the Boards to reconsider their proposals in light of the reality of the leasing market, which is comprised of millions of low-value plain vanilla contracts providing the use of straightforward business equipment. In Europe for instance, the average equipment lease is worth approximately EUR 27,000. We maintain that the Boards' concerns surrounding the existing bright lines present in the US GAAP leasing standard could easily be addressed by improving and enforcing the principles of the IFRS leases standard, IAS 17.

Additionally, we consider that the proposals have not been subject to the rigorous cost/benefit analysis that stakeholders expect in the context of high quality international accounting standard setting. In our opinion, the proposals set out in the Exposure Draft are disproportionately burdensome for preparers to apply, while not necessarily providing users of accounts with improved information in comparison to the existing lease accounting standard. This is confirmed by a recent survey of European preparers where around three quarters of companies surveyed report that the costs of the proposed standard outweigh its benefits.

Beyond the accounting and operational complexity for IFRS preparers, the proposals could very well have a number of wider-reaching consequences that also need to be taken into account. For instance, it is likely to be only a matter of time before the concepts developed by the Boards in this Exposure Draft are applied in national GAAP and/or IFRS for SMEs. Whether the businesses applying these standards would be able to cope with the right of use model in its current form is highly questionable. Moreover, were the proposals for lessor accounting to remain unchanged, there is a significant risk that leasing may cease to be easily accessible for businesses.

With leasing representing approximately 20% of all equipment investment at European level, the economic consequences may therefore be severe, particularly as it is unlikely that businesses will be able to find alternative sources of finance. It is essential therefore that these types of economic impacts are factored in to the Boards' analysis before any new accounting standard is finalised.

In our view, many of the conceptual and technical aspects of the proposals set out in the Exposure Draft require further consideration. Generally speaking, the proposed standard is weak at its boundaries (leases vs services and leases vs sales/purchases). The definition of a lease, in addition to being insufficiently robust, is too broad in the context of a right of use model. Additionally, the conceptual premise of the right of use model has not been reflected consistently throughout the proposed standard, as is visible in the proposals for lessors and sale and leasebacks. Moreover, the proposals for the treatment of options and contingent rentals are inconsistent with the Conceptual Framework, particularly burdensome for preparers and do not necessarily provide users with appropriate information. Lastly, the subsequent measurement proposals for lessees will not depict the economics of leases as total lease costs will be front-loaded. All of these issues need to be resolved.

We also have significant concerns with the proposals for lessors. While the European leasing industry maintains that lessor accounting must be revised if a right of use model is to apply to lessees, the current proposals for lessors can in no way be considered to be an improvement on existing accounting. No convincing justification has ever been provided for the performance obligation model. Not only is this model inconsistent with the underlying rationale for lessees having liabilities under lease contracts, it fails to depict the economics of a lease from the lessor's point of view. The de-recognition model on the other hand is consistent with the right of use premise. However, in the form presented in the ED where residual assets remain frozen after initial measurement, it also completely fails to depict the economic reality of leasing. This is far from being a marginal or technical issue as the presence of even limited residuals would have a major and permanent impact on lessors' reported profits which would be vastly understated compared to their true economic performance. A hybrid approach combining the performance obligation and de-recognition model is impossible to reconcile with the proposals for lessees. Leaseurope therefore urges the Boards to review the lessor accounting proposals and to adopt the de-recognition model as the general approach for lessors under the condition that the discount on the lessor's residual asset is unwound over the course of the lease. Without this change, the de-recognition model would provide no more meaningful information than the performance obligation model.

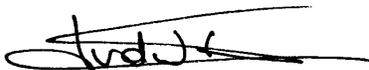
In our opinion, the June 2011 convergence deadline has placed a great deal of pressure on the Boards, as is visible for instance in the decision to exclude intangible assets from the proposals or in the proposals for lessors. While we are supportive of the convergence process, it should not come at the cost of poor quality standards. We encourage the Boards to take the time needed to finalise a robust and workable lease accounting standard. In our opinion, the proposals set out in the Exposure Draft are not of sufficient quality to proceed directly to a final standard. Instead, we urge the Boards to re-expose their proposals on the basis of feedback they will receive during this comment period together with the results of comprehensive impact assessment.

We consider that the alternative view of IASB member, Stephen Cooper would form a good basis for improving and simplifying the proposals, on the condition that the issues surrounding the boundaries of the lease project (purchase – lease – service) and lessor accounting are resolved. In order to continue to constructively contribute to the goal of a high quality financial reporting standard for leases, we have provided an alternative right of use model in this response that attempts to address the main concerns summarised above and which are described in further detail in our letter below.

Our comment letter is divided into three sections. The first section provides our general comments on the review of existing lease accounting and highlights fundamental issues that need to be addressed before any new lease accounting standard is finalised. The second section provides our detailed responses to the individual questions posed in the Exposure Draft and the third section summarises Leaseurope's proposal for an alternative, simplified right of use model that can be applied to all leases.

We thank you for taking the time to consider our response and remain at your disposal to discuss any of the issues raised in this letter further. Please do not hesitate to contact us or Leaseurope's Senior Adviser, Jacqueline Mills (j.mills@leaseurope.org, +32 2 778 05 66) for any additional information you may require.

Yours sincerely,



Tanguy van de Werve
LEASEUROPE DIRECTOR GENERAL



CHAIR, LEASEUROPE ACCOUNTING COMMITTEE

About Leaseurope

As a Federation, Leaseurope brings together 45 member associations in 32 European countries representing the leasing, long term and/or short term automotive rental industries. In 2009, these associations represented more than 1 300 leasing firms and more than 780 short term rental companies. The scope of products covered by Leaseurope's members ranges from hire purchase to finance leases and operating leases of all asset types (automotive, equipment and real estate) and also includes the rental of cars, vans and trucks. Leaseurope represents approximately 93% of the total European leasing market. The firms represented via its member associations granted new leasing volumes of over €209 billion in 2009, with the average equipment lease being worth EUR 27,300.

Further information on Leaseurope and its members can be found at www.leaseurope.org.

Leaseurope Response to the IASB/FASB Exposure Draft Leases

I. General Comments

The case and process for changing lease accounting

Leaseurope's comment letter to the 2009 Discussion Paper: Leases Preliminary Views (hereafter referred to as the DP) recommended that the IASB undertake further work to assess the precise informational needs of users of financial statements with respect to lease transactions, identify areas where the existing model did not provide such information adequately and develop solutions to address these. The letter stressed that this should be done while considering the costs that would be generated for preparers of accounts together with any potentially broader economic impacts before proceeding to overhaul IAS17.

In our opinion, the Leases Exposure Draft (hereafter referred to as the ED) provides little evidence that any such analysis has been performed. The result is that the proposed draft standard for leases is disproportionately burdensome for preparers, may give rise to a number of unintended economic consequences and very possibly does not address the diverse needs of users of financial statements appropriately¹. It seems logical therefore to question the process that has led to the development of the ED, starting with the fundamental assumption that existing lease accounting is "broken".

At the heart of the issue is the fact that current US GAAP guidance for leases uses a number of bright line tests to determine whether a lease should be classified as a finance lease or an operating lease. Consequently, standard setters appear to have assumed that leasing is used almost exclusively as a tool to achieve a certain form of balance sheet presentation. The draft standard has been designed on the basis of that assumption. However, this ignores the realities of the leasing market and the real reasons why businesses choose to lease.

¹ EFRAG's [Draft Comment Letter](http://www.efrag.org) (available from www.efrag.org) lists the different types of information that users may potentially be interested in as being "the volume of assets used in the operations of the entity; the entity's exposure to asset related risks; the amount of unavoidable lease payments; the amount of unavoidable payments under leases and executory contracts; the amount of expected lease payments; or the leverage in an entity's financing structure". The ED does not make it clear which of these are most useful to users.

Leaseurope has repeatedly pointed out that the vast majority of leases in terms of numbers of deals are plain vanilla leases² for straightforward, low value assets. In 2009, leasing firms represented through the member associations of Leaseurope in 20 European countries granted more than 5 million individual lease contracts. Of these, 97% were equipment leases, with an average contract size of approximately EUR 27,300³. Companies enter into these types of contracts for a number of reasons⁴, particularly as they provide effective and flexible solutions for obtaining the use of an asset without in many cases bearing the asset's risk. Leasing is also crucial as it is often accessible to businesses, such as SMEs or startups, when other means of financing assets are not available. Studies conducted within the EU-15 show that more than half of European SMEs have made use of leasing or rental at some point⁵. Such transactions are far removed from the big ticket, structured deals that standard setters appear to be the most concerned with.

It should also be noted that property rentals make up the lion's share (by value) of current operating leases. The US Equipment Leasing and Finance Association has estimated that approximately 80% of the total undiscounted dollar amount of committed operating lease payments in the US, which is in the region of 1.25 trillion USD, is for leases of property. A recent survey of European preparers⁶ reveals that the situation is similar at European level, with 82% of the operating lease commitments reported by respondents being for leases of property. Another survey of preparers⁷, confirms the predominance of real estate in operating leases in the UK. Further, it finds that a significant share of non-property operating leases is concentrated within a few companies, in particular sectors (transport, storage and communications). Moreover, these leases are of particular types of high-value assets that display the characteristics normally associated with property⁸. Such leases are of a very specific nature and bear little in common with the general leasing business represented through Leaseurope's members.

² The existence of features such as renewal options does not make a lease inherently more complex. This is a misconception as, on the contrary, such features provide the lessee with a greater amount of flexibility and simplicity.

³ Figures reported by Leaseurope's member associations in its 2009 Annual Enquiry. If real estate leases are included, the average deal size is EUR 36,800.

⁴ Leaseurope's [response](#) to the Leases Discussion Paper provides an overview of the reasons for why businesses enter into lease contracts.

⁵ SME Access to Finance, Flash Eurobarometer 174, TNS Sofres/EOS Gallup for the European Commission, October 2005

⁶ ["Are you ready for the new leases standard? Preparers' Views on new Lease Accounting: European Impact Survey 2010"](#), PWC Accounting & Valuation Advisory Services

⁷ ["The potential impact of the "right-of-use model" for lease accounting on a sample of UK companies"](#), Winchester Business School

⁸ i.e. "substantial expenditure tied to very long term asset infrastructure". Winchester Business School research

Early consideration of these facts and the real nature of businesses' use of leasing would have made it apparent that the approach adopted in the ED is disproportionate as it treats all leases, including simple equipment leases and leases that are similar to outsourcing contracts, as if they were the high-value, structured deals the Boards are seeking to address. Moreover, the Boards have failed to adequately recognise the qualities of the existing IFRS standard for leases that, contrary to the equivalent US GAAP, is a principles-based standard adopting a substance over form approach. If the current IFRS standard for leases is correctly applied, it is very difficult to structure a lease simply to achieve off balance sheet presentation. Lastly, it should be understood that in practice there is a limit to the extent to which leases can be designed to circumvent accounting guidance. The risks related to the transaction will have to be borne by at least one party and that party will consequently require appropriate compensation, implying that the costs of such deals will be significant. Particularly in a small size deal, such as the average European equipment lease, there is no margin to cover such costs.

Leaseurope therefore maintains that it would be preferable to address the issues associated with big-ticket lease contracts that are structured by reference to bright line classification tests by improving and encouraging the use of principles to determine lease classification. This should be done in combination with more robust disclosures.

In comparison to the proposed standard, such an approach would much have less of a negative impact on straightforward equipment leases, which contribute to financing around 20% of all European investment⁹. As it stands, the new standard comes at an unjustified level of complexity for plain vanilla leasing and could very well have a significant impact on this key means of making assets available to businesses, and consequently on levels of European investment, which have already suffered tremendously during the recession.

Impact assessment

In addition to inadequate assessment of the nature of leasing and areas where current lease accounting is weakest, the proposed standard in the ED has not been subject to sufficient analysis comparing its presumed benefits for users of financial statements to the costs it would create for preparers of accounts. The proposals have also not been tested for the wider impacts they would create beyond accounting related burdens. It is our view that feedback provided to the Boards during the DP phase indicated that the costs and complexity of the proposed model would be far greater than suggested in paragraphs BC200 – BC205 of the ED¹⁰. We also wish to recall that the European

⁹ Excluding investment in property. Source: Leaseurope estimate based on data reported in its 2009 Annual Enquiry. Investment figures taken from Eurostat.

¹⁰ Source: Leaseurope analysis of approximately 150 comment letters submitted in response to the Leases Discussion Paper

Commission has repeatedly called for the IASB to conduct full effects analysis as soon as possible in the life-cycle of a project¹¹.

We consider that comprehensive impact analysis is the responsibility of the standard setters and that this is particularly important in the context of achieving credible, high quality global accounting standards. To date, it is the entities required to apply the standard that have had to produce such analysis, whereas we would expect the burden of proof of whether the benefits exceed the costs to lie with the bodies proposing the new approach. The European leasing industry has tried to contribute constructive input and practical examples to the IASB whenever possible throughout this process but it is disappointed by the limited extent to which this appears to have been taken into account.

In particular, the results of the aforementioned survey¹² of European lessees confirm that the costs of the proposals, were they to remain unchanged, are disproportionate. The vast majority of the preparers responding to the survey consider that the costs of the proposals would outweigh its potential benefits¹³. Moreover, they do not generally see the proposals as bringing about a substantial improvement to financial reporting¹⁴ and consider that certain aspects of the proposals, such as the proposed treatment of options and contingent rental features, would be in particular be a huge source of complexity. We note here that, contrary to what is suggested in ED¹⁵ the proposals have not been simplified to any meaningful extent.

As further evidence of the burden that preparers would incur in applying the new standard, our members have undertaken a preliminary analysis of the number of steps an entity would have to go through to account for their leases in the future, in comparison to what is required under the existing standard¹⁶. They estimate that in the case of the new standard, preparers would have to go through more than 75 individual steps, requiring access to various documentation, experts or other information sources, for each of their individual lease contracts. In comparison, a lessee would have to deal with approximately 30 steps under existing guidance for a finance lease and around 10 steps in the case of an operating lease. While there may be some degree of divergence in opinion as to the precise number of steps required in each situation, we consider that the overall conclusion would remain the same: the new standard as written in the ED is disproportionate. Even a simple lease cannot be accounted for simply. The so-called “concession” for short term leases included in the ED does not provide any real relief to preparers in this context and should not be presented as such.

¹¹ See for instance European Commission’s Contribution to the IASCF Constitution Review, 22 June 2009

¹² PWC [European Impact Survey 2010](#)

¹³ Nearly three quarters of respondents consider this to be the case, with only 11% considering that the benefits outweigh the costs and a further 16% responding that they did not yet know.

¹⁴ Indeed, 74% of respondents consider that the new standard would provide little or no improvement in financial information for users of financial statements.

¹⁵ See paragraph BC 205

¹⁶ See for instance the [Finance and Leasing Association \(FLA\) comment letter](#) to the Leases ED.

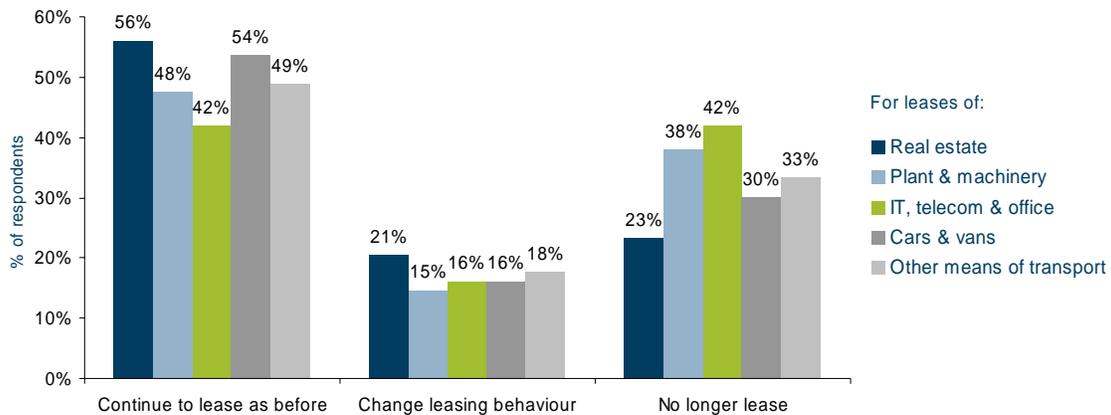
It is not generally assumed that changes to an accounting framework have any influence on businesses' economic decision making processes. However, the new proposals for leases are sufficiently complex that, even though a business may have valid economic reasons for entering into a lease, the efforts involved in identifying and collating data on possibly tens of thousands of contracts located throughout an entity, developing new reporting processes and internal controls, hiring additional staff and allocating resources to systems changes upon implementation will very possibly cause preparers to view their use of leasing differently. In fact, the entire leasing decision-making process will have to change at a fundamental level. In the future, finance departments will bear this responsibility whereas today many lease contracts are entered into at a de-centralised level as part of general operating expenditure budgets.

In addition to one-time impacts upon implementation, firms will constantly be required for each individual contract, every one being slightly different to the other, to make complex estimations on their lease terms and rental payments, to reassess these assumptions and to adjust their accounts for any changes frequently on an ongoing basis. In combination, these factors are likely to result in businesses considering that the complexity associated with accounting for leases will exceed their economic benefits.

There is now evidence that, given the cost and complexity of the proposals, European preparers would not continue to lease in the same manner (see Figure 1 below)¹⁷. While just under 60% of lessees of real estate would continue to lease in much the same way as today, lessees of equipment would be more affected by the proposals. Around 38% of lessees of plant and machinery and 42% of lessees of IT, telecom and office equipment would no longer choose to lease at all, as opposed to only 23% of property lessees. This clearly demonstrates that the Boards' proposals will indeed have consequences which go beyond financial statement and related financial metric impacts. Moreover, the side effects will be most negative for equipment leases. Whether these firms will be able to find alternatives allowing them to obtain the use of assets is questionable as not all will be in a position to substitute their leases with outright purchases. Bearing in mind that leasing currently accounts for a considerable share of total European equipment investment, we would expect that to see a decrease in investment levels as a result of the changes.

¹⁷ PWC [European Impact Survey 2010](#)

How do you expect the proposed standard for leasing will affect the extent to which you use leasing/rental?



Source: PWC European Impact Survey 2010

Figure 1

Leaseurope acknowledges the Boards’ current efforts to engage in outreach activities to better understand the effects of their proposals. However, these activities are taking place after the publication of the ED and have therefore not contributed to shaping the proposals to date. This is particularly disappointing as we have repeatedly asked the Boards to investigate the impacts of their proposals before moving to the ED stage and many of the comments that we and other stakeholders have provided on the impacts of the proposals have not yet been taken into account.

While we would clearly expect the Boards to integrate the results of this outreach into their re-deliberations going forward, given the current schedule for completing a final standard, we are extremely concerned that such a process would at this stage only be superficial and would not result in the level of improvement and simplification required.

Convergence deadline

We are of the view that the June 2011 deadline has put a significant amount of pressure on the Boards to complete the Leases project rapidly, with the result that the proposed standard is conceptually lacking and contains major inconsistencies in certain areas. Currently, it is ill-suited to the businesses that will have to apply it because it fails in many circumstances to faithfully reflect the economics of lease transactions.

Much more preliminary analysis, impact assessment and consideration of the feedback received from constituents to the DP would have been possible had there been less pressure on the Boards’ timetable. The Boards would have had the opportunity to consider fundamental issues that are now creating great difficulties for its constituents, such as the difference between a lease and a service. The IASB/FASB Working Group would have had the opportunity to meet prior to the publication of the ED to discuss its

content and provide guidance to the Boards on the direction the project was taking¹⁸. The lessee proposals would have been tested and simplified and proposals for lessor accounting would have significantly benefited from further reflection in general. The outcome of this process could and should have resulted in the publication of a second, comprehensive discussion paper presenting analysis on the overall model for both lessees and lessors before a near final standard was exposed.

Leaseurope does not consider that the current the ED provides a sufficient basis for moving forward at this stage, particularly as the self-imposed June 2011 deadline is unlikely to afford standard setters the time required to re-design the standard to the extent required to address the concerns of its constituents. There is therefore a significant risk that the final standard will not be operational and/or fail to provide a significant improvement in financial reporting, possibly requiring further modification in the short term if the June 2011 date is maintained. We would not consider this to be a satisfactory outcome of such an important, long-term project. The Boards must ensure that the final guidance is of the quality that their constituents expect.

We note that several MoU projects have been postponed beyond their initial mid-2011 deadline and would encourage the Boards to do the same for the leases project to allow for in-depth re-deliberation and simplification of their proposals. We understand that many other constituents, including EFRAG¹⁹, have indicated that this would be a preferable option. We note that deadline need not be postponed by years, but rather by a number of months or quarters. If the Boards do persist in maintaining the June 2011 deadline, their rationale for doing so must be clearly explained and supported.

¹⁸ The last meeting of the joint IASB/FASB Leases Working Group was in September 2009

¹⁹ See EFRAG's [Draft Comment Letter](#)

Lessor accounting

Leaseurope is extremely disappointed with the outcome regarding the proposed accounting for lessors. In this context, we think it is useful to recall the decisions taken on lessor accounting throughout the course of the project:

Developments in Lessor Accounting

July 2006: Boards announce fundamental review of lease accounting, including both lessee and lessor accounting.

March 2007: Board deliberations begin, considering the rights and obligations of both lessees and lessors.

July 2007 – May 2008: Little progress made on the project in general.

April 2008: Decision taken to postpone lessor accounting, Leaseurope writes to IASB to advise against this decision.

November 2008: DPaper publication deadline imminent, IASB and FASB do not agree on how to deal with accounting for subleases (from the perspective of lessors). FASB begins work on lessor model.

March 2009: DP published with last minute inclusion of a high-level discussion on lessor accounting but no preliminary views. Leaseurope expresses concerns to Trustees on the process followed with respect to lessor accounting, argues that a DP with lessor accounting is needed

May 2009: Boards discuss lessor accounting and continue to work on performance obligation model developed by FASB.

July 2009: Leaseurope's response to the DP points out flaws of the performance obligation approach and sets out an alternative approach: de-recognition.

November 2009: Formal decision taken to include lessor accounting in the project in the context of the Boards' reconfirming their commitment to the Memorandum of Understanding.

January 2010: Leaseurope signals further concerns with performance obligation model and puts forward additional reasons as to why a de-recognition model should be used instead.

March 2010: Performance obligation nears completion, several IASB members express reservations on a number of aspects of this model and instruct staff to work on de-recognition model.

May 2010: De-recognition model developed by staff presented to the Boards. Boards make decisions on entire de-recognition model in one session as ED publication deadline looms.

June 2010: Boards consider which model to apply. FASB has preference for performance obligation, IASB more inclined to use de-recognition. Intense debate results in compromise hybrid model presented in ED as Boards lack time to consider further the fundamentals if the ED is not to be delayed.

We have consistently argued that lessee and lessor accounting need to be dealt with in parallel. There are several reasons for this, including the fact that an analysis of a lease is best performed when the rights and obligations of all parties to the contract are

considered at the same time. Additionally, many entities are both lessees and lessors (of different assets) or enter into subleases (of the same asset). If the accounting framework is changed from the perspective of entities acting as lessees, lessor accounting needs to be adapted accordingly to ensure coherent financial reporting for these entities and situations.

However, as a result of continuously changing project scope, last-minute deliberations and forced compromise between the two Boards (as shown above), the lessor industry is now faced with multiple models. Yet one of the project's aims was to remove classification and different accounting treatments for similar leases. The Basis for Conclusions states that "in the Boards' view a single approach to lessor accounting would not be appropriate for all leases because of the differences in the economics of the business models for different lessors". However, what these differences in economics and business models are is extremely unclear and immediately raises the question of why a single model for lessors cannot be found when the Boards argue that one model can cover all lessee situations.

Consequently, we view this so-called hybrid approach for lessor accounting as being totally inconsistent with the lessee approach. Moreover, it lacks clear principles for when the different models it covers should be applied. While the ED proposes that an assessment be made on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset, this concept appears to be broadly equivalent to the existing finance and operating lease split that is so often criticised. The principle itself is unclear as no convincing rationale for the link between the existence of a performance obligation for lessors and the concept of retention of risks and benefits has ever been provided. Therefore, while we are supportive of changing lessor accounting to a right of use concept if lessee accounting is changed, the lessor model proposed in the ED cannot in anyway be considered to be an improvement over the existing guidance for lessors. Its implementation will just create significant costs for lessors who will be obliged to modify all their systems without bringing about any benefit for users of accounts.

The European leasing industry has endeavoured to constructively and proactively contribute to the Boards' deliberations on lessor accounting and has repeatedly put forward a straightforward model for dealing with lessor accounting that would result in a coherent accounting framework for leases. While this approach is set out in more detail below, we recall here what we see as being some of the more fundamental flaws of the lessor model exposed in the ED.

- 1) Overall, lessors are faced with 5 different methods for accounting for existing lease contracts²⁰ based on bright line type classification tests, creating 1) unjustified complexity and 2) reduced comparability as lessors of similar leases will have very different accounting
- 2) If the economics of leases are so diverse that several models are effectively required to cater for lessor accounting, why isn't the same true for lessees? Can a contract providing an entity with the use of a printing press for a major part of its economic life really be accounted for in the same way as a contract for an in-house photocopying facility involving the use of a third party's copy machines from the acquiring entity's perspective?
- 3) No convincing argument has been made for the performance obligation model. If a lessor does have a performance obligation to make the asset available throughout the lease, a lessee cannot have a liability for its obligation to make payments over the lease term. The performance obligation model is therefore inconsistent with the right of use model for lessees.
- 4) The performance obligation model does not reflect the economic reality of leases. The cash flows of the lease contract cannot simultaneously support both a lessor's receivable and the physical asset it is required to hold at the same carrying value as if there was no lease. The result is that lessors' balance sheets are artificially grossed up. The Boards have, unsuccessfully, tried to deal with this side effect by using a specific form of presentation and by not providing guidance on how the lessor's physical asset should be considered for impairment.
- 5) The performance obligation approach could have significant regulatory capital implications for bank-owned lessors, despite their risk profile remaining unchanged.
- 6) In addition to inflating balance sheets, the subsequent measurement proposals under the performance obligation distort a lessor's constant return on asset and P&L statement.
- 7) The de-recognition model presented in the ED is equally flawed as it ignores the effects of discounting on the lessor's residual asset, which is the last cash flow of a lease. Consequently, it also fails to faithfully represent the economics of a lease. This is particularly unfortunate as we understand that users of lessor accounts are most interested in obtaining information on a lessor's residual risk – a frozen residual asset value does not provide users with useful information.

²⁰ Accruals accounting for short term leases, other standards for leases that are sales, the performance obligation model, the de-recognition model and the fair value option under IAS 40.

- 8) The initial development of the performance obligation model lead the Boards to scope out certain contracts from the scope of the leases guidance in order to allow revenue recognition for manufacturer/dealer lessors. Having introduced the de-recognition model, this scope out is no longer required.
- 9) Changes to lease accounting have provided the Boards with the opportunity to revise accounting for investment property. Given the flaws of the performance obligation model, these firms are effectively being discouraged from using historic cost. We do not believe that such a fundamental change in investment property accounting should be a side effect of the leases project but should rather be part of a separate project subject to its own consultation process.

In conclusion, the rushed deliberation process for lessor accounting has unfortunately resulted in the outcome that we had cautioned the Boards against: proposals that lack fundamental underlying principles and that do not provide meaningful information. We urge the Boards to reconsider their approach to lessor accounting and have suggested alternatives in Sections II and III below.

Fundamental issues that are not adequately dealt with in the ED

In addition to the significant issues identified above with respect to *accounting for lessors*, the Boards have not sufficiently explained the rationale for other fundamental aspects of their proposals. In particular, the proposals are weak at the boundaries that are required to determine the differences between the outright purchase of an asset compared to leases on the one hand and the differences between executory contracts and leases on the other.

These issues are further developed in our responses to the individual questions in the ED and are summarised briefly here:

- 1) *The fundamental issue of distinguishing between leases and services has not been addressed.* This crucial distinction should have been dealt with at the very start of the project as the greatest stress in applying the new standard will fall on this criterion. In particular, the ED does not why explain why entities should recognise assets when they have obtained physical access to assets under leases but not when they have obtained rights to other types of performance of a counterparty. Under existing guidance, this has been less of an issue as the accounting for operating leases and service contracts is very similar. However, in the future the accounting will be very different and therefore requires a set of clear and workable principles. IFRIC 4 was not designed for this purpose and does not provide sufficiently robust guidance

- 2) *Leases that are so-called sales or purchases have been scoped out of the standard when there is no convincing reason for doing so.* Under the right of use model, the accounting for such contracts would be similar to the accounting for purchasing or selling asset, but would reflect the fact that the lessor retains the ownership of the asset throughout the lease and that such are therefore not sales/purchases. The proposed principle for scoping out these contracts is so broad that most of the finance leases granted in Europe today may very well no longer be considered to be leases.
- 3) *By introducing the notion of risks and benefits, the Leases ED defines a sale differently to the Revenue Recognition ED.* Sales should be defined in the revenue recognition guidance in order to have one consistent and robust definition throughout the IFRS literature.
- 4) *Pressure from the June 2011 deadline has lead the Boards to converge to the lowest common denominator by excluding leases of intangibles from the scope of the new standard whereas they are covered by IAS 17 today.* This is a regression rather than an improvement and leaves a gap in the accounting literature, particularly for lessees of intangibles. It will also create significant practical issues as there are many contracts that involve the use of both tangibles and intangibles.
- 5) *The nature of the right of use asset is undetermined.* The ED requires presentation of the right of use asset along side property, plant and equipment (i.e. as a tangible asset). Yet, it also implies that a lessee's asset is an intangible asset, for instance by cross-referencing to IAS 38. Nowhere however does the ED clearly state what the nature of this asset is. This is a crucial issue for lessees in regulated industries such as banks.
- 6) *The notion of distinct services is not applicable to lessees.* This is a concept developed for entities entering into contracts to *provide* goods or services, not for entities *acquiring* such contracts. Consequently, these notions are difficult for lessees to apply. The Boards should provide guidance specifically designed for lessees. This is crucial as defaulting to lease treatment for the entire contract if a lessee cannot separate service components does not have any conceptual basis.
- 7) *From the point of view of a lessor, any service components granted in conjunction with a lease will always be distinct service components.* Consequently, lessors will always be able to split these components out from the lease and account for them separately. We do not think that indistinct service components can exist from a lessor's point of view. If ever they did, such contracts would include only the incidental use of assets and would not leases.

- 8) *The subsequent measurement proposals for a lessee's asset and liability do not reflect the economics of leasing.* Lessees should apply a linked measurement approach where the asset is amortised using mortgage-based amortisation.
- 9) *The proposed treatment of options is inconsistent with the Conceptual Framework, unlikely to provide users of accounts with better information and will be a significant source of complexity for preparers.* Under this approach lessees will be required to recognise assets and liabilities they do not have. Lessors will recognise assets and potentially revenue that they do not have.
- 10) *The inclusion of certain types of rent under the heading contingent rentals is misleading.* The ED treats variable rental payments (payments based on a rate or index) and contingent rental payments (based on asset usage or the lessee's performance) indiscriminately. The former are not in the lessee's control whereas the latter are.
- 11) *The current transitional requirements will have significant impacts for both lessee and lessors and need to be reconsidered.* For lessees, this issue, along with others can be solved by a linked approach to subsequent measurement.
- 12) *Disclosures are too long and burdensome.* In order for users to understand the new assets and liabilities that will be shown on the face of the financial statements, the proposed model requires preparers to provide a level of information in the notes to the accounts that is unjustifiably burdensome. We believe that the extent of the disclosure requirements illustrates that the model presented in the ED is not workable in practice and will actually result in an information overload possibly obscuring the numbers that are truly useful for users.

Re-exposure of the proposals is necessary

In conclusion, we do not consider that the standard proposed in the Exposure Draft is sufficiently close to a finalised standard. Instead, we urge the Boards to re-expose their proposals on the basis of feedback they will receive during this comment period together with the results of and conclusions drawn from a comprehensive impact assessment. We believe that re-exposure before issuance of a final standard would help the Boards to build consensus around their revised proposals.

We welcome the alternative view of IASB member Stephen Cooper and consider that this view would form a good basis for improving and simplifying the proposals, on the condition that the issues surrounding the boundaries of the lease project (purchase – lease – service) and lessor accounting are resolved. In order to continue to constructively contribute to the goal of a high quality financial reporting standard for leases, we have outlined in this response an alternative right of use model that attempts to address the main concerns identified above.

II. Leaseurope Response to the Exposure Draft Questions

Question 1a: Lessees – recognising assets and liabilities

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?

No. Leaseurope does not consider that a lessee should necessarily always recognise a right-of-use asset and a liability to make lease payments. Instead, the Boards should take IAS 17 as a starting point and improve its principles as suggested above.

This being said, if the Boards do pursue a right of use model, it is necessary to for them to:

- 1) Clearly explain why assets and liabilities arise under leases but do not under other types of contracts,
- 2) Appropriately define what a lease is (this is discussed further in our response to Question 4 below) and
- 3) Significantly simplify the model by limiting its application to amounts that lessees are contractually committed to pay under a lease in order to mitigate the costs of its implementation for preparers (see our response to Question 9 below).

Recognising assets and liabilities for all leases – a conceptual shift

In designing the new standard, the Boards have not acknowledged the reasons that firms have for leasing. Securing the long term availability of an asset or securing flexible access to assets without bearing asset related risk are different motivations. In the latter case, this use of lease documentation is often similar to a form of outsourcing where the lessee acquires a service from the lessor who takes care of all its asset related needs. In our view, such service contracts do not give rise to assets and liabilities for the lessee. The current lease accounting model recognises these differences between lease contracts whereas this will no longer be the case under the model proposed in the ED.

The difference between leases and executory contracts is still not clear

The ED fails to provide a compelling rationale for why lessees should recognise assets and liabilities for every lease contract. BC 7 (c) simply states “when a lessee enters into a lease, it obtains a valuable right that meets the boards’ definition of an asset. Similarly the lessee incurs an obligation that meets the boards’ definition of a liability”. This is an unsubstantiated statement.

In particular, the Boards have never taken a clear decision on what the “past event” giving rise to the lessee’s asset is: signature of the contract or delivery of the asset.

Consequently there is some contradiction in the ED, with BC 7 (c) implying that it is the *signature* of the contract, while BC 7 (b) states that “when the lessor provides access to the underlying asset, the lessee has an unconditional right to use the underlying asset (...)”, implying that it is *delivery* or the moment when the lessee obtains *physical access* that is the past event.

The proposed model therefore lacks sound conceptual grounding in that the question of which past event is the decisive factor and why this should be the case is not discussed. This is a key issue as it is on this basis that the Boards decide that assets arise under leases but not under executory contracts. Yet, as EFRAG points out in its draft comment letter, it is not clear why there should be a difference in accounting between rights to the performance of a counterparty (arising upon the signature of a contract) and rights to use an item (arising when access is granted to the item).

We had understood that the Boards would take the opportunity of the ED to provide enhanced explanations as to why lessees are not in an executory contract position²¹, particularly given the substantial feedback received on this issue at the DP stage. We do not see any evidence of this in the ED. Consequently, it is likely to be difficult for the Boards’ constituents to fully understand the underlying reasoning on which the lease proposals are based.

The analysis of lessee and lessor rights and obligations is inconsistent

For lessees, on the obligation side, the Basis for Conclusion indicates that it is the provision of access to the underlying asset that gives rise to a liability²². We wish to draw attention here to the fact that there is therefore an underlying presumption that once the lessor has delivered the asset, it has performed its obligation²³. Indeed, it is *this* performance that gives rise to the lessee’s asset and unconditional obligation and that appears to conceptually underpin the entire right of use model. We therefore do not understand how the Boards can argue that the lessor still has an obligation to permit the use of the asset in the context of the Performance Obligation approach to lessor accounting. It cannot be both ways. If the lessor does have a continuing obligation to permit the lessee to use the asset as the Performance Obligation approach suggests, the lessee does not have a liability (neither does it have an asset).

Different conclusions can be drawn from considering real life contracts

We wish to point out that the entire discussion of a lessee’s rights and obligations in a lease have been conducted on the basis of a simple lease example, very different to real life leases. We have already pointed out that even run-of-the mill leases such as car or photocopier leases will include options to extend the contract or rentals that are based

²¹ IASB/FASB Meeting October 2009, Agenda Paper 10A

²² BC 7 (b)

²³ See for instance IASB/FASB Meeting October 2009, Agenda Paper 10A

on a contingent factor such as usage of the asset. We think that leases change in nature as such features are added to agreements taking on the form of a lease. Such contracts are more like executory contracts than financing contracts and it is not at all clear to us that conclusions which may be valid for the simple lease example remain true for these types of contracts.

Question 1b: Lessees – measuring assets and liabilities

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 do not agree with the current proposals for subsequent measurement as they imply that lessees will in practice be required to amortise the right of use asset on a straight-line basis. This creates a number of significant issues for lessees and the users of their accounts:

- 1) *A lack of comparability between lessee accounts.* Consider two lessees of identical assets with the same market rentals. The only difference between the two is that one lease is originally granted for 15 years and is 10 years into the contract while the second lease is for 5 years (of an asset in equivalent condition to that in the former lease) and is at inception. Although both lessees have identical rights and obligations, under the proposals the values of their assets in the accounts would be very different, as would the charges they record in the subsequent years. The first lessee would appear to be more profitable over the remaining period even though its position is identical to that of the second lessee.
- 2) *A permanent increase in lease costs.* Under the proposals, the amortisation and interest charge will exceed the cash rental paid in the earlier years of a lease. This means that lessees will experience significant losses on transition (as all leases will be treated as new leases on transition) but also on an ongoing basis. While the effect would even out over a portfolio of leases where older leases would compensate for the effects of higher lease expenses found in newer contracts, growing businesses will have more new, incoming leases than old, expiring leases, implying that in practice there will not be any such compensation but rather a permanent loss.
- 3) *A mismatch between lease costs and cash rentals paid.* In many jurisdictions this will result in book/tax timing differences that will not help improve the clarity of nor facilitate the comparability between lessee financial statements.
- 4) *A misrepresentation of the economics of the deal.* In taking out a lease, a lessee often seeks to match its lease expenses and revenues in order to achieve a straight-line P&L. It will no longer be able to do so under the current proposals.

While we do agree that subsequent measurement should be done on an amortised cost-basis, we consider that this should reflect the fact that a lessee's asset and liability are intrinsically linked. Indeed, the asset and liability form an inseparable package, originating from the same contract, contrary to say a purchase of an asset financed by a loan where the loan and the purchase have distinct contractual origins. In a lease, the lessee cannot sell the liability without selling the asset or vice versa. Subsequent measurement should therefore reflect this linked nature, thereby overcoming the negative side effects identified above.

The Boards recognise the linked nature of lease assets and liabilities for the purposes of initial measurement and have not made a case of why this should cease to be the case for subsequent measurement. There may be instances where the right to use asset becomes impaired or increases in value without there being a change to the lease payments. However, this does not prevent a lessee from using a form of measurement reflecting the linked nature of its lease assets and liabilities and otherwise performing impairments or revaluations as required, effectively de-linking the asset and liability values when necessary.

Consequently, we advocate a measurement approach whereby the lease liability is apportioned between a finance charge and a reduction in the outstanding liability and the decrease in the lessee's right of use asset is determined by using mortgage-based amortisation. This would best reflect the pattern of consumption of economic benefits of the lessee's right to use asset as the lessee effectively uses the asset as it pays for it. We understand that this approach could be applied to all leases and still functions in cases where rentals are uneven.

We recommend that interest recognised on lease payments and amortisation expenses on right of use assets be clearly identified separately from other interest and amortisation charges in the P&L so that users of accounts can easily aggregate the two to the total lease cost (equivalent to cash rentals paid). This will be important for preparers and users who consider that leases represent operating expenses rather than the financing of an acquisition of a right of use asset. Under future financial statement presentation requirements, lessees should be allowed to make the choice of whether their interest and amortisation expenses arising under leases are part of a financing/investing activity or an operating activity.

Question 2a: Lessors (The hybrid model adopted in the ED)

(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?

Leaseurope does not agree with the proposed hybrid model for lessors²⁴.

Why should there be one model for lessees but not for lessors?

No persuasive justification for having different models for lessors when there is just one model for lessees has ever been given by the Boards. References in BC 25 and 27 to differences in economics of business models for lessors do not hold up to scrutiny. While we do not disagree that there are different business models for lessors, we consider that in the case of business models where the principal risk being taken is asset risk, those lessors are providing a service to lessees instead of financing a right to use asset. Consequently, if one accepts that there is such a distinction to make, we think this should have an impact on the accounting for lessees too. The argument that some lessors are in the business of financing assets and that others are in the business of managing assets implies that they are providing different products. In the first case, lessees are acquiring rights of use that they are financing, and in the second case they are acquiring services, involving the use of assets. Manufacturer/dealer lessors are only different to 3rd party lessors (banks, finance companies) in that they are also in the business of producing assets. The leasing businesses of the two are the same, i.e. they are either financing or service activities. The only differences in accounting between these two types of lessors must therefore relate to the manufacturing of assets, and not to the entities' respective leasing businesses.

No clear principles

The principle exposed in the ED for when lessors are required to apply one model as opposed to the other, i.e. the exposure to significant risks and benefits associated with the underlying asset during or after the lease, is not indicative of whether a lessor has a performance obligation to permit the lessee to continue to use the underlying asset during the lease term. There is no relationship between these two concepts. Surely the principle for applying the performance obligation model should be “does the lessor have a performance obligation?” As discussed above, it is argued in the ED that they do not.

²⁴ We note that the lessor model goes beyond a choice between performance obligation and derecognition approaches, but also includes the fair value option under IAS40 for investment property lessors, accruals accounting for lessors of short term leases and sales/financing accounting for lessors granting leases that are “sales”.

Rather, the notion of “significant risks and benefits” appears simply to be an importation into the new standard of the existing concept of significant risks and rewards found in IAS 17 that is used to classify leases as operating or finance leases. It appears that no other meaningful principle for when the performance obligation should apply has been found. We think that it is questionable to maintain such a distinction when it is precisely this classification that the Boards object to in IAS 17.

BC 26 states that the Boards think that if a lessor retains exposure to significant risks and benefits associated with the underlying asset, then it is not appropriate to apply the de-recognition model. However, the ED does not explain why this is the case. We do not see any link between this statement and the quality of information provided under the de-recognition model. On the contrary, we consider that the de-recognition model, which shows a lessor’s right to receive lease payments (receivable) and its residual interests in the leased asset (residual asset) would provide users with information on the level of credit risk and asset risk the lessor is exposed to.

Paragraphs B22 – B25 provide indicators of when a lessor is considered to have retained exposure to significant risks and benefits associated with the underlying asset. However, B26 states that the existence of one or more indicators is not conclusive in making this determination. Consequently, and particularly in the absence of a clear principle, it is very unclear as to how these indicators should be interpreted by preparers.

Some of the individual indicators are also flawed. For instance, the existence of rentals that are contingent on the usage of an asset would protect a lessor against risks associated with the underlying asset (specifically that the underlying asset’s value would be affected by more or less usage) rather than exposing it to risk. Contrary to what is suggested in B22 (c), lessors do not provide leases that include non-distinct service elements (the concept is inappropriate). Lastly, B24, which refers to significant *risks* or benefits, seems to contradict paragraph 28 (b) where lessors have the expectation or ability to generate significant returns (but not losses).

If the Boards did intend to import the existing finance/operating lease principle into the new standard, at least this should be made clear as preparers are familiar with and understand this concept. The ED principle, together with its list of unclear indicators, will just create confusion for preparers, auditors and users. Lessors will do their best to make a determination, but comparability is likely to be significantly hampered as lessors of economically similar leases will interpret the indicators differently, resulting in very different accounting.

No improvement on the existing approach

Lastly, we would encourage the Boards to carefully consider the costs and benefits of the approach in the ED. In our opinion, there are no visible benefits for users of accounts to this approach, whereas preparers would be required to implement two different methods of accounting with no clear principles. In addition to entities whose main business is leasing, many businesses are “lessors” in an incidental capacity (i.e. it is not their core business to lease). A significant portion of these firms may not have realised that they have been granting leases (as the leases would have been operating leases accounted for as the provision of services). These firms will suffer a great deal of complexity: a new model on the lessee side and a several entirely new models on the lessor side.

De-recognition should be the general model applied to leases

Instead of the approach proposed in the ED, Leaseurope recommends that the de-recognition model (with the accretion of residual assets as described below in Question 2b) should apply as the general model for all leases. This is because only the de-recognition model is consistent with the right of use model for lessees and will result in a coherent overall model for leases.

The de-recognition model²⁵ is also superior as it allows manufacturer/dealer lessors to recognise sales revenue to the extent of the rights transferred to the lessee (i.e. a portion of the sales revenue that would otherwise be recognised in an outright sale of the underlying asset). We consider that this is appropriate as it is consistent with the view that the lessee has acquired a right of use. The lessor must therefore have sold it and should be able to recognise associated revenue and cost of sales. If such lessors are prevented from recognising sales revenue (as is the case under the performance obligation model), manufacturers who run their own leasing companies to support their sales will either be forced to turn to third party lessors to obtain their sales revenue or will have much greater difficulty in selling the products they manufacture. In either case, accounting will be driving and altering business practice.

It has been argued by some that the use of the de-recognition model would not be appropriate in cases where the carrying amount of the underlying asset is less than its fair value (i.e. in the case of assets of very long useful lives such as property) as gains would be recognised under the de-recognition approach. This is in fact an issue of measurement of the underlying asset (assets carried at historic cost) and is not a flaw of the de-recognition model. Had these assets been held at fair value, there would be no such issue. Day one gains for 3rd party lessors do not occur on new leases in any case.

²⁵ We refer here to the partial de-recognition model presented in the ED.

We accept that lessors of investment property using the fair value option under IAS40 should continue to do so. We would suggest that the only remaining category where de-recognition may possibly not be appropriate would be for other property leases (i.e. non-investment property and investment property held at historic cost). In such cases existing operating lease accounting could easily be applied. As a consequence, accounting for lessors of investment property should not change compared to the existing approach for these lessors.

Requiring the application of the de-recognition model to very short term leases would be burdensome (though not theoretically incorrect). Consequently, we support an accruals approach for lessors of short term leases.

Additionally, if the de-recognition model applies to all leases, there is no longer any need to maintain within the leases standard a scope-out for leases that are sales/purchases. The only reason this distinction was introduced was because manufacturer/dealer lessors are not able to recognise sales revenue under the performance obligation approach. The issue of leases that are sales/purchases is further discussed in our response to Question 4b) below.

Finally, we note that an approach where de-recognition applies as the general model with the exception of property and short term leases is the approach recommended to the Boards by the IASB staff²⁶. From listening to the Boards' deliberations on lessor accounting, we understand that many IASB members were supportive of this approach but voted in favour of the ED approach in order to reach a compromise solution with the FASB view that the performance obligation model should be the only model lessors apply. If the IASB cannot find conceptual reasons for supporting the performance obligation, convergence with FASB standards should not be the sole driving factor in developing an IFRS standard. The IASB should therefore reconsider the model exposed in the ED for lessors.

Question 2b: Lessors (Performance obligation and de-recognition)

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?

No. Leaseurope does not agree with the proposals for the recognition of assets, liabilities, income and expenses for the performance obligation approach to lessor accounting. We support the de-recognition approach where residual assets are accreted.

²⁶ IASB/FASB Meeting June 2010 – Agenda Paper 3D

Leaseurope considers that the performance obligation approach has no persuasive conceptual grounding and does not represent the economics of a lease transaction. Had the Boards examined the rights and obligations of both the parties involved in a lease contract concurrently, it is unlikely that this model would have been developed further as it misrepresents these rights and obligations and is inconsistent with the conclusions the Boards had previously reached for lessees.

The performance obligation model does not faithfully represent a lessor's assets and liabilities

The ED describes the performance obligation approach as an approach where the underlying asset is viewed as the lessor's economic resource. It argues that a lease contract creates a new right and a new liability and that the lessor does not lose control of the leased property for the lease term. Therefore, it continues to recognise the leased item²⁷.

However, during the lease, it is the lessee that controls the leased asset²⁸. By definition therefore, the lessor cannot make use of the asset during the lease term, it has given up this right to the lessee. For example, when providing a car lease, the lessor cannot drive the car itself; it has allowed the lessee to drive the car instead²⁹. Yet, under the performance obligation approach it would be accounting for this car on its balance sheet as if it was effectively able to use it. For instance, it would depreciate the asset, implying that it was consuming the economic benefit of the car. This would be misleading to the users of the lessor's financial statements as it is the lessee that is consuming that economic benefit (and is reflecting this in the subsequent measurement of its right to use asset) and not the lessor.

In the context of lessee accounting, the Boards have frequently argued that airlines should have the rights associated with their use of leased aircraft on their balance sheets. In reality, the global airline fleet is made up of some 20,000 aircraft, of which approximately one third are leased, many using finance leases. Consequently, many aircraft are on the balance sheets of the companies using them. Under a performance obligation approach, the Boards now seem to be saying that aircraft lessors should have those same aircraft on their balance sheets, even though they cannot be used by the lessor.

²⁷ See BC 16

²⁸ Indeed, a lease is a contract that conveys to the lessee the control of the underlying asset. See definition of a lease, for instance B1(b), B4, BC 30, etc.

²⁹ In other words, the lessor has provided the lessee with a right to quiet enjoyment of the asset. While there may be contracts that allow substitution in the event of non-performance, this is a right for the lessee to demand replacement, rather than for the lessor to withdraw the asset. The vast majority of lease contracts prevent the lessor from intervening in any way except in the event of default.

Consider a situation where an entity has purchased two identical assets. It uses one asset and leases the second one out. At a certain point, the first asset becomes unavailable for a period of time (e.g. it is confiscated and can only be recovered after a legal procedure or is temporarily inaccessible, etc.). The entity can therefore not use the asset and would consequently make an adjustment to its carrying value to reflect this. The entity is in exactly the same situation when leasing out the second asset – it cannot use the asset for a period of time and should consequently reflect this in the asset's value. This is effectively what the de-recognition model does and what the performance obligation model fails to do.

From a conceptual point of view, no justification has been (or can be) given for the fact that, while there is only one physical asset in the “lease system”, generating one stream of economic benefits, a lessee would have an asset for the right to use the physical asset and the lessor two assets: a receivable and the physical asset. Under this approach, the lease has created three assets out of one initial asset. It is also difficult to understand why entities that write leases would have balance sheets showing twice the amount of assets compared to entities that offer other forms of finance such as secured loans. Logically, a right to future cash flows cannot be used to support both a physical asset and a receivable. If the cash flows are attached to a receivable, then the physical asset has no future income stream (during the lease) and would be impaired.

This issue is further highlighted by the fact that the ED is silent as to how preparers should consider the underlying asset for impairment under the performance obligation approach. Given that the ED is silent, one would assume that preparers should refer to IAS 36 where it is likely that one will conclude the asset is impaired³⁰.

The ED proposes a form of linked presentation of a lessor's assets and liabilities occurring under the performance obligation model. In other words, the receivable, underlying asset and performance obligation are presented separately but are summed up to a total net lease asset or liability. This approach to presentation is simply an attempt to dissimulate the artificial grossing up of lessor assets created by the performance obligation approach. It is not at all clear how users of financial statements will interpret this presentation and, if they rely on the gross amounts, a lessor's return on assets will appear to be dramatically reduced and will be accompanied by an apparent increase in leverage. The result is that many shareholders of leasing companies may cease to see leasing as an attractive investment.

³⁰ In which case the performance obligation model comes closer to the results shown under the de-recognition model

Moreover, in the case of bank-owned lessors³¹ who would have to apply to performance obligation, a significant increase in regulatory capital could very well occur, in spite of their risk profile remaining unchanged. This is because lessors using this approach have to recognise two different assets for the lease, whereas today they only recognise one. There is therefore a risk that leasing would no longer being considered as an attractive business proposition by their parents. If many lessors reduce their operations or cease to operate as a consequence of applying the performance obligation model, the result will be that the European economy will be deprived of a vital source of funds.

Even with some form of net presentation, a lessor's return pattern, instead of reflecting a constant rate of return, would still be variable. Indeed, for a given transaction where the terms are negotiated at the start of the contract and remain unchanged throughout the term, one would not expect accounting guidance to reveal any other return pattern than a constant, contractual yield. Under the performance obligation model however, a lessor's performance will be distorted and the accounting treatment will not reflect the economic reality of the contract. Consequently, as the underlying principles of the performance obligation model are flawed, it would be much more appropriate to simply opt for the more correct de-recognition approach in the first place.

Moreover, in addition to balance sheet issues, the performance obligation model creates distortions in the P&L of lessors. For example, by not being able to de-recognise leased asset, lessors have to hold and measure these assets and therefore are required to recognise depreciation. This would negatively distort any operating expense ratios (e.g. the cost/income ratio for bank owned lessors) while bearing no reflection on the lessor's real, underlying efficiency. The Boards should also bear in mind that the lessee will be depreciating the right of use asset and the lessor the underlying asset. While these two assets are not exactly the same, the right of use asset does represent a significant portion of the leased asset. As a result, an important share of the economic costs of the asset would be recorded twice by different entities over the lease term, yet there is only one physical asset, generating one stream of economic benefits in existence. We think this is yet another example of how the performance obligation model does not faithfully represent the economics of the transaction.

De-recognition depicts the economics of a lease

We do not agree that the signature of a lease contract can ever lead to the creation of multiple new assets as suggested by the performance obligation approach. In reality, when a lease is entered into, a lessor is *exchanging* its right to use the asset for a series of payments that is appropriate consideration. It is not creating new rights; it is instead transferring existing rights to the lessee.

³¹ Many European leasing firms belong to banking groups. According to Leaseurope's 2009 Ranking Survey of European leasing firms, 17 of the top 20 leasing companies in Europe are bank related.

Therefore, in order to develop a coherent accounting model for leases where accounting for lessors is consistent with the conclusions that the Boards have come to when considering accounting for lessees, the following, indisputable facts must be taken into account:

- 1) *The lessor has performed upon delivering the asset to the lessee*³². It does not have a continuing performance obligation to permit use of the leased asset throughout the contract and therefore cannot recognise a liability for such an obligation (as it does not exist).
- 2) *The lessor has given up the right to use the leased asset which has been acquired by the lessee*³³. This implies that an asset is a bundle of rights, some of which can be transferred (via a lease contract for instance). If some of these rights are transferred, the lessor has effectively given up some of the “value” of the asset i.e. it has foregone its entitlement to the future economic benefits associated with this right to use during the lease term. On the other hand, it has retained rights over the residual value; these rights are independent from that part of the asset that gives rise to rentals. This shows that rights over the asset are clearly identifiable and separable and that the lessor’s measurement of the leased asset should reflect this situation.
- 3) *The lessor no longer controls the right to use the asset during the lease term. As it is the lessee that controls this right, in order to be consistent with the Basis for Conclusions in the Derecognition Exposure Draft which states that “two parties cannot control the same asset simultaneously”*³⁴, the lessor cannot control this right and should de-recognise the part of the asset associated with the right.

The only model that effectively takes into account the above facts and that consequently represents the economics of a lease is the de-recognition model, where the lessor de-recognises the leased asset to the extent of the rights it has transferred to the lessee, retaining only any residual rights it may have in the leased asset.

With the exception of the proposed treatment for subsequent measurement of the lessor’s residual asset (see below), Leaseurope is therefore supportive of the partial de-recognition model described in the ED.

³² See BC 7 of the ED where point (b) states: “When the lessor provides access to the underlying asset, the lessee has an unconditional right to use the underlying asset and therefore has an unconditional liability to make lease payments”. This is further reinforced by the next sentence of the same paragraph: “At that point the lessor cannot prevent the lessee from using the underlying asset nor can the lessee avoid payment without causing a breach of contract”.

³³ The Basis for Conclusions explains that the Boards’ hold the view that with a lease the lessee has financed the acquisition of a right of use (see for instance BC 10 (c) or BC 147)

³⁴ BC18, Exposure Draft ED/2009/3, Derecognition, Proposed Amendments to IAS 39 and IFRS 7

The lessor's residual asset under the de-recognition model should be accreted

Paragraph 50 of the ED describes the amounts that the lessor de-recognises and retains as being “determined according to the portion of the fair value of the rights the lessor has retained and the fair value of the rights the lessor has transferred to the lessee”.

The lessor's residual asset, i.e. the rights it has retained, is the present value of the expected value of the asset at the end of the lease, excluding a deferred sales profit amount in the case of manufacturer/dealer lessors. This is because lessors use the fair value (normal selling price) of the underlying asset as the basis for calculating lease payments and thus the value of the right of use of the asset (i.e. the present value of lease payments). In performing this pricing exercise, the lessor will decide on the level of residual it is willing to accept at the end of the lease, considering this amount to be the last cash flow in the lease.

Given that the initial measurement of the residual is based on the present value of its expected value at the end of the lease (excluding a deferred sales profit for manufacturers), we consider that this discount should be unwound over the term of the lease. If the residual asset is frozen as suggested in the ED, the accounting will not reflect the lessor's constant contractual yield. Instead, the lessor's return on assets will i) be lower than contractual yield, ii) decrease through the lease term and iii) increase significantly when the lessor sells or releases the asset.

Freezing the residual also hampers comparability between 3rd party and manufacturer lessors as for the same lease contract the returns shown by these two parties would not be the same. This is illogical as the accounting for the same financing transaction should yield the same results regardless of the type of entity granting the deal. The only difference between a 3rd party and a manufacturer lessor's accounts should be the sales profit that the manufacturer is seeking to realise. We recall here that the 3rd party lessor has no such profit to recognise and indeed is not in the business of selling assets.

Users of financial statements of lessors are interested in obtaining information on the level of residual risk a lessor faces. Freezing the measurement of residual assets will therefore not provide users with the best information available. Given that the initial measurement of the residual asset is on a present value basis, the most relevant information to the users of accounts in subsequent periods is the fair value of the residual asset and the best proxy for fair value is the discounted expected future value of the asset. We do not advocate a full fair value approach to subsequent measurement given the difficulties of establishing current fair values of future second hand prices. However, a present value basis is far more informative than freezing measurement at the initial amount.

We note that under IAS17, residuals are effectively accreted over the lease term. The only difference with the finance lease accounting model³⁵ and the de-recognition model is that under a finance lease, the lessor's residual is not shown separately from its right to receive rentals whereas de-recognition splits these two assets, thus providing better information to users.

Additionally, it is important to understand that a lessor's residual asset represents its remaining rights to an asset after it has transferred the right to use the asset to a lessee. It is therefore not directly comparable to the underlying asset itself (e.g. the car or the equipment). Rather, it represents a *future physical asset* or the asset the lessor will have once the lease has come to term and when all of the rights associated with the underlying asset (i.e. ownership and usage rights) have been reunited. As the residual represents the lessor's rights to control of the underlying asset in the future (i.e. at the end of the lease), we consider that its subsequent measurement should reflect the time value of money and that this would not be inconsistent with a cost-based approach to measurement.

Another way of looking at a residual asset is to describe it as the remaining portion of the leased asset that is not encumbered by the transfer to the lessee of the right to use the item. As the lease term progresses, this asset becomes progressively less encumbered (i.e. the lessor comes closer to reuniting all the rights associated with the asset). Subsequent measurement of the residual asset should therefore reflect this progression. In other words, residuals should accrete at the rate inherent in the lease so that they equate to the expected asset value at the end of the lease term (absent impairment).

Lastly, we note that the accretion of residual assets is supported by IASB member Stephen Cooper in his alternative view to the Leases ED.

In conclusion, the de-recognition model, *with accretion of residual assets*:

- 1) Is conceptually and fundamentally consistent with the right to use model for lessees.
- 2) Reflects the fact that a lease creates a transfer of rights from one party to another.
- 3) Is the only model that appropriately reflects the economics of a lease transaction
- 4) Can be applied to all leases, i.e. it does not require the creation of artificial categories of contracts such as a distinction between leases/sales or de-recognition and performance obligation leases
- 5) Allows manufacturers/dealer lessors to recognise sales revenue to the extent of the rights they have transferred to the lessee
- 6) Reflects lessor business models and will not force market (commercial) practice to change

³⁵ Ignoring the difference between the two models for accounting for options and contingent rentals.

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?

Leaseurope considers that the proposals for short term leases do not go far enough.

Given the significant level of complexity that the new standard will introduce for all leases and in particular for the small ticket end of the market (which makes up a substantial share of the leasing business), it is unreasonable to apply this approach across the board. Consequently, we would advocate a solution that does not impose disproportionate costs on the users of such types of contracts.

We consider that the so-called concession for lessees of short term leases does not provide this type of solution as the only simplification made is the omission of a present value calculation. The bulk of the burden involved in indentifying the large numbers of small, short term contracts that many companies are likely to have, and applying all of the other requirements of the proposals such as determining the lease term and lease payments, has not been alleviated. We therefore do not agree with the statement in BC 205 that the Boards have simplified the accounting for short term leases from the perspective of lessees.

Over and above the simplifications we would wish to bring about to all leases, we consider that lessees of short term leases should be allowed to continue to apply existing operating lease accounting. While some may argue that treating contracts under 12 months differently to others has no conceptual basis, we see this as being a pure cost/benefit trade off.

Another way of simplifying the implementation of the standard is to limit the definition of a lease to leases other than those for assets that are fungible (i.e. they can be substituted for equivalent assets as for instance in the case of cars, photocopiers, etc.) and can be easily replaced on the open market. A principles-based distinction along these lines could be constructed as part of the necessary clarification of IFRIC 4 (see below, Question 4(a)), where it will be necessary to make clear whether contracts such as these, which also frequently contain significant service components, are in fact more like outsourcing contracts than leases.

It is crucial the Boards develop this type of concept further if they are to produce a workable final standard. Moreover, we feel it is important in this context to stress that the Boards must not ignore the interests of SMEs. Although the proposed standard may apply initially only to a relatively small number of publicly traded entities, it is highly likely that it will be applied subsequently to all reporting entities, whether directly by the IASB through IFRS for SMEs, or indirectly by national standard setters. It is also likely that it will also be applied eventually within the public sector. If the standard set described in

the ED were to apply to SMEs as it is, it is likely that these types of businesses would simply not be able to lease any longer because of the complexities of the approach. As described above, leasing is a key source of finance for these businesses and their use of the product should not in any way be undermined. The responsibility to take account of SMEs' interests sits firmly with the Boards, because the standard it is now considering will in due course have to be followed by small companies³⁶.

On the lessor side, we agree with the proposal that entities providing short term leases should continue to recognise the underlying asset and recognise lease payments in profit or loss over the lease term. Again, we think that conceptually the de-recognition model can be applied to these leases but that the costs involved in de-recognising extremely small fractions of the physical asset, recognising receivables at the present value of rental payments, accounting for interest, etc. in such cases would be disproportionate to the benefit in information for users of accounts.

Question 4a. Definition of a lease (general)

Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

No. Leaseurope considers that the definition provided in the ED i.e. "a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration" is too broad.

This definition has simply been imported from the existing leases standard without adequate consideration as to whether it remains applicable in the context of the new accounting model. While some argue that because the definition remains unchanged it should be straightforward to apply, this view fails to recognise the fact that under the new standard much more strain will be placed on making the determination between what is a lease and what is an executory contract as the accounting for these two types of contracts will be very different. Today however there is no such strain as the accounting for an operating lease and for a service contract are very similar, to the extent that it is possible that many do not consider "rental" contracts to be leases but rather "service" contracts. The fact that these contracts are often for low value items, or can be viewed as outsourcing contracts making use of lease documentation, further compounds many preparers' view that these contracts do not give rise to (material) assets.

If the Boards are to pursue the right of use approach, for it to be workable we recommend that the definition of a lease be adapted to take account of the following elements:

³⁶ We note that the European Commission's ["Small Business Act"](#) promotes the "think small first" principle in developing new legislation.

- 1) An entity is only entering into a lease contract when it is acquiring a more substantial use of an asset rather than an ancillary use of an asset. In other words it is interested in consuming some share of the economic benefits of that asset. Contracts involving the incidental or ancillary use of assets should be excluded from the scope of the new standard.
- 2) When a transaction involves the use of generic, easily exchangeable assets, the entity entering into the transaction is more likely to wish to obtain a service contract than the use of an asset – the asset’s use is likely to simply be a vehicle allowing it to obtain that service.
- 3) The fact that the supplier can replace an asset, even if it does not do so in practice, is also indicative of the fact the client wishes to obtain a service rather than the use of an asset. It is therefore not surprising that a lot of the issues surrounding the IFRIC 4 guidance relate to how one interprets the notion of a specified asset and we would recommend that that concept be clarified

Leaseurope therefore proposes the following definition of a lease:

A lease is as a contract that, in exchange for consideration, conveys to a lessee the right to use a specified asset for a period of time that is more than a minor part of its economic life. The lessee will have obtained a right to use when it controls the asset for more than a minor part of its economic life.

When will a lessee have obtained control?

The lessee will have obtained that control when the contract conveys the ability to the lessee to direct the use of the asset for more than a minor part of its economic life and when it has obtained the right to consume more than a minor share of the future economic benefits of the asset through its use of the asset over the lease term.

When is an asset specified?

An asset is specified when the agreement specifically identifies the asset (or part of a larger asset). An asset is not specified when, even though the agreement specifically identifies the asset, the lessor can substitute the asset at any time without requiring the lessee’s consent or, if the lessee’s consent is required, it is feasible or practical for the lessor to substitute the asset, having obtained that consent. Assets that are fungible and easily replaceable on an open market do not therefore generally qualify as specified assets. In many outsourcing type contracts, assets may well be specified by serial or registration. This is simply a precaution on the part of the lessor to ensure clear identification on the assets it owns rather than an indication that the lessee requires that specific asset.

While we appreciate that the precise drafting of such a principle represents a challenge, we encourage the Boards to take the time required to develop the definition of a lease along these lines. Otherwise, the difference between a lease and service will be too fine and many contracts that are today considered to be services will be required to be accounted for as leases.

Importantly, the tightening up of the lease definition will also contribute significantly to alleviating the complexity of the model for preparers of accounts and will facilitate the application of a single right of use model to both lessees and lessors – the objective that the Boards were aiming for with this project. We note also that a similar approach is supported by EFRAG in its draft comment letter to the IASB.

Question 4b. Definition of a lease (leases vs purchases/sales)

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?

Leaseurope does not agree with the proposal. We consider that such a distinction is not required as it creates a new bright-line classification requirement between different kinds of leases. We note that the current standard does not include such a distinction as the accounting for these contracts can very well be catered for under the existing accounting which provides similar results to accounting for outright sales/purchases. We think the same is true of the new standard where lessees will acquire rights to use that are equal to or near 100% of the rights associated with the underlying asset and where the lessor will de-recognise those same rights³⁷.

The only reason for introducing the notion of “leases that are sales or purchases” into the leases guidance was the need for manufacturer/dealer lessors to be able to recognise sales revenue at least in some circumstances as under the performance obligation model, the only model considered initially for lessors, manufacturers are not able to recognise such revenue. Now that de-recognition has been introduced (and we argue should apply as the general model for lessors), there is no longer any need to scope out such contracts from the existing guidance. Manufacturer/dealer lessors will be able to recognise a sales profit that is proportionate to the rights they have transferred to the lessee. If these rights represent (close to) 100% of the rights associated with the underlying asset, then the manufacturer recognises (almost) all the profit that they would have otherwise recognised in the case of an outright sale. In such cases lessors would also show no (or a very small) residual asset, effectively indicating that they have transferred the bulk of the rights associated with the underlying asset to the lessee.

³⁷ The only difference would be accounting for contingent rentals and options, proposals that we do not support

Not only is this distinction no longer required for above purpose, it introduces into the IFRS literature several definitions of what constitutes a sale. Given that the Boards are conducting a parallel project on revenue recognition where sales of goods and services are defined, we believe that it is not appropriate for a second, different definition to be introduced into another standard. Paragraph B9 of the Leases ED defines a sale or a purchase as the transfer of control and all but a trivial amount of risks and benefits associated with the underlying asset, whereas the Revenue Recognition ED refers only to control. We are unsure whether the meaning of the word control is the same in the Leases ED and the Revenue Recognition ED but fear there may be cases where a contract qualifies as a sale under one of these but not under the other.

Moreover, although the definition of a purchase/sale in the Leases ED is slightly narrower than the definition of a finance lease today, in practice the two are not very different. This is because the criteria of “all but a trivial amount of risks and benefits” is very similar to the criteria for determining finance leases today. Some Leaseurope members report that a majority of their existing finance lease contracts would likely qualify as sales under this definition. This would have a number of practical implications:

- 1) Under the lessor model currently proposed, although the criteria for distinguishing between de-recognition leases and performance obligation leases are not necessarily clear, it could be that in reality there will be very few cases where de-recognition effectively applies (leaving a sales model and the performance obligation model as the *de facto* accounting approaches for lessors)
- 2) The lessor’s ownership rights to the asset will not be visible, jeopardising its position in the event of lessee default. Even though such contracts may bear some similarities to outright sales, they are not outright sales as the lessor continues to have legal title to the asset. Legal title does not have to be a decisive factor, but does play a role as it is indicative of a higher security lien than other forms of secured lending. Applying the right of use model to such contracts recognises legal title of the lessor but provides equivalent accounting to that for secured loans or financed sales.
- 3) The distinction may possibly to lead to a number of other consequences in terms of the tax treatment of leases and the regulatory environment that is applicable to lessors (lessors will no longer be lessors but lenders and sellers). Decisions taken in the field of lease accounting will influence other areas of legislation and these effects on the business cannot be ignored by the IASB.

Question 4c. Definition of a lease (leases vs services)

Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

No, we do not think this guidance is sufficient. The importation of the existing IFRIC 4 concepts into paragraphs B1 – B4 has not provided preparers with the additional guidance needed to make the determination between a lease contract and a service contract. In addition to our comments above, we note that difficulties will arise in the areas discussed below.

Specified asset

What does specified mean? In other words, to what extent does an asset have to be specified to qualify for consideration as a lease contract? Consider a contract providing an entity with the use of a car for a period of time. Will this asset be specified if the chassis number or other unique identifier is mentioned in the contract, if the contract refers to a specific make and model of car or if the contract provides for the use of a certain category of car (e.g. luxury saloon or mid-size hatchback)? Should it matter? One of the main reasons for a contract referencing a serial number is to enable the entity granting the contact to track its assets and secure them in the case of non-payment for instance. It may not be indicative of the fact the client wants to use that referenced (“specific”) asset.

Capacity-type leases are also a good illustration of where determining precisely what the asset is that is being leased is far from straightforward. Consider for instance an entity looking to store goods in a warehouse. Is the asset being used the warehouse or is it a particular allocated space in the building? A satellite may have hundreds of different nodes used by various customers. Is the asset being used the node or the satellite? Is the node dedicated to one customer or not? Similar questions arise for instance with fibre optic cables. Does an entity have an exclusive right to use a fibre or does it have use of any fibre that happens to be free at a particular time? Or is the asset the cable as an indivisible whole? Again, should this make a difference in determining the nature of the contract?

In addition to these difficulties, the use of the specific asset criteria may lead to some illogical results. For instance, if a shipping company provides a manufacturer with the right to use a ship to transport goods and only has one vessel in its fleet, this would be considered a lease (the asset is implicitly specified); however, if it has several vessels in its fleet and any one of these can be used for the purposes of transporting the goods, then there is no lease but a service contract. If only one vessel of the fleet is effectively available because the others are on the other side of the world, then the asset would implicitly be specific and again there would be a lease. However, in all three cases, the

contracts and the service being provided are exactly the same. The accounting will be very different.

The current drafting of B2 – B3 is also difficult to understand as paragraph B2 appears to suggest that if a lessor can substitute an asset, but rarely does so in practice, the contract would be a lease. B3 on the other hand says that a contract that permits an entity to substitute an asset does not contain a lease, without referring to whether this would need to be done in practice but instead to the supplier having the right and current ability to do so. Which paragraph provides the principle that preparers should follow? As noted above, the provider having the ability to substitute the asset is a strong indicator of the customer wishing to acquire a service instead of a lease, regardless of whether the asset is substituted in practice or not.

Control

The notion of control as described in paragraph B4 does not necessarily function well when determining the difference between a lease and service. Why should the fact that a node in a satellite, a fibre optic cable or an in-house photocopy shop is dedicated to (i.e. controlled by) one customer be a determining factor in characterising the arrangement? In such cases, the customer is unlikely to be concerned with whether it has an exclusive right or whether other parties can also use the assets involved, the customer will simply want to acquire a service to transfer data or make copies.

BC29-32 are also very difficult to understand. B31 - B32 suggests that situations where the lessee is obtaining all but an insignificant amount of the output of an asset and where payments are specified in terms of the time that the underlying asset is made available for use may meet the definition of a lease, but in cases of contracts where payment is based on market price per output, the entity is paying for a product or service. We agree that payment based on output is an indication of a service situation. This reasoning can be applied to contingent rentals based on usage. For example, is the output or utility of a car not the ability to drive a certain number of kilometres against payment of a “per kilometre” price? We believe that B4 (a) and (b) can in certain circumstances be contradictory with (c). Where an entity has the ability to operate the asset or to control physical access to the asset and obtains more than an insignificant amount of the output but the price for the output is fixed or at current market price per unit, then (c) would indicate that it is not a lease while (a) or (b) would indicate that it is a lease³⁸.

³⁸ Criteria (a) and (b) make no mention of the pricing mechanism

We are therefore not convinced that some of the notions used in B4 are helpful in distinguishing between a lease and a service contract. Instead, we recommend that the Boards consider how the notion of control developed in the context of the Revenue Recognition project could be adapted to determine whether a contract is a lease, as suggested above in our alternative definition of a lease.

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 do not agree that leases of intangible assets should be excluded from the scope of the new standard. This represents a step backwards from the existing scope of IAS 17. Entities frequently provide or acquire rights to use intangibles and by not addressing the accounting for such situations, the Boards have introduced a gap in the accounting literature. In particular, there will be no guidance for *lessees* of intangibles. While leases of these assets are explicitly out of scope, in the absence of any other relevant standard and given the IFRS hierarchy, preparers are likely refer to the new leases standard when trying to account for such contracts. Preparers will therefore find themselves in the awkward situation where on the one hand, intangibles have been scoped out of the leases standard (due to a lack of time to consider issues surrounding the use of the right of use model for these assets), but on the other hand, in practice, they will still probably have to refer to this guidance.

Additionally, many contracts involve both tangible and intangible assets, for example where equipment is provided together with application software³⁹. Entities will now have to separate those contracts into components but will lack specific guidance on how to make such an assessment as well as on how to account for the intangible component. This potentially opens the door for a significant additional amount of complexity for preparers.

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 do not agree with the approaches.

The proposed accounting does not reflect the simplicity and flexibility of leasing

Many lease contracts contain service elements in addition to the right to use the leased item. In some cases, the service component may be rather incidental to the right of use component and in others it will be much more significant. The latter type of contract is

³⁹ For instance, in the office equipment market, the portion of application software is approximately 15% of the total amount financed and this figure is growing.

akin to an outsourcing contract where the “lessee” effectively outsources all asset-related needs and costs to the “lessor” in exchange for a single, convenient invoice. In such cases, it will be extremely burdensome for preparers to identify and separate service and lease components, if not impossible. As explained above, we consider that such contracts should not be defined as leases.

It is also important to keep in mind that these types of contracts are becoming more and more popular as firms choose to focus on their core activities and tend to outsource those asset needs that are auxiliary to their business. In fact, the service package can often be the decisive factor in opting for a contract that takes on the form of what would today be called a full service lease instead of another product or several, separate products. If these lessees are required in the future to estimate their service payments, to account for them separately from the right to use asset, to set up asset registers for right to use assets and incur major systems costs, part of the economic rationale for opting for these contracts falls away. This is one of the many sources of complexity of the new proposals and we consider that there is a very significant risk that the entire business model for these types of contracts could be jeopardised.

Treatment of leases with services from the perspective of lessees

When considering true lease contracts granted in association with service components, we question whether the notion of “distinct services” can be applied to lessees. Indeed, this concept has been developed in the context of the revenue recognition guidance for entities entering into contracts to provide goods or services, not for entities acquiring such contracts. Therefore, we consider that the Boards should define specific guidance for lessees. We suggest that lessees should estimate service components. This could be done for instance by comparing the lease to a lease with no services or to a stand-alone service contract. However, if this is not feasible, instead of the default to treatment of both right of use and service components as a lease contract suggested in B5 (a), lessees should make an assessment of whether the contract they have entered into is in-substance a lease or a service. If the Boards resolve the issues surrounding the boundaries between lease and service contracts along the lines of what is suggested above, lessees will be less frequently confronted with this assessment.

Treatment of leases with services from the perspective of lessors

From the point of view of a lessor, any service components granted in conjunction with a lease will always be distinct service components, separable from the lease. Although we disagree that there would ever be non-distinct service components in a lease, we do support the IASB’s approach to require separation of services components from lease payments when applying the de-recognition model. We do not advocate the application of the performance obligation model in any circumstances.

When discussing leases with service payments, we understand that the Boards were concerned that there would be “services that are totally integral to a lease” such that they could not be separated from the rest of the rental and would generate a day-one profit for lessors under the de-recognition model. The examples that were considered included a property lessor being obligated to clear snow, mow lawns or maintain lifts, or any lessor being obligated to pay a personal property tax.

However, these are simply (distinct) service elements of the rental which were consistently presented to, and by, the Boards as being excluded from rentals before discounting them to find the initial value of the lessee’s right of use and liability and of the lessor’s lease receivable. Indeed, the Boards’ entire reasoning was based on the famous “simple lease example” that did not contain any service elements at all. The idea that some service payments are so “integral” that they could not be separated from lease payments was never an issue when considering the right of use model for lessees. Had this concept been considered during the lessee phase of the project, the Boards may have concluded that if such service payments did exist, the contract may not have given rise to an asset for the lessee.

Beyond the fact that this concept was never discussed in the context of developing the lessee accounting model, we consider it to be entirely misleading. In property leases for instance, services, even if essential, are paid for through a distinct, periodic service charge and are obviously separable from the rest of the rent. Above all, no sensible lessor of any sort (property or otherwise) would sign a lease with an all-inclusive rental covering services whose cost cannot be reliably estimated. Lastly, if obligations to clear snow (that has not yet fallen) or pay a personal property tax (that is not yet due) in future periods constitute performance obligations for the owner of an asset that leases it out, why do they not receive the same treatment in the case of the owner of an asset that occupies or uses it for its own purposes?

We therefore urge the IASB and FASB to align their views on this issue so that service components are always separated from lease payments for lessors and to the extent that lessees are able to do so. If lessees are not able to do so, they should not be penalised by a requirement to capitalise the full payments, which lacks any conceptual basis, but should instead make an assessment as to the nature of the contract.

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 do agree with the proposed treatment of purchase options but think that purchase options and renewal options should be treated consistently and as explained in our response to question 8 below.

Question 8: Lease term

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

We do not agree. As stated in our response to the Leases Discussion Paper, Leaseurope takes the view that the Boards' decision to adopt a single asset and liability approach for leases, and in particular to take into account renewal/extensions options on the basis of the longest possible lease term that is more likely than not to occur, is not appropriate. Under this approach lessees will be required to recognise assets and liabilities they do not have. Lessors will recognise assets and potentially revenue that they do not have. This approach is i) inconsistent with the Conceptual Framework ii) unlikely to provide users of accounts with better information and iii) a significant source of complexity for preparers.

A conceptually incorrect approach that is far too complex to apply

We agree that individual components such as options may meet the definition of an asset for lessees. However, because of the difficulties in measuring lease components, an approach requiring the outright valuation of options would simply not work in practice. For example, there is no market for options to extend or terminate a lease and lessees cannot determine their value on a standalone basis.

Nevertheless, these difficulties do not imply that the approach proposed in the ED is a sound alternative. Not only does it fail to recognise the difference between a 2 year lease with an option to extend for a further 2 years and a 4 year lease⁴⁰, it also vastly overstates the value of such options. For instance, if a lessee is required to account for rental payments over a period of 4 years in the former situation, it would be effectively valuing its option at an amount equal to a full 2 years of rentals.

Moreover, the approach, which requires preparers to make assessments of the likelihood of exercising options at the start of a lease, will be extremely burdensome to apply⁴¹. Entities will choose leases with optional features precisely because they do not know for how long they will need to use an asset. This flexibility should not be underestimated as it is one of the key reasons why companies choose to lease instead of buy (or lease with a fixed term) and can be an inherent part of their company's operating model⁴². In this sense the use of leases with optional features reduces their

⁴⁰ Proposed disclosures are not sufficient to mitigate this issue.

⁴¹ PWC [European Impact Survey 2010](#)

⁴² For example, a construction firm will chose to lease an excavator to use on a building site for an original term equal to the expected construction period. However, as significant delays can occur in construction, or a second construction contract may be signed later, the lease will allow the firm to prolong the use of the excavator for as long as required. Equally, the firm will be able to return the excavator if construction is competed ahead of schedule or to acquire the use of additional machines if needed.

exposure to risk. Given the efforts that firms will have to go through to determine their lease terms, the proposals as they stand are likely to hamper this important benefit that leasing can currently convey.

How do you rate the costs associated with the implementation & ongoing complexity of the proposals for options?

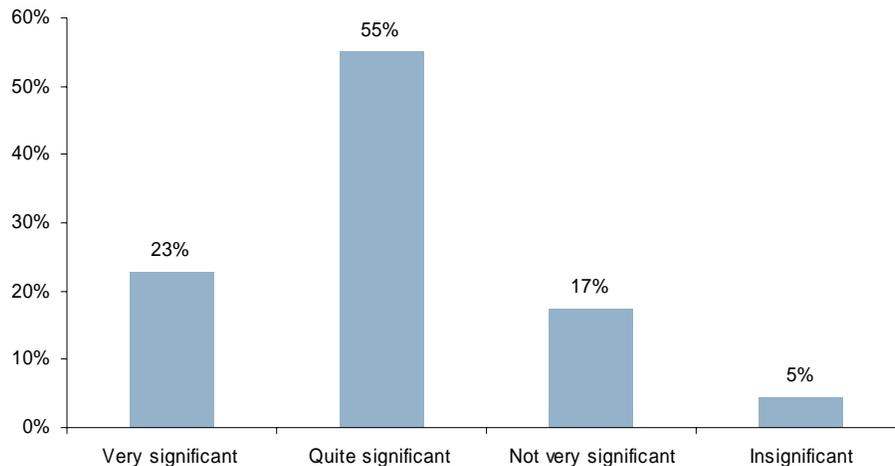


Figure 2

Source: PWC European Impact Survey 2010

Lastly, the approach is likely to reduce comparability between entities with very similar leases but who may end up accounting for vastly different assets and liabilities (an issue that the Boards wish to overcome in the context of the current standard) depending on how they assign probabilities to the various scenarios for exercising such options. This lack of comparability between entities is unlikely to be helpful to users of accounts who will also have difficulties in appreciating the underlying assumptions used by preparers and therefore in assessing the reliability of the information provided on the face of the financial statements.

Alternative treatment for leases with optional features

As an alternative, we suggest an approach where only lease payments required to be made during the initial contractual lease term are recognised. This would include any amounts that are required to be paid by the lessee either to obtain the ability to extend the lease term beyond the initial contractual term or to obtain the ability to purchase the asset at the end of the contract in addition to any amounts the lessee is required to pay if the lease contains a renewal or purchase option but where the lessee does not renew the lease or purchase the asset. The maximum amount payable under a residual value guarantee provided by a lessee to the lessor should also be included in the payments that are recognised⁴³.

⁴³ We note that this is the approach currently adopted in IAS17 for lessee provided residual value guarantees

We consider an approach that requires these amounts to be taken into account would mitigate any potential negative side-effects of not separately accounting for options or considering their impact in determining a likely lease term, while at the same time effectively reflecting their value and the commitments and risks that a lessee has under a lease. This is because renewal options will fall into one of the following categories:

- 1) *Renewal options allowing the lessee to extend the lease after the initial lease term at the then market rate (or an equivalent one-off payment.)* Such an option has no intrinsic value as the lessee could simply obtain a new lease at the end of the initial lease.

- 2) *Renewal options allowing the lessee to extend the lease after the initial lease term at a rate lower than the then market rate rentals (or an equivalent payment).* Renewal options at lower than market rentals (or an equivalent payment) will either have been priced into the level of rentals of the initial lease term (which will be higher than if there is no such option) or will be granted in conjunction with a residual value guarantee designed to protect the lessor from the shortfall between the secondary period rentals and market rentals. In the first case, the value of the option reflected in the higher rentals will already have been taken into account into the lessee's obligation to make rental payments and its right of use asset. In the second case, the maximum amount payable under a residual value guarantee is included in minimum lease payments. Consequently, the value of the option is appropriately taken in to account.

- 3) *Renewal options allowing the lessee to extend the lease after the initial lease term at a rate higher than the then market rate rentals (or an equivalent payment).* Renewals could also be granted at an above market rental. In such situations, if the rentals in the initial lease period are lower than they would be otherwise, the lessor is exposing itself to a significant risk that the lessee will not renew the lease (indeed, the lessee has no obligation to renew). The de-recognition model for lessor accounting will reflect this situation clearly, by showing a large residual asset that will be clearly visible to users. Lessors will therefore only grant such leases if they are effectively comfortable with taking on such risk. In practice, it is unlikely that they will do so to any great extent but even if such contracts are granted, the accounting model will always appropriately reflect the true risks and commitments of both parties.

The same treatment can and should be applied to options other than renewal options.

Indeed, the same reasoning as above is applicable to purchase options:

- 1) Purchase options where the exercise price is at market value of the asset do not have any intrinsic value
- 2) The value of a purchase option where the exercise price is lower than the market value of the asset will be priced into the rentals and thus reflected in the lease payments
- 3) Purchase options where the exercise price is higher than the market value of the asset could be used as a tool to structure lower rentals. However, if this is the case, the lessor will have a higher residual asset reflecting its larger exposure risk.

Leases with termination options should be viewed as being the economic equivalent of a lease (for a shorter initial term) with a renewal option and again the same reasoning applies.

Although we have a preference for the approach set out above, another alternative the Boards could consider would be to increase the probability threshold used in determining the lease term from the current threshold of “longest possible lease term more likely than not to occur”. This threshold is very low and consequently will imply that preparers will be required to recognise assets and liabilities for the full amount of rentals under optional periods in situations where there is little compelling evidence that they actually will exercise the option. Again, this is why this approach will not provide truly meaningful and reliable information. If the Boards decide to retain their current approach, a higher, more robust threshold should be chosen for determining the lease term, where only optional features with a “highly probable” chance of being exercised are taken into account. In such cases, preparers would be required to consider whether they are economically incentivised to do so. This approach is consistent with the alternative view presented in the ED.

The discussion and alternatives set out above are described from the point of view of lessees but the comments apply equally to lessors. If anything, we consider that the approach, were it to be applied to lessors, would result in accounting that is even more questionable than on the lessee side as lessors would be reporting assets they do not control. Such amounts clearly do not meet the Framework’s definition of an asset. The risks a lessor is exposed to will appear to users to be credit risks (receivables will be overstated) whereas in reality, the lessor will be taking on asset risk. Again we note that the two different types of risks lessors are faced with, credit and asset risk, are most appropriately reflected under the de-recognition model.

Additionally, requiring lessors to include rentals under optional periods in their receivables comes with the risk of creating an incentive for management to recognise longer lease terms to benefit from additional revenue and any linked compensation schemes. The Boards may also wish to look into past cases of lessor bankruptcies (e.g. Atlantic Computer, Itel, Sound Diffusion) which could be attributed to an overstatement in assets (e.g. anticipated extensions did not arise). Despite the lessor undertaking regular review of recoverability and this being reinforced through the external audit process, in our view there still remains significant risk that lessors could report assets that only much later are deemed irrecoverable.

Lastly, in situations where an entity would sell its leases to another party (which occurs frequently in vendor lease programmes for instance), the lessor may estimate a longer lease term but it is unlikely that the purchaser would pay for anything else than an amount based on contractual, committed payments. The result is that revenue would differ depending on whether the entity decides to retain the lease on its books or not.

Consequently, we are extremely uneasy with the method proposed and are of the opinion that users would not welcome such treatment. Our recommendation is therefore that lessors should only account for committed lease payments.

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?

The approach is inconsistent with the Conceptual Framework

We do not agree with the proposed approach for accounting for contingent rentals and expected payments under residual value guarantees. This approach implies that lessees will recognise obligations they have the discretion to avoid and lessors assets they do not control. We view this as being inconsistent with Conceptual Framework definitions. Moreover, the approach amalgamates lessee liabilities and assets that are financial in nature and those that are not. Lastly, it fails to take into account the there are fundamental differences between the items referred to under the heading of contingent rentals.

There are differences between the various features grouped under the contingent rental heading

Payments that are based on changes in an index or rate are simply variable rentals and are different in nature to contingent rentals. With the former, the lessee is unable to avoid making the required payment, whereas with the latter, the lessee is only obliged to make payments once the contingent event has occurred. This should therefore be reflected in the accounting model for leases. We suggest that they be included in the lease payments that are recognised, using the index or rate existing at inception of the lease upon initial measurement. Changes in amounts payable arising from variations in the underlying rate or index should be recognised in profit or loss in the period in which they occur. This would be consistent with the treatment of other financial liabilities.

Rentals that are contingent on a performance or usage factor are not liabilities for lessees, nor are they assets for lessors, because lessees have the discretion to avoid such payments. Consequently, we see no justification for recognising and measuring these items on the basis of a probability weighted outcome technique. It is important that the Boards understand that when granting such leases, a lessor is exposing itself to the possibility that the contingency will not arise and thus that it will not receive payment. It is therefore exposing itself to risk, a situation that will clearly be reflected in the accounts of the lessor using the de-recognition model, as these will show a higher residual asset than if it had granted a lease with fixed rentals.

We observe that rentals which are entirely contingent and based on a performance factor such as turnover are extremely rare in equipment leasing contracts. This type of feature can more typically be found for instance in commercial property developments. In order to ensure the presence of an anchor tenant (such as a well known supermarket or fashion chain) in the development, the lessor will base the rentals of the anchor tenant on a percentage of its future sales. It is unlikely that the lessee will effectively be able to avoid payments as there is clearly an underlying economic rationale for its choice to establish a commercial premises. Consequently, we suggest that the standard captures contingent rentals *only in such cases*, i.e. when contingent rentals are being used as a means to “disguise” minimum rental payments.

An alternative approach

There are several ways in which such situations can be identified and we could encourage the Boards to explore this approach. For instance, a principle for recognising such situations could be “*situations where contingent rentals are included in lease contracts to compensate for below market committed rentals*”. The Boards could provide guidance or indicators to help preparers establish when this could be the case. For example a comparison could be carried out to ensure that minimum lease payments are at a level consistent with the right of use being conveyed to the lessee. This would involve comparing the amount of the asset that is being financed through the minimum

lease payments to the portion of the economic life of the asset that has been transferred to the lessee with the lease contract. If the first element is smaller than the second, there is a strong indication that the lessee will effectively systematically be obliged to make contingent rent payments.

When “disguised minimum lease payments” are identified, lessees should either include them in their lease liability on the basis of a most likely outcome approach (which we consider on balance to be more reliable and slightly easier to apply than an expected outcome technique), or lessees should be required to reconstruct the rentals they would otherwise pay had there been no contingency. All in all, we believe that this approach would discourage the use of contingent rental payments as a method to simply minimise rental payments.

The approach in the ED generates significant complexity for preparers

Beyond the conceptual reasons for not adopting the approach set out in the ED, we consider the proposed treatment to be disproportionately complex for preparers to apply⁴⁴. In spite of the clarification that a reasonable number of outcomes have to be considered in the expected outcome calculation, preparers will still have to shoulder the burden of analysing a wide range of different scenarios and associating probabilities to these scenarios. Companies are simply not likely to have reliable data on most payment scenarios and the further in the future the possible payments are, the more unreliable any information and judgement will become. The Boards seem to be aware of this issue, as the requirements for lessors include a reliability threshold for the measurement of contingent rentals. However, this is not just an issue for lessors, lessees face the same difficulties.

How do you rate the costs associated with the implementation & ongoing complexity of the proposals for contingent rentals?

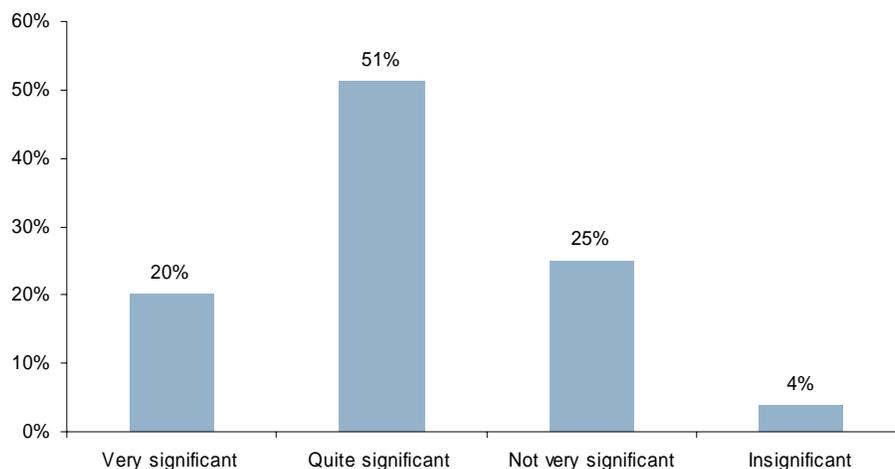


Figure 3

Source: PWC European Impact Survey 2010

⁴⁴ PWC [European Impact Survey 2010](#)

Moreover, while performance based rentals are rare in the equipment leasing industry, usage-based rentals are much more common. There is a clear tendency for this type of contract to develop further, with demand from clients for solutions that provide them with the flexibility of paying as they use an asset. Particularly in the current economic climate, these solutions provide customers with the possibility to mitigate asset risk and control costs very tightly. Again, because of their inherent complexity, the Boards' proposals are likely to hamper the development of such products.

There are also additional complexities surrounding the proposed treatment of contingent rentals that the Boards have ignored to date. For instance, in cases where rents are based on additional mileage for a car lease or extra copies for a photocopier lease, these rentals will contain a significant service component. In other words, the amount the lessor is charging per mile will include a component for the right to use the asset and a component for services required, such as continued insurance or maintenance of the asset. The burden for lessees to have to make such estimates is extremely high.

Again, we consider that neither party has performed until additional usage is made of the asset and that such contingent rentals are purely executory in nature as. Consequently, they should therefore be expensed when occurred and should not be included in the lessee's liability or the lessor's receivable.

Residual values should be treated in the same way as today

Leaseurope does not believe that an approach combining the lessee's liabilities to include expected amounts payable under residual value guarantees would provide users with a clearer picture of the lessee's commitments. Residual value guarantees are different to contingent rentals as they relate to the value of the leased item. We think that lessees should include the maximum amount payable under a residual value guarantee in their lease payments, as is the case today.

Particularly from a lessor point of view, residual value guarantees are important features of lease contracts and the implications of such features have not been sufficiently deliberated by the Boards. This is visible in the ED which is completely silent as to how lessors should account for 3rd party residual value guarantees, although they would intervene in determining the model lessors should apply. For lessors, we consider that the appropriate approach would also be to continue to apply the principles in the existing leases standard, where both lessee and 3rd party provided residual value guarantees are included in the lessor's receivable.

Lastly, we note that the ED uses the term "term option penalties" but does not define what this means. This is not a term that is recognised by the leasing industry.

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 do not agree with the proposals regarding reassessments as we do not agree with the underlying approach to dealing with lease terms and lease payments as described above. We consider that these requirements are simply a consequence of an inappropriate approach to lease accounting. They are required under the current proposals precisely because of the issues surrounding unreliable measurement and judgments and they introduce yet another source of complexity as well as volatility in preparers' accounts.

The Boards state in BC205 that they have modified the treatment of options and contingent rentals and imply that the new proposal to require reassessment only when facts and circumstances indicate there is a significant change in the lessee's liability or the lessor's asset is an important simplification for preparers compared to the DP. It is not. Preparers will still need to go through the difficult exercise of considering whether facts and circumstances have changed and whether there would be any significant impact. Businesses will also have different views on what a "significant" change is. Finally, the changes proposed since the DP, contrary to what is implied in the Basis for Conclusions do not address preparers' fundamental concerns with the model, i.e. that payments under optional periods and contingent rentals are not liabilities.

The alternatives suggested above by Leaseurope should be considered by the Boards as they deal effectively with the rights and commitments of lessees and lessors, without requiring burdensome reassessments such as those currently proposed.

Question 11 Sale and 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?

We do not agree. As explained previously, we think that sales should be defined in the context of the revenue recognition guidance and not in the leases standard. The sale component of a sale and leaseback should be determined in reference to the revenue recognition definition (which needs to be sufficiently robust to be able to cater for such situations).

We support the approach adopted by EFRAG in its draft comment letter whereby the conceptual premises that an asset is a bundle of rights that can be separated should apply in the case of sale and leasebacks too. In this context, the seller/lessee is transferring only the residual rights to use the asset after the lease term has expired to the purchaser/lessor, and retains a right to use the asset during the lease term. These rights can easily be determined using the de-recognition methodology. The decisive element in determining whether the residual asset should be de-recognised from the financial statements of the seller/lessee should be whether control of the residual has been transferred to the purchaser/lessor, as defined in the revenue recognition guidance.

Leaseurope also considers that the Boards need to distinguish between sale and leaseback situations where the asset has been that of the lessee for certain period of time and where the lessee decides to enter into a sale and leaseback in order to generate cash flow for instance⁴⁵, and those cases where the lessor's route to title of the asset happens to be through a transaction involving a sale and then a leaseback for convenience. In practice, there are two alternative routes to title for the lessor at lease inception. In the first the lessor purchases the asset directly from the supplier on the lessee's behalf and title to the asset does not pass through the lessee. The second is technically a sale and leaseback since the supplier sells to the lessee who makes a more or less immediate onward sale to the lessor. These "route to title" situations are and should be treated as normal leases and should not be covered by the provisions for "true" sale and leasebacks.

Question 12a: Presentation - 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?

Leases are distinct instruments with specific characteristics. As a result, Leaseurope takes the view that they should be shown on a separate line of the balance sheet, on both the asset (e.g. distinct asset class in addition to intangibles and PP&E for instance) and liability side (lease liability distinct from other liabilities).

Whatever the final approach to presentation on the face of the financial statements may be, we think it is crucial that lessee right of use assets be presented separately from assets that are owned outright by the lessee. If there is no distinction, in case of lessee

⁴⁵ We note that under the right of use model, the assets and liabilities of a lessee under a sale and leaseback will always be recognised. These types of contracts will not be able to be used to obtain off-balance sheeting financing, but will only be entered into in order to generate cash flow or to reduce asset risk for instance.

bankruptcy for instance, creditors will not be able to identify which assets belong to the company and those that are under lease and belong to others.

As already stated, we believe however that more debate is required as to nature of the lessee's right to use asset. The current proposals amount to presenting an intangible asset together with tangible assets. The ED effectively ignores the need to clarify this issue which could have major ramifications, including significant impacts on the capital requirements of lessees operating in the banking industry.

Question 12b: Presentation - Statement of financial position

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

We do not support the performance obligation model for lessors and consider that the presentation issues that arise under this approach are a clear indication that it does not reflect economic reality.

Question 12c: Presentation - Statement of financial position

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?

The above comment that leases are distinct instruments with specific characteristics applies for lessor accounting too. We therefore recommend that leases be treated as a separate category for lessors too. A specific category "leases" should be introduced, under which lease receivables and lease residual assets should be shown separately. We think that residual assets are different to PP&E (they are rights to "future" assets).

This approach will provide the most information to users who will be seeking to understand a lessor's credit risk on the one hand and its asset risk on the other.

Question 12d: Presentation - Statement of financial position

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?

Yes, for the reasons given in BC156. One could distinguish within the "leases" category receivables and residual assets arising under head and subleases.

Question 13: Presentation - 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?

Yes, we think this is crucial. For lessees, users will want to aggregate interest and amortisation expenses to be able to assess total lease operating expenses. If these expenses are aggregated with non-lease expenses, users will not be able to make this assessment. Under future financial statement presentation requirements, lessees should be allowed to make the choice of whether their interest and amortisation expenses arising under leases are part of a financing, investing or operating activity.

Question 14: Presentation - 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?

Yes, we think that it would be more useful to disclose cash flows arising from leases separately from other cash flows. We are however concerned that the requirements in paragraph 27 of the ED would force preparers to always present cash payments for leases as financing activities. This would be a departure from the current requirements of IAS 7 under which entities present cash flows as operating, investing or financing activities in a manner which is most appropriate to their business. We do not see any reason for moving away from this approach for leases and recommend that the existing approach be maintained.

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
- (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 do not agree with the proposals. In the context of the model proposed, the overall objectives of the disclosure requirements make sense but only because this level of information will be necessary if users are to understand any of the information presented in the financial statements.

The consequence of the model is that the disclosure requirements are simply too burdensome for preparers. We cannot see the justification for this. Not only will preparers be required to go through a significant additional number of decisions, judgments, calculations and accounting steps to come up with a balance sheet number, they will have to give much more information, far exceeding existing requirements, in the

notes. We consider this to be indicative of the fact that model itself does not work well. If it did, the level of disclosures would be much more reasonable.

We are also of the opinion that there is a significant risk that users will actually not be able to identify decision-useful information amongst these disclosures and in any event will still need to make adjustments to what they see in the financial statements. The objective of the leases project was to avoid precisely this.

Question 16a Transition

(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?

We do not agree. In the context of the de-recognition model, lessors should apply a modified version of the simplified retrospective approach developed by the Boards where the residual asset is recognised at the present value of the future value of the asset at the end of the lease term. This overcomes the difficulties associated with establishing current fair values of second hand assets. It should be noted that lessors will have information on the original asset value and its future expected value.

Issues will also arise on transition for lessees given the proposed measurement of their assets and liabilities, i.e. they will recognise significant losses as all leases will be treated as new leases. Adopting a linked approach to subsequent measurement for lessees would resolve this transition issue (see our response to Question 1 (b) above).

Question 16b Transition

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

Under the form of the standard exposed in the ED, preparers should have the option to adopt full retrospective application as it is the only way to resolve occurrence of significant losses on implementation. The adoption of linked measurement of lessee assets and liabilities would make full retrospective application unnecessary.

Question 16c Transition

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

In the case of existing finance leases, other than those specified in paragraph 92 of the ED, lessees will recognise assets that have already been (partly) depreciated and going forward may thus re-recognise depreciation they have already accounted for. Again, linked measurement can solve this issue.

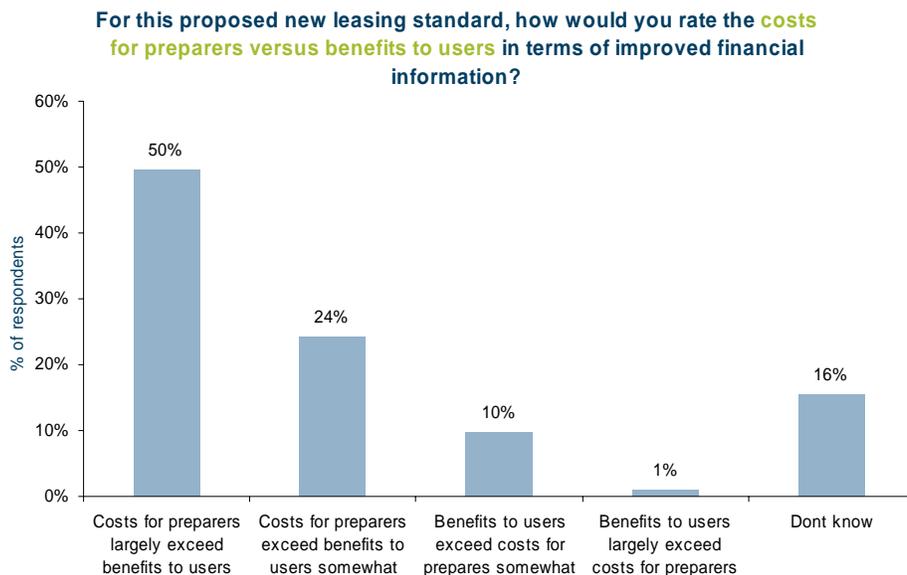
Additionally, the ED provides no transitional provisions for sale and leaseback transactions.

Question 17 Benefits and 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?

We do not agree with the Boards’ assessment of the costs and benefits of the proposed requirements. Although we appreciate that the Boards weigh the comments they receive, giving greater importance to the views of the user community, we note that only around 2% of the comment letters received during the DP phase were from investors, analysts or other user groups and their representatives. This low response rate could be indicative of the fact that not all users consider current lease accounting to be as broken as the Boards suggest. Whatever users’ views are, it is very difficult for the Boards’ constituents to draw conclusions on any potential benefits of the proposals on the basis of the DP feedback. Even though there may be some benefits, such as users not having to make adjustments, similar accounting for similar contracts etc., we have argued above that these benefits are not always clear and in any event, they cannot be considered in isolation to the costs that preparers will have to incur to provide the information requested. The vast majority of the other 300 or so respondents to the DP, while appreciating the merits of capitalising (committed) lease payments in some circumstances, expressed significant concerns on the costs of the proposal in relation to its benefits.

The views expressed during the DP have been confirmed in the PWC European Impact Survey. Indeed, 74% of the respondents to this survey consider that the costs of the new standard for preparers exceed the benefits for preparers, with 50% taking the view that the costs for preparers largely exceed the benefits for users. Only one survey participant responded that the benefits for preparers would largely outweigh the costs for preparers.



Source: PWC European Impact Survey 2010

Figure 4

The views of preparers are therefore clear. Yet they do not come across as such in BC200 – BC205, where it appears that only the retail industry had some degree of concern. This section of the Basis for Conclusions could be misleading in that implies that by making minor modifications to the initial proposals (in the areas of the frequency of required reassessments of lease terms and payments and the omission of the present value calculation) the Boards have addressed any major concerns preparers had during the DP. This is not the case.

We have consistently questioned the process the Boards have for evaluating the relative costs and benefits of the proposed standard. The Basis for Conclusions sheds no light on that process. BC202 includes a boilerplate description but no proof of the type of thorough impact assessment constituents would expect from international standard setters. It also refers to the International Working Group on Lease Accounting, which the Boards have acknowledged has not functioned properly (mostly due to a lack of time and resource).

Our response to the DP summarised the main areas of complexity that we then saw for lessees as follows:

- Firms will be faced with complex judgement calls when determining whether they have a lease contract or a service contract.
- Companies who make use of lease documentation to effectively outsource asset related needs will be faced with managing asset registers and accounting for these assets. Even the simple aspects of accounting for rights of use will be problematic for these entities as they will have chosen to lease because they are able to account for these contracts today as straightforward operating expenses.
- Businesses will have to analyse the service components that are part of lease contracts. Currently, one of the major benefits of a lease is that lessees do not have to consider such aspects. Instead they receive a single invoice encompassing all the costs related to the use of the asset.
- Lessees opt for leasing as it offers them a degree of simplicity that other arrangements cannot convey. However, in the future they will be required to account for their leases in a way that destroys this simplicity.
- Requiring firms to make assessments of their most likely lease term or contingent rental payments will create significant burdens as many companies will simply not possess the data or the resources to do so. This is true for companies of all sizes and is a particular problem when it comes to those firms who have many small leases that will need to be dealt with in this way.
- Requiring reassessments of these estimates at each reporting date will lead to even more costs for lessees.
- It should be noted that whilst firms may be able to manage some of the complexities noted above at the level of a single lease contract, a much more significant form of complexity arises in the organisational process required in entities to collate, verify, assemble and present reporting on the many small ticket leases that are managed in varying locations around the company. These leases will all be different from one another and in many cases cannot be aggregated and dealt with in “batches”.

We take the view that little has been done to address these issues. With the exception of the frequency of reassessments and discounting for short term leases, all of these concerns with the proposals remain and the approach to lessor accounting has further reinforced the inherent complexity of the model. We note that EFRAG has expressed the view that “implementing the Board’s proposals could be very costly, beyond the satisfaction of a reasonable cost/benefit trade-off”⁴⁶.

Going forward, we consider that it is therefore essential that the Boards take the feedback they have received into account and perform and publish a through cost/benefit analysis. The results of this analysis must be integrated into their re-deliberations and, if more time is needed, it must be taken.

⁴⁶ See summary of the main messages expressed by the EFRAG during the Joint EFRAG-IASB Meeting of 12 November 2010, available at www.efrag.org.

III. An Alternative: A Simplified Right of Use Model for All Leases

This section of our response *recaps* what we consider should be used as an alternative right of use model applying to all leases. The detailed rationale for this proposal is provided in the responses to the individual ED questions in Section II above.

I. Scope

Definition of a lease

A lease is a contract that, in exchange for consideration, conveys to a lessee the right to use a specified asset for a period of time that is more than a minor part of its economic life.

Control

The lessee will have obtained a right to use when it controls the asset for more than a minor part of its economic life. The lessee will have obtained control when the contract conveys the ability to the lessee to direct the use of the asset for more than a minor part of its economic life and when it has obtained the right to consume more than a minor share of the future economic benefits of the asset through its use of the asset over the lease term.

Specified asset

An asset is specified when:

- The agreement specifically identifies the asset (or part of a larger asset)

An asset is not specified when, even though the agreement specifically identifies the asset:

- The lessor can substitute the asset at any time without requiring the lessee's consent or,
- If the lessee's consent is required, it is feasible or practical for the lessor to substitute the asset, having obtained that consent

Assets that are fungible and easily replaceable on an open market do not therefore generally qualify as specified assets.

Situations where a contract is always a lease (as opposed to a service contract)

The existence of one or more of the following features implies that an agreement conveying the right to use a specified asset is a *lease* and not a service contract. This list is *non-exhaustive*:

- An option to purchase the asset
- A renewal option that allows the lessee to extend the contract to a term that equates to substantially all of the economic life of the asset
- A residual value guarantee provided by the lessee or a party related to the lessee

Economic life of an asset

The economic life of an asset is the period over which the asset is expected to be economically useable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users.

- The existing guidance currently set out in IFRIC 4 which has been subject to significant criticisms from IASB constituents is replaced by the definitions above.
- The definition of a lease is slightly narrower under this approach than under existing guidance. The advantage of this definition is that it allows for the application of one, simple right of use model to lessees and lessors, thereby addressing concerns surrounding the current guidance (i.e. assets and liabilities not recognised under operating leases) and clarifies that outsourcing-type contracts involving the incidental or ancillary use of assets and contracts where the asset is readily substitutable are not leases, thus avoiding a significant amount of the complexity that would be generated for preparers were the existing proposals to become a new standard.
- This approach does not define whether an agreement constitutes a sale of the underlying asset. This distinction is not required as the accounting treatment of the purchase of an asset and a lease that conveys a right of use equivalent to 100% of the asset are very similar under this model. Moreover, the need to distinguish between leases and purchases/sales within the leases guidance arose only when manufacturer/dealer lessors were precluded from recognising sales revenue under a performance obligation approach to lessor accounting. This model uses a partial de-recognition approach to lessor accounting which allows manufacturer/dealer lessors to recognise sales revenue proportionately to the right of use asset they have sold (see below). Not defining sales/purchases within the leases guidance also avoids the creation of several such potentially different definitions with the IFRS literature.

When a lease contains both right of use and service components, an entity shall separate the service components from the components for the right of use and account only for the latter part under the leases standard. The service component should be accounted for under the appropriate IFRS (Revenue Recognition).

If a lessee does not have precise information relating to the service components of a lease it should make an estimate of this component. If this cannot be done, it should make an assessment of whether it has acquired a lease or a service.

- Lessees should make estimates of their service components. Defaulting to treating the entire rental payment including service payments as a lease would be inconsistent with the treatment of an outright asset purchase. Therefore, if an estimate cannot be made, lessees should assess whether they have an in-substance lease or service contract.
- Lessors will always be able to clearly identify service components of their leases as this is part of their business model. A lessor that does not have such information will not be able to price a lease contract.

Leases of intangible assets should be covered by the standard

- Constituents have shown strong support for including leases of intangibles in the scope of the guidance. The exclusion of intangibles from this standard would represent a step backwards from existing lease accounting guidance rather than an improvement.

Arrangements granted for a maximum possible lease term of no more than 12 months should be excluded from the scope of the standard, and be accounted for as service contracts under the relevant IFRS (Revenue Recognition) (both lessees and lessors).

Lessors shall not apply this standard to leases of investment property. Lessors of other types of property should use existing operating lease accounting.

II. The Model

Accounting for lessees: right-of-use model

Lessees recognise, for all leases, a liability for their obligation to make rental payments and an asset for their right-to-use the leased asset.

Accounting for lessors: partial de-recognition model

The lessor de-recognises the rights it has transferred to the lessee via the lease contract from the underlying leased asset. Any remaining rights are the lessor's residual asset.

III. Initial Measurement

Lessees

The initial measurement of the obligation to make lease payments is the present value of the lease payments (defined below), discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the interest rate implicit in the lease.

The initial measurement of the lessee's right-of-use asset is the amount of the obligation to make lease payments, measured as above plus any initial direct costs.

Lessors

A lessor recognises a receivable for its right to receive lease payments at the present value of lease payments (defined below) discounted at the rate implicit in the lease, which includes any initial direct costs incurred by the lessor.

The lessor de-recognises from the carrying value (i.e. purchase price in the case of a third party lessor) of the underlying asset an amount equal to the portion of the rights of the underlying asset it has transferred to the lessee. To determine this portion, the lessor considers the share that the fair value of the rights transferred to the lessee, measured at the PV of lease payments, represents in relation to the fair value of the underlying asset.

In other words the lessor calculates the fraction

$$\frac{\text{PV (lease payments)}}{\text{Fair value of the asset}}$$

and applies it to the carrying amount of the asset. The remaining rights are reclassified as the lessor's residual asset.

Day one gains on releases may occur if the carrying value of the asset is different to its fair value. This is an asset valuation issue and the gain that would occur on a release is similar in nature as gains that arise when a wholly owned asset is sold.

Lease payments

Lease payments are the minimum lease payments the lessee is required to make over the lease term together with

- 1) any amounts paid by the lessee to obtain the ability to extend the lease term beyond the initial contractual term or to obtain the ability to purchase the asset at the end of the contract
- 2) if the lease includes a renewal or purchase option, any amounts the lessee is required to pay if it does not renew the lease or purchase the asset
- 3) the maximum amount payable under a residual value guarantee provided by the lessee to the lessor⁴⁷
- 4) variable lease payments based on an index or rate
- 5) contingent rentals meeting the requirements below

Variable lease payments

Variable lease payments are payments that are based on changes in an index or rate. They are included in the lease payments, using the index or rate existing at inception of the lease upon initial measurement. Changes in amounts payable arising from variations in the underlying rate or index should be recognised in profit or loss in the period in which they become payable.

- Variable rentals are different in nature to contingent rentals. With the former, the lessee is unable to avoid making the required payment, whereas with the latter, the lessee is only obliged to make payments once the contingent event has occurred. This should be reflected in the accounting model for leases.
- The proposed treatment of variable rentals is consistent with the treatment of other financial liabilities.

Contingent rentals

Contingent rentals should not be taken into account in the lease payments and should be recognised in profit and loss when they occur unless they are included in lease contracts to compensate for below market committed rentals.

Such situations could be determined by comparing the amount of the asset that is being financed through the minimum lease payments to the portion of the economic life of the asset that has been transferred to the lessee with the lease contract:

$$\frac{\text{PV(MLP)}}{\text{fair value of the asset}} < \frac{\text{lease term}}{\text{economic life of the asset}}$$

⁴⁷ Cases where residual value guarantees are granted to protect asset values in *optional* periods will need specific treatment.

If the first fraction is smaller than the second, there is a strong indication that the lessee will effectively systematically be obliged to make contingent rent payments. Consequently, when this is the case, lessees and lessors should be required to include their estimate of the most likely contingent rental payments in the lease payments.

- When not taken into account by the lessee, contingent rentals are also not de-recognised from the lessor's underlying asset, thus reflecting the fact that, by granting such rentals, the lessor has potentially exposed itself to significant risks, shown by a higher level of residual asset.
- This approach addresses concerns surrounding contingent rentals when they are used to minimise lease payments while not imposing a blanket approach treating these as liabilities even in circumstances that do not meet Conceptual Framework definitions.
- The approach should be significantly easier for preparers to apply than the current proposals.

Options

Apart from upfront payments for options or payments for non-renewal of a lease or non-exercise of a purchase option, options are not taken into account in the lease payments.

This is because they will fall under one of the following categories:

1) Renewal options

- Renewal options allowing the lessee to extend the lease after the initial lease term at the then market rate (or an equivalent one-off payment)

Such an option has no intrinsic value as the lessee could simply obtain a new lease at the end of the initial lease.

- Renewal options allowing the lessee to extend the lease after the initial lease term at a rate lower than the market rate rentals (or an equivalent payment)

Renewal options at lower than market rentals (or an equivalent payment) will either have been priced into the level of rentals of the initial lease term (they will be higher than if there is no such option) or will be granted in conjunction with a residual value guarantee designed to protect the lessor from the shortfall between the secondary period rentals and market rentals. In the first case, the value of the option reflected in the higher rentals will already have been taken into account into the lessee's obligation to make rental payments and its right of use asset. In the second case, the maximum amount payable under a residual value guarantee is included in minimum lease payments. Consequently, the value of the option is appropriately taken in to account.

- Renewal options allowing the lessee to extend the lease after the initial lease term at a rate higher than the market rate rentals (or an equivalent payment)

Renewals could also be granted at an above market rental. In such situations, if the rentals in the initial lease period are lower than they would be otherwise, the lessor is exposing itself to a significant risk that the lessee will not renew the lease. The lessor accounting model will reflect this situation clearly, showing a large residual asset. Lessors will therefore only grant such leases if they are

effectively comfortable with taking on such risk. In practice, it is unlikely that they will do so to any great extent and the accounting will always appropriately reflect the true risks and commitments of both parties.

2) Purchase options

The same reasoning as above can be applied to purchase options:

- Purchase options where the exercise price is at market value of the asset do not have any intrinsic value
- The value of a purchase option where the exercise price is lower than the market value of the asset will be priced into the rentals and thus reflected in the lease payments
- Purchase options where the exercise price is higher than the market value of the asset could be used as a tool to structure lower rentals. However, if this is the case, the lessor will have a higher residual asset reflecting its larger exposure risk.

3) Termination options

Leases with termination options should be viewed as being the economic equivalent of a lease (for a shorter initial term) with a renewal option and the same reasoning applies.

- This approach addresses the Boards' concerns surrounding the use of options to structure contracts.
- At the same time, it overcomes the issues raised by a significant number of constituents on the proposed treatment of options under the new standard. These constituents argue that although options are an asset for the lessee, the accounting method proposed by the Boards is inconsistent with the Conceptual Framework and leads to an overstatement of the lessee's asset and liability. This treatment is also a significant source of complexity within the new proposals.
- The approach suggested above alleviates this complexity as lessees and lessors do not have to undertake subjective and burdensome probability assessments and reassessments. It also leads to increased comparability between entities and less volatility of the accounts.

IV. Subsequent Measurement

Lessees

Absent impairment and revaluation, subsequent measurement should continue to reflect the linked nature of the obligation to make payments and the right of use asset recognised at the start of the lease.

The lessee's liability should therefore be apportioned between a finance charge and a reduction in the outstanding liability consistently with the treatment of other financial liabilities

The lessee's right of use asset should be measured on an amortised cost basis (unless the revaluation provisions apply) using mortgage-based amortisation to appropriately reflect its pattern of consumption of economic benefits (the lessee effectively uses the asset as it pays for it)⁴⁸.

If the lessee has included the most likely payment under contingent rentals in its lease payments (i.e. in the cases described above under the contingent rentals section), the lessee should reassess this estimate at each reporting date. Any changes in its estimate arising from its reassessment should be included in the carrying value of the right of use asset as the lessee has effectively purchased more or less of the right to use the leased asset.

The lessee would apply IAS 36 (Impairment) and, if it revalues equivalent classes of owned assets in accordance IAS 16 (PP&E), the revaluation provisions of IAS 38 (Intangible Assets) to its right of use asset.

If a lessee exercises a renewal option, it would account for this transaction as if the lease were a new lease.

Lessors

After the commencement of the lease term, the lessor measures the right to receive rentals at amortised cost using the effective interest method and applies IAS39 for impairment.

The residual asset should be accreted at the rate implicit in the lease so that, absent impairment:

- For 3rd party lessors it equates to the fair value of the asset at the end of the lease term that was projected at the outset of the lease
- For manufacturer/dealer lessors it equates to the expected fair value of the asset at the end of the lease term less the future value of the unrealised manufacturing profit (i.e. if the asset is sold at fair value at the end of the lease, a manufacturer/dealer will realise its 'deferred' profit at this time).

This subsequent measurement method of the residual asset reflects the fact that, as the lease term progresses, the residual asset becomes gradually less "encumbered" by the lease (i.e. the lessor comes closer to reuniting all the rights associated with the asset).

The residual asset should be assessed for impairment in accordance with IAS36.

▮ This approach to subsequent measurement for the residual asset is the only measurement approach that effectively reflects the economics of a lease transaction as it shows the lessor's true, constant return on assets. Freezing the residual (or using another rate than the rate implicit in the lease to accrete the residual) leads to a different/variable return on assets. Indeed, for a given transaction where the terms are negotiated at the start and remain unchanged throughout the contract term, one would not expect any other return pattern than the constant, contractual yield. Consequently, this measurement basis provides superior information to users than freezing the residual as currently proposed.

⁴⁸ We accept that in some cases (e.g. impairment, re-valuation, upfront payments, etc.) the value of the asset and liability will not always be strictly equal.

If the lessee exercises a renewal option, the lessor treats this lease as a new lease where the value of the residual asset is used as the cost of the underlying asset.

V. Presentation

Lessees

The lessee's obligation to make lease payments should be presented separately from other financial liabilities

The lessee's right-to-use asset is a specific asset and should be presented under a separate, dedicated balance sheet caption.

- This form of presentation reflects the specific nature of a lease and allows users to clearly identify lease related assets and liabilities.
- Moreover, it can be argued that a right of use is different to both tangible and intangible assets. Therefore, it should be presented separately, thereby recognising the fact that it is different to owned (physical) assets and avoiding the intangible asset association which would have severe capital consequences for entities operating in regulated industries such as banks.

Lessors

Lessors should present separately under a specific category "leases", their lease receivables and residual assets

- More transparency for users (asset and credit risk exposure visible)
- Separate presentation also justified by specific measurement of residual assets

VI. Sale and Leaseback Transactions

An entity shall account for a sale and leaseback transaction if the transfer of the underlying asset meets results in the purchaser/lessor obtaining control of the asset as described in the relevant IFRS (Revenue recognition). This will be the case when the purchaser/lessor has the ability to direct the use of and receive the benefit from the asset. The seller/lessee shall account for the sale in accordance with the relevant IFRS requirements and for the right of use asset and obligation to make lease payments in accordance with the leases standard.

- This approach is straightforward to apply as it refers to the revenue recognition definition of control and avoids multiple definitions of control throughout the IFRS literature.
- Given that the leaseback is dealt with under the right of use model, the potential for structuring to obtain the off-balance sheet treatment of a sale & leaseback under today's guidance is no longer relevant.

VII. Transition

Lessees shall either apply the standard retrospectively or use the simplified retrospective approach developed by the Boards (including the provisions for simple finance leases).

Lessors shall apply the standard retrospectively or use the simplified retrospective approach developed by the Boards modified so as the residual asset is recognised at the present value of the future value of the asset at the end of the lease term.

- Entities should not be prevented from applying the new standard retrospectively.
- For lessors, the above approach overcomes the difficulties associated with establishing current fair values of second hand assets. It should be noted that lessors will have information on the original asset value and its future expected value.