Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany
® Der Standardisierungsrat

DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Berlin, 20 December 2010

Dear David,

Exposure Draft ED/2010/9 *Leases*

On behalf of the German Accounting Standards Board (GASB), I am writing to comment on the Exposure Draft ED/2010/9 'Leases' (herein referred to as the 'ED'). We appreciate the opportunity to comment on this Exposure Draft.

The GASB welcomes the efforts of the IASB to develop a comprehensive lease accounting standard to provide users of financial statements with a complete and understandable picture of an entity's leasing activities.

As already stated in our comment letter on the Discussion Paper 'Leases – Preliminary Views' (herein referred to as the 'DP'), we generally support the right-of-use approach mainly since it appears to be a conceptually consistent approach. However, we note that the introduction of the right-of-use approach as proposed in the ED would cause significant measurement as well as other practical problems. While we generally support the implementation of the right-of-use approach, we ask the IASB to simplify specifically the determination of the lease term and the proposed initial and subsequent measurement requirements. In the attachment to this comment letter we have detailed suggestions for changes we consider necessary, of which the most important ones are:

- The lease term should basically be determined by non-cancellable lease periods extended by terms subject to renewal options in case these options create economic compulsion to exercise (instead of defining the lease term as the longest possible term that is more likely than not to occur as proposed in the ED).
- The present value of lease payments receivable / payable during the lease term as defined above should be determined based on the single best estimate approach including fixed and contingent rentals as well as term option

penalties (instead of basing the present value on the expected outcome approach as proposed in the ED).

In our comment letter to the DP we expressed our belief that fundamentally changing lease accounting should be done in a comprehensive manner by including lessor accounting issues at the same time as lessee accounting issues (in contrast to the approach proposed by the IASB in the DP to defer consideration of lessor accounting). The IASB appreciated this view and included proposals addressing lessor accounting in the ED. However, we have strong concerns with these proposals. The main concern relates to the proposed implementation of a hybrid model, i.e. to either account for leases under the performance obligation approach or the derecognition approach, depending on the exposure to risks or benefits associated with the underlying asset. The proposed hybrid model would

- introduce an undue complexity, and
- establish a dichotomous classification characterised by a high degree of subjectivity.

This is why we propose that the future standard on leases provides for the application of one approach only. Based on our analysis, we – on balance – recommend that the derecognition approach be implemented. For the arguments in favour of this approach please refer to the attachment of this comment letter. The most important argument is that the derecognition approach conceptually corresponds to the approach as proposed for lessees.

Requiring the hybrid model as proposed by the IASB would not result in an improvement as compared to the current situation under IAS 17 *Leases*. While the general discussion of the two models as proposed in the ED for lessor accounting indicates that the models do not appear to be fully developed, the IASB in light of the above arguments should consider requiring lessors to apply the derecognition approach only. However, in case the IASB decides to introduce a hybrid (dichotomous) model or the performance obligation approach for lessors, we prefer that the lease accounting for lessors should continue to be required in accordance with IAS 17 until lessor accounting has been considered more broadly and thoroughly.

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

Yours sincerely,

Liesel Knorr
President

Appendix

The accounting model

Question 1: Lessees

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability for its obligation to make lease payments? Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on its liability for lease payments? Why or why not? If not, what alternative model would you propose and why?

In general, we support the right-of-use approach, both for conceptual reasons, and because we believe that it provides useful information and satisfies users' needs about recognition of assets and liabilities arising from leases. Therefore, we consider the proposal to be an improvement compared to the current situation for simple leases. In that regard, we agree that the lessee should recognise a right-of-use asset and a liability to make lease payments.

However, we note that the introduction of the right-of-use approach as proposed in the ED would cause significant practical measurement problems and / or provide structuring opportunities in conjunction with options and contingent rentals (i.e. more complex leases).

Thus, while the major disadvantage of the existing accounting model (mainly not recognising the assets and liabilities arising from a lease contract in the statement of financial position of lessees in case of an operating lease) may be addressed by the proposed right-of-use approach, the advantages of such an achievement would be reduced or even offset by challenging measurement and reassessment issues resulting from leases with options, contingent rentals and residual value guarantees.

Therefore, we propose that the IASB adjust the proposed right-of-use approach for lessees as follows:

- The lease term should be limited to the non-cancellable period for which the lessee has contracted to lease the underlying asset (or – if a lower total amount payable results from a shorter lease period including term option penalties – this shorter period sanctioned by penalty payments should be considered); this term should be extended by terms subject to renewal options in case these options are in substance not an option because they create economic compulsion to exercise (i.e. their exercise is *virtually certain* and would, thus, give rise to a contingent asset).
- The determination of the present value of the liability to make lease payments during the lease term as defined above should be based on the rentals agreed including contingent rentals and considering term option penalties in accordance with

the single best estimate approach (instead of basing it on the expected outcome approach as proposed in the ED). In case an agreed residual value guarantee does have an intrinsic value different from nil at the inception of the lease, it should be included in the measurement of lease assets and liabilities.

- If term options or options to renew a contract, which are not part of the lease term as defined above, are granted at lease rates lower than the lease rates agreed for the lease term as defined above, lessees should recognise a separate asset for this option. This asset should be measured as follows (if rentals are agreed to be paid monthly, as an example):

  total liability to make lease payments for the lease term as defined above
  less (average monthly lease rentals for the period covering the lease term as defined above and optional lease periods for which lower rental payments are granted)
  multiplied by (the number of months of the lease term as defined above)

  The asset should further not be subject to any subsequent measurement changes. At the end of the lease term as defined above, the asset should be fully expensed in case the lessee does not opt to extend the lease. If, however, the lessee opts to extend the lease period, the asset should be expensed over the additional lease period. Lessors should account for such term options or options to renew a contract respectively.

Considering the above comments, we agree that if the right-of-use model was applied, a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments.

Question 2: Lessors

(a) Do you agree that a lessor should apply
  (i) the performance obligation approach when the lease exposes the lessor to significant risks and benefits associated with the underlying asset, and
  (ii) the derecognition approach otherwise?
  Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree with the boards' proposals for recognition of assets and 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?

We do not agree that the lessor should apply the hybrid model as proposed by the IASB, for the reasons set out below. We strongly prefer that lessors apply the derecognition approach in all instances.

Our main arguments against a hybrid model are as follows. Requiring the hybrid model would

- result in too much complexity for preparers (lessors) since it would require at the date of inception of the lease an assessment for each single lease. This assessment requires considering different factors (indicators) depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset either during or after the expected term of the current lease. The complexity is further increased by the provision of ED.B26, which stipulates that the existence of one or more indicators is not conclusive in determining whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. Also, two different accounting procedures need to be implemented, applied and monitored to similar business transactions;
- not result in an improvement as compared to the current situation under IAS 17 *Leases*. The current accounting model based on the distinction between operating and finance leases is rather subjective in determining the classification of a lease. However, when we compare the problematic dichotomy of IAS 17 with the hybrid model proposed in the ED with its equally judgemental distinction between the performance obligation and the derecognition approach, we do not consider the proposed new accounting to be an improvement to lease accounting. On that basis it even appears preferable to stick to the current lease model for lessors as required by IAS 17; in other words the implementation of the hybrid model as proposed in the ED would mean, that preparers to a certain degree would have to maintain the old patterns required under IAS 17 with respect to the risks and rewards approach. It would mirror to some extent the distinction in the existing IAS 17 between finance and operating leases.

Our main arguments against the performance obligation approach are as follows:
- it would not correspond to the approach as proposed by the IASB for lessees (i.e. the right-of-use model), so that it conceptually does not fit to what has been proposed for lessees. The IASB seems to have adopted a conceptual premise based on the view that an asset is a bundle of rights. In this context we understand that the performance obligation approach is not consistent with this premise. The lessee’s requirement to recognise a right-of-use asset and a liability once a lease has been agreed implies that a transfer has been executed by the lessor and, therefore, the lessor should be able to derecognise an asset or part of it. Once the lessor provides the lessee with access to the underlying asset, the lease ceases to be an executory contract and the lessee has an unconditional right to use it, the lessor cannot prevent the lessee from using the asset anymore. If the lessee has an obligation for the lease term to pay lease rentals once access to the asset has been obtained, then it follows that from that moment the lessor has completed the execution of its part of the transaction;
- the lessor would continue to recognise the whole underlying asset but at the same time also recognise a right to receive lease payments with respect to this underlying asset. The right to receive lease payments embodies part of the future cash flows that the underlying asset will generate for the lessor, so leaving the underly-

ing asset recognised would, in our view, result in double counting because the future cashflows would be considered in both, the measurement of the underlying asset and the measurement of the right to receive lease payments;
- the performance obligation does not appear to be a liability in line with the definitions of the framework since its settlement is not expected to result in an outflow from the entity of resources embodying economic benefits;
- it would not be an appropriate approach for manufacturers and dealers, who upon entering into a lease contract should be in a position to realise an adequate portion of their gross margins. We consider the recognition of an adequate portion of the gross margin by manufacturer or dealer lessors to be consistent with the proposals in the exposure draft ED/2010/6 *Revenue from Contracts with Customers* since upon delivery of the right-of-use asset to the lessee the performance obligation is satisfied and the (portion of the) gross margin is also not attributable to the financing component of the lease.

On the other hand, we are also aware that the derecognition approach has some disadvantages as follows:
- for short-term leases, such as renting hotel rooms or motorcars, it produces counter-intuitive consequences in the form of the derecognition of the underlying asset;
- the residual asset appears to be a unique type of asset since the lessor for the underlying asset conveys the right of its use for a period of time to the lessee, which leads to the partial derecognition of the asset;
- causes day one gains to be realised which could be overstated in case the amount of the underlying asset to be derecognised is largely determined by optional lease terms, which need to be taken into account in order to determine the fair value of the right to receive lease payments (e.g. a significant part of the gross margin of an underlying asset may need to be recognised at the commencement of the lease, largely due to an option to renew the lease for 6 years at the end of a non-cancellable 4-year term, the former to be taken into account in line with the requirements to determine the lease term (ED.13 – so that the lease term is assumed to be determined as a 10 year period in total). However, after the 4 years non-cancellable term the lessee does not opt to renew the lease for the 6-year term – other than expected at the commencement of the lease).

Taking into account the above arguments, on balance we are of the opinion that only one model should be applied by lessors, and based on the above assessment we believe that this model should be the derecognition approach.

Considering our comments above where we recommend implementing only the derecognition model, we agree with the boards' proposals for recognition of assets and liabilities, income and expenses for the derecognition approach to lessor accounting.

Question 3: Short-term leases

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

(a) At the date of inception of a lease a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently,
   (i) the liability to make lease payments at the undiscounted amount of the lease payments and
   (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs.

   Such lessees would recognise lease payments in profit and loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from short-term leases in the statement of financial position, nor derecognise any portion of the right to use the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit and loss over the lease term (paragraph 65).

(See also paragraphs BC41-BC46.)

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?

Generally, we concur with the approach of introducing a simplified approach for short-term leases based on cost-benefit considerations. Nevertheless, we believe that the proposed simplification for lessees is not a significant relief. We propose to completely exclude short-term leases as defined in the ED from the new lease standard (i.e. leases that, at the date of commencement of the lease, have a maximum possible lease term including options to renew or extend, of twelve months or less).

In addition, leases should also be excluded from the scope of the future standard, if leases are agreed without an expiration date for the contract, but may be cancelled at any given time with a notice period of one year or less, so that the lease may end after a term of twelve months or less after the commencement of the lease. This type of contract is common, as an example, for regular rental agreements such as renting office space or warehouses.

The main reason for these proposals is the fact that lessees appear to see the main burden of applying the model as proposed by the IASB for short-term leases in the cost- and time-consuming identification and tracking of a large number of expected lease contracts, rather than the impact of discounting those lease payments. Further, the application of the accounting model for lessees is considered to be complex, especially when the contract includes contingent rentals. Therefore, the simplification as proposed for lessees by the IASB appears not to be a major relief in practice.

In ED.BC43 it is stated that a scope exemption for short-term leases would introduce an artificial distinction between leases that are recognised and leases that are not. While we basically agree that short-term leases are not different from other leases, we note that users mainly criticise the existing lease model under IAS 17 in relation to long-term arrangements.

Further, we do not expect that our proposal will have an adverse affect on the information value of the financial statements since the financing effect of leases with a lease term of twelve months or less is considered not to be material. To the extent it is material (Framework para. 29 f.), leases concerned should be recognised in line with the requirements as currently proposed in ED.64.

As above for lessees, we also for lessors propose to completely exclude short-term leases as described above from the scope of the new lease standard.

Definition of a lease

Question 4

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

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

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

We do not believe that the wording '… for a period of time …' as part of the definition of a lease appropriately corresponds to ED.B16-B20, where the approach for determining the lease term is further elaborated. In that context, we consider it more appropriate to change the wording to '… for a determined period of time …' or similar.

In ED.97(d) the Boards propose to supersede SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* by the new lease standard. However, we have not identified any guidance in the ED addressing the transactions covered by SIC 27, since we are concerned that, otherwise, in the future there will be no guidance for this area.

According to ED.7, an entity should apply the proposed accounting requirements for leases to investment property that it holds under a lease unless specified criteria require that IAS 40 *Investment Property* be applied. In this context we believe that adequate guidance for the accounting of such leases is missing in IAS 40. As an alternative, a paragraph could be inserted in IAS 40 with a cross-reference to the respective guidance in the ED. We also note that both the definition of investment property in IAS 40 and some of the examples in IAS 40.8 f. are based on the distinction between finance and operating leases. Since the proposals intend to remove this distinction and Appendix C is not clear on this issue, consequential amendments to IAS 40 should be made to clarify when a property held under a lease is considered an investment property.

We note that the IASB proposes in ED.B9 that a contract represents a purchase or sale of an underlying asset if, at the end of the contract, an entity transfers to another entity control of the underlying asset <u>and</u> all but a trivial amount of the risks and benefits associated with the underlying assets. The wording clearly indicates that both conditions have to be met so that the contract represents a purchase or sale. However, we note that the two criteria indicated in ED.B10 ((a) automatic transfer of title and (b) existence of a bargain purchase option) only deal with the transfer of control and do not refer to the exposure to risks and benefits.

While it is undisputed that an entity should consider all relevant facts and circumstances when determining whether control of the underlying asset is transferred at the end of the contract (as required in ED.B10), we recommend that additional indicators be provided in this context.

In any case, the IASB should ensure in this respect full consistency of this ED and ED/2010/6 *Revenue from Contracts with Customers*, which only requires the transfer of control as a condition to recognise revenue.

Since ED.B10(b), which refers to bargain purchase options, in its application is subject to a high degree of judgement, we propose that this paragraph not be taken forward to the final standard. This suggestion has to be seen in the context of our proposal that only the derecognition approach should be applied by lessors. If an agreement contains what is considered to be a bargain purchase option, the lessor normally fully amortises the underlying asset based on the lease agreement with one lessee. If that was the case, the accounting for this lease as a sale on the one hand or as a lease under the derecognition approach on the other hand would not be materially different with respect to the gross margin recognised in profit or loss at the beginning of the contract. We consider this proposal to be a simplification for lessors since the decision whether the option for a lessee to purchase the asset at a price that is or is not expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable does not need to be made.

However, should the IASB decide to carry forward the guidance of ED.B10(b) referring to bargain purchase options to the new standard, we recommend that the IASB widen the requirement to make it more general and principle-based. As an example, it should also be assumed that a contract transfers control of an underlying asset when it is virtually certain that the lessee will opt for purchasing the underlying asset due to economic reasons (e.g. economic compulsion).

We believe that the criteria indicated in IFRIC 4 *Determining whether an Arrangement contains a Lease* (which, in substance, have been carried forward to the ED) are neither fully operational nor appropriate. Too much weight is given to physical delivery or access to the asset, while we believe that it is important to identify the business purpose of the transaction. In other words, when the lessee is mainly interested in receiving a service – and is indifferent as to the 'specific' asset used to provide that service – the transaction should be treated as a service arrangement. However, we are aware of the fact that this approach would introduce a high degree of subjectivity to the guidance.

With respect to ED.B2-B4 and our previous comment we further consider it necessary for the IASB to clarify and improve these requirements (ED.B2 f. relate to the fulfilment of the contract depending on providing a specified asset and ED.B4 relates to conveying the right to control the use of a specified asset based on the contract).

We are of the opinion that the ability of the supplier to replace the assets and continue providing the required goods or services with another asset is a key indicator for determining that the customer is not interested in the use of the specific asset – or, in other words, that the asset is rather a 'vehicle' for receiving a service. However, this would not be sufficient to conclude that the agreement is a service. We consider it to be relevant that there is an observable business practice of replacing such assets – the mere existence of the 'ability' to replace the assets appears not to be sufficient to conclude (without any other evidence) that the agreement covers a service.

Specifically the application guidance provided in ED.B4(c) should be subject to further specification, since, in practice, this area is often used to avoid accounting for such a transaction as a lease. Additionally, the guidance should address at least combinations of the two pricing scenarios mentioned in this paragraph.

Finally, we noted that the main body of the ED does not refer to paragraphs B2-B4 of the ED. We consider that to be inappropriate since in all other instances references are included in the main body of the standard if relating application guidance is provided in Appendix B of the ED.

Scope

Question 5: Scope and scope exclusions

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

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

We agree with the boards' proposals on the scope and scope exclusions.

One may argue that the exclusion of all intangible assets and specifically licences, from the proposed new standard on leases represents a setback as compared to the scope of IAS 17, which excludes only some intangible assets from its scope. We agree with the IASB's statement in ED.BC36 that there is no conceptual reason to exclude leases of intangible assets. We understand that it is the board's approach that leases of intangible assets should not be within the scope of the proposed new standard until the boards have considered the accounting for intangible assets more broadly. We support this approach and recommend reviewing and addressing possible problems and issues in the context of leases of intangible assets as soon as it may be possible (e.g., we noted that the lease of a non-exclusive software licence for three years would, under the proposals of the ED be treated differently from a purchase of a three-year licence as required by the guidance proposed in ED/2010/6 *Revenue from Contracts with Customers*, although both transactions are identical from an economic perspective).

According to our understanding, contracts including both tangible and intangible assets are typical for some industries, namely the IT industry, where many lease offerings include both hard- and software. Entities will have to segment these contracts and apply different requirements to each component. We believe that this creates additional complexity that does not benefit users – thus the above mentioned consideration of problems and issues in the context of leases of intangible assets by the boards should be made as soon as it may be possible.

Question 6: Contracts that contain both service and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B6-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not distinct:

(c) the FASB proposes that the lessee and lessor should apply the lease accounting requirements to the combined contract.

(d) the IASB proposes that

- (i) a lessee should apply the lease accounting requirements to the combined contract.
- (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
- (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements and the service component in accordance with the proposals in *Revenue from Contracts with Customers*.

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

We have concerns regarding the accounting for contracts that contain both service components and lease components that are not distinct, in particular from the perspective of the lessor accounting.

Based on the criteria in ED.B7 non-distinct services are those where a profit margin cannot be determined because, e.g., the lessor cannot separately identify the resources needed to provide the service. We are not quite sure whether, based on this decision, distinct and non-distinct services could be easily identified. We propose to define distinct services from a lessor's perspective as those the cost of which can be determined reliably. In general, a lessor should be able to determine the cost for a service component and separately account for the service and the lease component. Based on this definition with regard to lessor accounting we can hardly find examples for material non-distinct services. If there are any, we propose that the IASB should describe them in the application guidance.

With regard to lessee accounting, a combined contract with non-distinct services should be accounted for according to the lease standard only if the lease component is the predominant component. Contracts with a predominant service component should be accounted for as service contracts.

Question 7: Purchase options

The exposure draft proposes that a contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus a contract is accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraph 8 and BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options when they are exercised? Why or why not? If not, when do you think that a lessee or a lessor should account for a purchase option and why?

We fully support the approach proposed by the IASB.

It should, however, be clarified that purchase options do neither need to be accounted for under the requirements of the new lease standard nor in accordance with any other IFRSs (e.g. IAS 39 / IFRS 9).

We do not consider it necessary for lessees to separately account for purchase options since we assume that in most cases the pricing of the lease rentals already reflects any such options. On the other hand, lessors should consider the impact of purchase options when measuring the residual values of the underlying assets.

Measurement

Question 8: Lease term

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

We believe that the proposal to determine the lease term under consideration of term options by estimating the probability of occurrence for each possible term
- is inconsistent with the Conceptual Framework,
- increases unnecessarily and significantly the complexity of lease accounting and
- does not provide reliable information to users of the financial statements.

We consider it to be appropriate to determine the lease term as laid out by us in the answer to Question 1 of this comment letter.

Further, we consider it to be extremely difficult to determine the ‘longest possible term that is more likely than not to occur’ in the case of regular rental agreements (e.g. renting office space or warehouses; in this context please refer to our proposal in the answer to Question 3 (second paragraph) of this comment letter).

We fully share the concern expressed by Stephen Cooper in ED.AV2 ff. It is also our understanding that options to extend or cancel a lease help the lessee in reacting to changing business circumstances and remain flexible. Consequently, these features reduce risks. If the measurement of the lease liability is based on the probability of occurrence for each possible term, a 10-year lease would be accounted for in the same way as a 5-year lease with a 5-year extension period (assuming the lessee is likely to extend the lease). In our view, this fails to provide useful information about the different economic position of the lessee in each of these transactions.

We also consider that rentals payable in an optional extension period (at the commencement of the lease) generally do not meet the definition of a liability based on the Conceptual Framework. The lessee does not have an unconditional obligation to pay rentals as long as it does not exercise the option. Likewise, rentals to be received for an optional extension period (at the commencement of the lease) generally do not meet the definition of an asset based on the Conceptual Framework – the lessor does not have an unconditional right to receive lease payments as long as the lessee does not exercise the option.

Therefore, we propose to determine the lease term as follows: The lease term should be

- limited to the non-cancellable period for which the lessee has contracted to lease the underlying asset (or – if a lower total amount payable results from a shorter lease period including term option penalties – this shorter period sanctioned by penalty payments should be considered), and this term should
- be extended by terms subject to renewal options in case these options are in substance not an option because they create economic compulsion to exercise (i.e. their exercise is *virtually certain* and would, thus, give rise to a contingent asset); this would – for example – be the case if failure to renew the lease would trigger a penalty in excess of the lease rentals to be paid in case the lessee would opt to renew the contract.

In accordance with this approach options are treated based on their economic substance for accounting purposes.

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 contract should be included in the measurement of lease assets and lease liabilities 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 can only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the lease receivable if they can be measured reliably? Why or why not?

We do not agree that contingent rentals should be included in the measurement of lease assets and lease liabilities using an expected outcome technique. We are concerned about introducing the proposed approach since it requires lessees and lessors to follow the guidance as detailed in ED.14, .35 and .52 as well as B21 of the ED, which means that the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes needs to be determined. Let us assume that an entity can reasonably estimate that it will have to pay a contingent rental of CU1,000 with a 20% probability, while it is 80% probable that it will not have to pay any contingent rental. According to the proposals in the ED, the entity would recognise an additional liability to make lease payments in the amount of CU200, even though it is more probable than not that it will not pay anything and therefore would be forced to adjust its liability in a future reporting period. We believe that such an approach does not provide useful numbers in the statement of financial position. We therefore think that a single-best-estimate approach would result in more adequate accounting for contingent considerations.

Term option penalties should be considered by both, lessees and lessors in the boundaries of the approach as we have described above in the answers to Questions 1 and 8.

In case a residual value guarantee does have an intrinsic value different from nil at the inception of the lease, we propose that it should be included by both, lessees and lessors in the measurement of lease assets and lease liabilities. In accordance with this approach, agreements made between the lessor and the lessee in the form of a residual value guarantee, which we in such instances consider to be a disguised rental payment, are treated for accounting purposes based on their economic substance.

If, however, the residual value guarantee does have an intrinsic value of nil at the inception of the lease, largely due to simplification purposes we propose the following:

- lessees should account for it in accordance with IAS 37 – i.e. a provision should

be recognised in case the requirements of that standard are met;
- lessors should account for it by taking into consideration the residual value guarantee in the course of the subsequent measurement of the underlying (residual) asset.

If term options or options to renew a contract, which are not part of the lease term as defined in our answers to questions 1 and 8 of this comment letter, are granted at lease rates lower than the lease rates agreed for the lease term as defined by us, lessees should recognise a separate asset for this option. This asset should be measured as follows (if rentals are agreed to be paid monthly, as an example):

total liability to make lease payments for the lease term as defined by us
less *(average monthly lease rentals for the period covering the lease term as defined by us and optional lease periods for which lower rental payments are granted)*
multiplied by (the number of months of the lease term as defined by us)

The asset should further not be subject to any subsequent measurement changes. At the end of the lease term as defined by us, the asset should be fully expensed in case the lessee does not opt to extend the lease. If, however, the lessee opts to extend the lease period, the asset should be expensed over the additional lease period. Lessors should account for such term options or options to renew a contract respectively.

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 obligation or receivable arising from changes in the lease term or contingent payments since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

In respect of the measurement proposals we made above, we support the proposed requirement to remeasure assets and liabilities when changes in facts or circumstances indicate that there is a significant change in the obligation or receivable since the previous reporting period in order to reflect current economic conditions.

For practical reasons we encourage the IASB to provide application guidance as to how the term 'significant change' is to be understood. For example, similar quantified guidance as provided in IAS 39.AG62 (or IFRS 9.B3.3.6) with regard to the derecognition of a financial liability is considered helpful.

Sale and lease back

Question 11
Do you agree with the criteria for classification as a sale and leaseback transaction? Why or not? If not, what alternative criteria would you propose and why?

We agree with the basic concept introduced by the IASB to determine whether to account for a transaction as either
- a sale / a purchase and a subsequent lease or
- a financing.

We do not agree that only the performance obligation approach can be applied to transactions qualifying as a sale / purchase and a subsequent lease.

Considering our proposal that lessors should apply the derecognition approach only, there is actually no need for specific guidance on sale and leaseback transactions since it may be derived from the other guidance in the ED.

Additionally, we noted the following: According to ED.BC162 the IASB proposes that a transaction be treated as a sale and leaseback transaction only if there is a sale of the underlying asset. In order to determine whether there is such a sale, it is stated that the same criteria for a sale should be used as those used to distinguish between purchases or sales and leases (refer to ED.B9). However, in ED.B31 the IASB has added examples of conditions that the parties must assess to reach a conclusion on whether the transfer is a sale (‘Additionally, such sale and leaseback contracts may have conditions that generally do not arise in other transactions and may result in the transfer not meeting the conditions for a purchase or a sale.’). This appears to be a contradiction since sale and leaseback transactions have to meet more stringent requirements in order to qualify as a sale than regular transactions dealt with in ED.B9 f. If this has not been intended by the IASB, we suggest this contradiction be resolved.

We consider the proposed requirements for instances in which the consideration for (1) a purchase or a sale or (2) the lease payments specified by the leaseback are not at fair value necessary and agree with the proposals.

Presentation

Question 12: Statement of financial position

(a) Do you agree that a lessee should present its liability to make lease payments separately from other financial liabilities and present right-of-use assets as if they were tangible assets within property, plant and equipment, or investment property as appropriate, but separately from other assets that the lessee does not lease (paragraphs 25-27, 42-45, 60-63 and BC142-159)? Why or why not? What alternative presentation do you propose and why?

(b) Do you agree that a lessor applying the performance obligation approach should present its 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? What alternative presentation do you propose and why?

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

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease separately (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?

As a general comment on these questions on presentation, we favour that separate presentation on the face of the financial statements relating to leases not be required per se, but only if it was material for the reporting entity. On that basis we are of the opinion, that the presentation requirements as outlined in IAS 1 are sufficient (specifically IAS 1.57, which requires separate presentation in the statement of financial position when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position). In any case, if an entity does not separately present financial information relating to leases in the statement of financial position, it should instead provide that information in the notes.

Subject to these general comments, we hold the following views.

We agree with the proposals for lessees and the arguments provided in ED.BC143. We see a difference between assets owned and assets held under a lease, and between liabilities relating to lease payments and liabilities resulting from other borrowings, respectively. Thus we believe that separate presentation is justified. However, whether this presentation should be provided on the face of the statement of financial position or in the notes, should be decided based on the above mentioned guidance in IAS 1.

Since we do not support lessors applying the performance obligation approach, we do not comment on the related presentation proposals.

We agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and residual assets separately within property, plant and equipment. Whether this presentation is to be provided on the face of the statement of financial position or in the notes should be decided based on the general guidance in IAS 1 as outlined above.

We agree that lessors should distinguish assets and liabilities that arise under a sub-lease separately. However, this should only be done on the face of the statement of financial position if the requirements for separate presentation under IAS 1 are met – otherwise that information should be provided in the notes.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and expense separately from other income and expenses in the statement of comprehensive income (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? 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?

Again, as a general comment on this question on presentation, we favour that separate presentation relating to leases is not required per se, but only if it is material for the reporting entity. On that basis we are of the opinion that the presentation requirements as outlined in IAS 1 are sufficient (specifically IAS 1.85, which requires the presentation of additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance). In any case, if an entity does not separately present financial information relating to leases in the statement of comprehensive income, it should instead provide that information in the notes.

Subject to these general comments, we support the presentation requirements in the ED and believe that they provide useful information. In other words, whether this presentation should be provided on the face of the statement of comprehensive income and the separate income statement (if presented) or in the notes should be decided based on the above mentioned guidance in IAS 1.

Question 14: Statement of cash flows

Do you think that cash flows arising from lease contracts should be presented on 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?

Also with reference to the statement of cash flows and as a general comment on this presentation question, we favour that separate presentation relating to leases is not required per se, but only if it is material for the reporting entity. On that basis we are of the opinion that the presentation requirements as outlined in IAS 7 are sufficient (specifically IAS 7.11, which requires an entity to present its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business).

Subject to these general comments, we agree with the proposals and believe that they provide useful information – however, cash flows arising from lease contracts should be presented in the statement of cash flows separately from other cash flows taking materiality into account.

However, we disagree with the proposed classification of ED.27 according to which a lessee should classify cash payments for leases as financing activities in the statement of cash flows. In the light of the IASB project *Financial Statement Presentation* we suggest not to prescribe the classification of cash payments for leases by a lessee but to require lessees to disclose as part of their accounting policy how such payments are classified in the statement of cash flows instead and to apply this policy consistently.

Disclosures

Question 15

Do you agree that lessee and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognised in the financial statements arising from lease contracts; and

(b) describes how lease contracts 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 generally agree with the proposed approach as detailed in ED.71 that an entity should consider the level of detail necessary to satisfy the disclosure requirements as described in ED.73-86. However, we have concerns that there is a tendency that converting these objectives into concrete disclosure requirements always results in additional disclosure requirements which appears especially true for this ED. We wonder why a proposal for a lease accounting model supposed to be superior compared to the current model needs such excessive additional disclosures.

Further, on the one hand we understand that the disclosures as required by IAS 17 *Leases* mainly need to be provided since the two models (finance and operating leases) do not provide a faithful representation of leasing transactions. In particular, they omit relevant information about rights and obligations that meet the definitions of assets and liabilities under the IASB's conceptual framework. On the other hand, it is also our expectation that once such relevant information about the rights and obligations are reflected in assets and liabilities recognised in the statement of financial position – as proposed by the IASB in the ED –, the required amount of disclosures would be reduced significantly. As mentioned above, it is our impression from the proposals that this will not be the case.

Specifically, we have concerns regarding ED.70(b), which requires an entity to describe how leases may affect the amount, timing and uncertainty of its future cash flows. These concerns would specifically apply to the detailed quantitative information to be provided in this context (ED.84 in connection with IFRS 7.34-42 and ED.85 f.). Therefore, we ask the IASB to change this requirement in a way that the information required in ED.70(b) should mainly focus on qualitative rather than on quantitative information.

Further, the list of disclosure requirements (ED.73-86) appears to be rather long, which is partly due to the complex measurement requirements, for which further explanatory information must be disclosed. We consider this to be inappropriate and therefore ask the IASB to review the proposed disclosure requirements with the view of reducing them to those which are truly necessary in the light of ED.70(a) and ED.70(b) considering the alteration requested above.

An additional concern relates to the information value of the disclosures as proposed in the ED. We believe that for diversified entities certain proposed disclosures (e.g. ED.73(a)(i)) will either result in boilerplate statements (e.g.: 'We have entered into lease arrangements for a wide variety of assets and for lease terms ranging from a few months up to above 60 years and with differing features with regard to contingent rentals, term options and residual value guarantees.') or in lengthy note disclosures that describe the entity's different lease agreements in different countries and regions, optional agreements etc. We believe that this neither represents decision-useful information nor is justified in cost-benefit terms.

Transition

Question 16

(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

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

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

While we agree with the simplified retrospective approach as proposed by the IASB, we suggest additionally permitting (without requiring!) full retrospective application of the new requirements. The main reason for this is that lessors under the derecognition approach (ED.95(b)) at the date of initial application should recognise the residual asset at fair value determined at the date of initial application. However, for underlying assets in use it may be challenging and burdensome to determine the fair value as described above, while it may be more practical (in accordance with a full retrospective approach) to go back to the initiation of the lease, since the fair value in that case simply may be derived from the purchase costs of the underlying asset.

With respect to IFRIC 4 *Determining whether an Arrangement contains a Lease* we noted that similar but not identical guidance has been incorporated into ED.B2-B4. In our view, that similar but not identical guidance should not result in a requirement that entities should re-consider agreements that had already been appropriately evaluated under the current guidance of IFRIC 4.

Preparers need adequate lead time to prepare for application of the new guidance for lease accounting once the IASB issues the new standard. Specifically, contract management, internal work-flows and processes as well as IT environments need to be adjusted and prepared for the new guidance and to allow for a smooth transition.

There is no guidance on the transition for sale and leaseback arrangements in the ED. We ask the IASB to address also this issue so that an entity will be required to determine whether a sale has occurred in the past based on IFRS applicable at that time. Only the lease part of the transaction should be accounted for under either the simplified or full retrospective approach as proposed in the ED.

Benefits and costs

> **Question 17**
>
> Paragraphs BC200-BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals outweigh the cost? Why or why not?

Although we did not conduct a cost-benefit analysis ourselves, we do have concerns that the benefits of the proposal do outweigh the costs. We specifically consider the costs

- to determine the lease term by estimating the probability of occurrence for each possible term (taking into account the effect of any options to extend or terminate the lease) and the present value of the lease payments on the basis of expected outcomes including any contingent rentals and
- to apply the hybrid model by lessors

to exceed the benefits associated with these proposals. The costs and administrative burden arising from implementing these features and the ongoing monitoring as well as carrying out the required reassessments will be significant.

However, from a user's perspective, a benefit of better economic decision-making as a result of improved financial reporting – considering our above comments – is likely to be expected on the basis of lessees' financial statements in case the right-of-use approach will be implemented. On the other hand, we do not expect similar benefits with regard to the financial statements of lessors.

On balance, we are not convinced that, overall, the benefits of the information resulting from the proposed new standard will exceed the costs. Therefore, we strongly request an adequate cost / benefit analysis to be conducted and evaluated before the Board finally decides on the future lease standard. The analysis and its evaluation should also include a comprehensive review of the comment letters received and the results of other consultations (e.g. field tests, public hearings, round-table meetings, outreach activities). We consider this to be the only approach to reach appropriate results.

While carrying out its due process before the final standard is issued, the IASB should specifically investigate the cost-benefit advantages which will be triggered by the proposals as we made them in this comment letter, of which the most important ones are:

- instead of requiring a hybrid model for lessors, we propose requiring only the derecognition approach;

- instead of requiring the present value of the lease payments to be determined on the basis of expected outcome, we propose requiring its determination based on the single-best-estimate approach;
- instead of defining the lease term as the longest possible term that is more likely than not to occur, we basically propose to limit the lease term to the non-cancellable period for which the lessee has contracted to lease the underlying asset including optional term extensions in case these options create economic compulsion to exercise; and
- to fully exclude short-term leases (including leases which are agreed without an expiration date for the contract, which may be cancelled at any given time with a notice period of one year or less) from the scope of the proposed new standard.

Other comments

Question 18
Do you have any other comments on the proposals?

The ED does not address the following matters that we believe are pertinent to enable proper application of a new standard on leases.

As a general concern we would like to comment on the accounting treatment for executory contracts. We have observed that contracts similar to leases may have similar characteristics but are not accounted for consistently. For example, service contracts, maintenance contracts and lease contracts share similar characteristics but are subject to different accounting requirements (including those currently proposed by the IASB, e.g. ED/2010/6). If the IASB decides to implement the right-of-use approach to lease accounting, this will cause conceptual concerns in a way that similar transactions are accounted for differently.

Guidance currently available in IFRS and proposed to be superseded

According to para. 4 of IFRIC 4 *Determining whether an Arrangement contains a Lease*, the Interpretation does not apply to arrangements that are public-to-private service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*. Since the ED does not include such a scope-out, it appears to be unclear whether it still will be applicable under the proposed guidance in the ED. We suggest that this issue should be clarified specifically.

ED.97 stipulates that SIC-15 *Operating Leases – Incentives* will be superseded by the new lease standard. However, the ED does not address how incentives in a lease should be recognised in the financial statements of both, the lessee and the lessor. We propose to address this issue in the final new lease standard.

Definitions and terms

'Term option penalties' should be defined in Appendix A *Defined Terms* of the ED.

According to IAS 17 the interest rate implicit in the lease is 'the discount rate that, at the inception of the lease, causes the aggregate present value of (a) … and (b) … to be equal to the sum of (i) … and (ii) any initial direct costs of the lessor'. According to ED.B12 the discount rate used to determine the present value of lease payments for lessors

> 'is the rate that the lessor charges the lessee. The rate the lessor charges the lessee could be, for example the lessee's incremental borrowing rate, the rate implicit in the lease (ie …) or, for property leases, the yield on the property.'

However, it appears not to be clear whether the discount rate as defined in the ED should consider

- any initial direct costs, and / or
- guaranteed and / or unguaranteed residual values.

We propose to clarify these issues.

In addition, the ED does not provide any guidance on the new term 'yield on the property' (as used in ED.B12) and how this new rate should be determined. We consider such guidance necessary since in practice different methods to calculate a yield on property are in use. We propose to clarify this issue. Such clarification should, however, be principle-based.

As a general request, we ask the IASB to provide more guidance on the specific meaning of terms like (in-)significant and (not) trivial – and, specifically, how they interact with the established term (im-)material. This would greatly help preparers as well as users to gain a better understanding of the impact of these terms and how they are applied in the context of the proposed new guidance for leases. It also would help ensuring a consistent understanding and application of these terms.

Other

In general, and according to ED.B25, a residual value guarantee will reduce a lessor's exposure to downside risk but may give the lessor the potential to benefit from increases in the expected value of the underlying asset at the end of the lease. In this context, the IASB left open which risks or benefits the lessor should focus on when deciding to apply the performance obligation or the derecognition approach. The IASB should provide further guidance on this issue.

The ED does not address how to account for changes or modifications of existing lease contracts (e.g., in case an optional lease period is agreed for a four year lease after two years of the lease contract have passed). We propose that the IASB provides guidance for such instances.