

xx July 2009

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 6 July 2009

Dear Sir/Madam

Re: IASB/FASB Discussion Paper *Leases*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB/FASB discussion paper *Leases*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

Lease contracts are very important sources of financing for entities and the existing accounting standard on lease accounting has been criticised, particularly by users. We are therefore pleased that the IASB has decided to address lease accounting and we support the decision to do the work as a convergence project with the FASB.

Our detailed comments are set out in the appendix to this letter, but to summarise:

- The discussion paper (DP) focuses on lease accounting by lessees; consideration of lessor accounting has been deferred. Although we understand why this has been done, it does mean that fundamental decisions about the direction and key principles underlying the new lease accounting model have been taken from only one perspective (the lessees'). We are uncomfortable about this because we think some of the fundamental decisions might have been different had a more comprehensive analysis of the issues been undertaken, based on both perspectives. As a result, all the views we express in this letter are to some extent tentative until lessor accounting has been considered.
- We agree with the proposed conclusion in the paper that conceptually the 'right-of-use approach' should be used for all lease arrangements. However, we would be concerned about the cost-benefit implications were such an approach to be applied to short-term lease arrangements. We have discussed whether the normal materiality considerations might make it unnecessary in many cases to apply the 'right-of-use approach' to such arrangements, and think it would be helpful if this matter could be addressed specifically at the next stage of the project.

EFRAG's Draft Comment Letter on the IASB/FASB Discussion Paper Leases

- Having said that, we believe that applying the 'right-of-use approach' to all leases will make the distinction between leases and service arrangements even more important than it is currently. We think it would be particularly unfortunate if the result of the DP was simply to replace one difficult border—between operating and finance leases—with another—between service arrangements and leases.
- EFRAG members are divided on the DP's proposal that a components approach should not be used to account for options in lease agreements. Some members believe that the approach proposed is pragmatic and makes it possible to propose important improvements in lessee accounting. Some other members believe that the approach proposed will result in amounts being recognised as liabilities that are not liabilities, and that this will reduce the usefulness of the information provided.
- However, if we assumed that the approach adopted by the DP on this issue is correct, we would broadly agree with most of what the DP says about the recognition and measurement of leases, although we do not support some of the proposals relating to the reassessment of the obligation to pay rentals, or to some of the proposals relating to contingent rentals. In particular:
 - we do not believe the obligation to pay rentals should be revised for changes in the incremental borrowing rate; and
 - we believe it is preferable to adopt a consistent measurement approach to the uncertainty that arises from term options and contingent rental payments. Thus we do not support using a probability-weighted approach for measuring contingent rental payments.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Aleš Novak, Jeff Waldier or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix

EFRAG's detailed responses to the questions asked in the discussion paper

CHAPTER 2: SCOPE OF LEASE ACCOUNTING STANDARD

Question 1—The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

- 1 EFRAG generally believes that the objective in a major project such as the lease accounting project should be to try to deal with the subject matter in a comprehensive manner. Yet the proposal is that the scope limitations in the existing standard should be carried forward without any attempt being made to eliminate them.¹ We are not aware of any conceptual reason for those scope limitations.
- 2 On the other hand, we are also aware that the criticism by users of the existing lease accounting standards has in the main not been about the scope of the standards. Rather it has been focused on the belief that operating leases give rise to assets and liabilities that should be recorded in the financial statements of the lessee. We recognise that, if the discussion paper (DP) is to result in a new standard by 2011, there is probably not enough time to address the main concerns of users and have an extensive debate about scope. Therefore, although we generally would have preferred a more comprehensive review of the scope issue, we understand and accept the boards' preliminary view that the scope of the proposed new standard should be based on the scope of the existing standards.
- 3 However, thinking ahead, since this is a joint project of IASB and FASB, there will presumably need to be work done prior to finalising the standard to try to reduce or eliminate the scope differences that currently exist between SFAS 13 *Accounting for Leases* and IAS 17 *Leases*. SFAS 13 applies only to arrangements that convey a right to use property, plant and equipment, while IAS 17 has a wider scope because it defines a lease as a right to use an asset, including most intangible assets. We would prefer the scope of the new standard to be based on IAS 17 rather than SFAS 13 because we see no reason to exclude intangible assets from the scope of a lease accounting standard. Furthermore, if intangibles were to be excluded from the scope of the new lease accounting standard:
 - (a) it would mean that the IASB would need to address—as a matter of priority because there would now be a large potential gap in IFRSs—accounting for leases of intangibles in a separate project;
 - (b) we suspect the application of the IFRS hierarchy would mean that leases of intangible assets would be accounted for in accordance with the leasing accounting standard.

¹ The existing scope limitations relate to: leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

For these reasons, we think the real issue is whether there are any intangibles where lease accounting would not make sense.

- 4 That said we are concerned that there is currently some uncertainty as to how and where the boundary should be drawn between service arrangements and lease arrangements. We think the recognition and measurement proposals in the DP might result in this existing grey area becoming even more important, thus putting greater pressure on the existing guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease*. It would be a pity if the result of the DP was to replace one difficult border—between operating and finance leases—with another—between services arrangements and leasing arrangements.

Question 2—Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Background notes for EFRAG constituents

- 5 *The DP explains that, although some constituents have suggested that the new standard should provide scope exclusions for non-core asset leases and short-term leases, the boards have not reached any preliminary views on either of the issues.*

EFRAG's response

- 6 The 'right-of-use approach' requires all lease arrangements, all rental agreements and all hire arrangements to be treated in the same way, however short the lease/rental/hire period and regardless of whether the asset is a core asset. EFRAG is aware that some stakeholders are concerned about this because they doubt that the benefits that would arise from applying the approach to certain arrangements (perhaps short-term arrangements, or arrangements involving non-core assets) justify the costs that would be involved in doing so.
- 7 EFRAG believes that, under the conceptual model proposed in the DP (the right of use model)—a model with which EFRAG agrees—there are no conceptual reasons for any such exclusion. Conceptually, a right-of-use is a right-of-use, regardless of the type of asset involved. Similarly, a right-of-use for one day is still a right-of-use and rental and hire agreements are just other terms for a lease arrangement.
- 8 EFRAG is also concerned that, if a new standard differentiates between leases of, for example, core and leases of non-core assets, we might be replacing one 'two model approach' approach with another two model approach—and having a two model approach is one of the sources of the criticism with the existing lease standards.
- 9 On the other hand, we also recognise that, when users criticise existing lease accounting, the target of their criticism tends to be longer term arrangements that involve core, operating assets. As such, that raises legitimate concerns as to whether the cost of applying the recognition and measurement approach proposed in the DP to short-term arrangements and arrangements involving non-core assets is likely to exceed the benefits that would arise.
- 10 We think this is probably a materiality issue; just as small items of capital expenditure on plant and equipment are not capitalised on materiality grounds, so

it ought to be acceptable not to apply the 'rights-of-use approach' to relatively short-term leases. Nevertheless, we think it would be helpful were this addressed in the next stage of the project.

CHAPTER 3: APPROACH TO LESSEE ACCOUNTING

Question 3—Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Background notes for EFRAG constituents

- 11 *The boards identified the following rights and obligation in a simple lease²:*
- (a) *right to use the asset for the lease term,*
 - (b) *obligation to pay rentals and*
 - (c) *obligation to return the asset at the end of the lease term.*
- 12 *Having identified the rights and obligations arising in this simple lease, the boards then considered whether those rights and obligations meet the definitions of assets and liabilities. Although the wording of the existing IASB and FASB asset definitions are different, the basic concepts underpinning them are the same.*
- 13 *The boards identified the right to use the leased item as an economic resource of the lessee because the lessee can use it to generate cash inflows or reduce cash outflows. The boards tentatively concluded that:*
- (a) *the lessee controls the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of the lessee (or breach of contract);*
 - (b) *the control results from past events – the signing of the lease contract and the delivery of the item by the lessor to the lessee. unless the lessee breaches the contract, the lessee has an unconditional right to use the leased item;*
 - (c) *future economic benefits will flow to the lessee from the use of the leased item during the lease term.*

Accordingly, the boards tentatively concluded that the lessee's right to use a leased item for the lease term meets the definitions of an asset in the IASB's Framework for the Preparation and Presentation of Financial Statements and the FASB's Concepts Statement No. 6 Elements of Financial Statements.

² Reference is made to Example 1 in the DP. It is a fixed term, non-cancellable lease of a machine for five years, expected life of the machine is 10 years, with no rights to extend the lease term or to purchase the leased asset at the end of the term, with no guarantees of its (residual) value, with no maintenance or other arrangements and with fixed lease payments that are specified in the original agreement. To simplify the analysis further, the boards considered only those rights and obligations that exist after the leased item is delivered to the lessee. Assets and liabilities may arise before delivery of the leased item (e.g. when the contract is signed). Chapter 9 of the DP discusses that issue.

- 14 *The boards also tentatively concluded that:*
- (a) *the lessee has a present obligation to pay rentals.*
 - (b) *this obligation arises out of past events—the signing of the lease contract and the delivery of the item by the lessor to the lessee.*
 - (c) *the obligation is expected to result in an outflow of economic benefits (usually cash).*

Accordingly, the boards tentatively concluded that the lessee's obligation to pay rentals meets the definitions of a liability under both conceptual frameworks.

- 15 *On the other hand the boards decided that the obligation to return the leased item does not result in an outflow of economic benefits from the lessee and does not meet the definitions of a liability. They reasoned that although the lessee has physical possession of the leased item, it has no right to use the item once the lease term expires and that the position of the lessee at the end of the lease term is like that of an asset custodian. The lessee is holding an asset on behalf of a third party but has no right to the economic benefits embodied in that asset.*

EFRAG's response

- 16 The identification of the rights and obligations—and therefore assets and liabilities—arising in a simple lease contract depends on one's perception of what is being transferred in a leasing transaction. The 'right-of-use' notion is based on the view that ownership of a physical asset gives the owner a series of rights and those rights can be transferred individually by means of, for example, a lease arrangement. If this is one's view of what an asset and a lease arrangement involves, one would generally agree with the boards' view as to the rights and obligations and assets and liabilities arising under a simple lease. However, as explained in appendix C of the DP, there are other ways of viewing these issues. For example, some might argue that a physical asset is indivisible, and that a lease agreement involves transferring the whole, indivisible asset.
- 17 As explained more fully in our response to question 4, we favour the 'right-of-use approach' proposed in the DP and therefore are supportive of the boards' analysis of the rights and obligations—and therefore assets and liabilities—arising in a simple lease contract.
- 18 Having said that, we have two concerns about this part of the paper:
- (a) It seems to us that, having analysed a simple lease and reached a conclusion as to the assets and liabilities involved, the DP has simply extended that conclusion to more complex leases without asking whether the conclusion applies more widely. We question whether this is appropriate.
 - (b) We are concerned that the tests used in the DP to establish whether there has been a derecognition event are fundamentally different from those proposed in the recent IASB Exposure Draft on Derecognition of Financial Assets. For example, in this DP (and in the Revenue Recognition DP), a transfer is a derecognition event; but it is not in itself a derecognition event in the Derecognition ED. Furthermore, under the Derecognition ED if an entity transfers an asset to another party one would ask whether the transferee is able to transfer the asset to a third-party to determine whether the transferee

controls the asset, and therefore whether the transferor should derecognise it. Yet, in this DP there is no mention of control; it is assumed that an entity that transfers a right of use has given up control of that right and an entity that acquires a right of use has control of it. This is an important difference in approach, because it is common for lessees to need the consent of the lessor to sublease the asset, but it is not one we can see any conceptual justification for.

Question 4—The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise: (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset) (b) a liability for its obligation to pay rentals. Appendix C describes some possible accounting approaches that were rejected by the boards. Do you support the proposed approach? If you support an alternative approach, please describe the approach and explain why you support it.

The existing approach

- 19 It has become almost an unchallengeable truth that the existing IASB and FASB standards—which require each lease to be categorised as either an operating lease or finance lease and for each category to be accounted for differently—are broken. Certainly the existing IASB standard is much criticised by users, and EFRAG agrees with much of the criticism. For that reason, EFRAG agrees with the boards' decision not to base the new lease accounting standard on the existing approach.
- 20 Having said that, it is easy to forget that most leases are categorised without difficulty under the existing approach and that many of the leases that are categorised as operating leases are the leases that many are arguing do not really need to be capitalised. In particular:
- (a) as we mentioned in our response to question 2, many stakeholders are arguing that the 'right-of-use approach' should not be applied to leases of non-core assets and/or to short-term leases;
 - (b) we mention below that users we have spoken to are quite attracted to the 'whole asset' approach. Our understanding is however that users would not wish the whole asset approach to be applied to short-term contracts;
 - (c) we understand that some stakeholders are arguing that the 'right-of-use approach' should be applied only to those lease arrangements that are financing arrangements; and they argue that many of the shorter-term lease arrangements, particularly those involving non-core assets, are not financing arrangements.
- 21 It could therefore perhaps be argued that the approach adopted in existing standards should be seen as an attempt to draw a pragmatic line between leases that people want to see capitalised and need to be capitalised and leases where the demand or need is probably not sufficient to justify the costs involved. Under this way of thinking, the problems with the existing model arise from those leases that are close to the boundary between the categories and from the degree of judgement involved (which seems to result in too many assets appearing on no statement of financial position at all). Bearing that in mind, some would argue that it is wrong to abandon the whole approach; it would be better to try to tackle the specific problems involved. However, that is not our preference—we believe the

'right-of-use approach' should be applied to all leases—although we would be less supportive of the 'right-of-use approach' if it proved necessary, in order to make it operational and to take into account cost-benefit considerations, to introduce a new set of bright lines.

A variation on the existing approach

- 22 Another possibility might have been to retain the existing approach for accounting for finance leases and to extend that approach to all other leases. In other words, require all leases to be categorised as finance leases and make no other change to the existing standard.
- 23 One advantage of this approach would be that it would be unnecessary to recognise a liability for items that some believe do not meet the definition of a liability.
- 24 On the other hand, under the existing finance lease approach, the focus is on the minimum lease payments, where the term options and contingent rentals are largely ignored. Some would argue that such an approach does not faithfully represent the substance of the lease contract. EFRAG believes this is a weakness, and therefore favours an approach that takes such options more fully into account.

The whole asset approach

- 25 Another possible approach is the so called 'whole asset' approach. Under this approach the lessee recognises the whole asset—not merely the right-of-use—and also a liability to return what remains of the asset at the end of the lease.
- 26 We understand that some users have expressed their preference for this approach. They argue that including the whole asset in the statement of financial position of the lessee makes sense, because the whole asset is utilised to generate the returns to the lessee during the reporting period. They also argue that the lessee is often economically in the same situation as the owner who has taken out a loan to finance the purchase of the asset. They argue furthermore that, if the service potential inherent in the asset is needed for the entity to be a going concern, the fact that the lessee has to replace the asset is better reflected in the statement of financial position by applying the whole asset approach.
- 27 The 'whole asset approach' provides more comparable information because, they argue, it means that an entity's return on capital employed will be unaffected by whether it purchases its assets or leases them. The asset's generate similar returns and use up the same amount of productive capacity, and the accounts should acknowledge this similarity. Finally, they argue that adopting a whole asset approach would simplify the accounting for very complicated lease transactions. Users have suggested to us that, in order to avoid the problem of having to recognise under the whole asset approach the whole of an asset that an entity has rented for just one day, they would exempt short-term leases. This can be criticised for having no apparent conceptual basis, but of course it is an issue that also arises under the DP's favoured 'right-of-use approach'.
- 28 In rejecting the 'whole asset approach', the DP argues that entities that lease their assets have more flexibility to reduce their capital base than those that purchase their assets—and that therefore the transactions are not identical economically. We think that is true in some cases, especially for leases of shorter duration.

However, for longer leases and particularly when 'core' assets are involved, we think the issue is not that clear cut. For example, someone who purchases an asset can also sell it at any time, whereas a lessee will often be restricted from subleasing the asset and heavily penalised if it terminates that lease early. On the other hand, someone who purchases an asset—and therefore owns it—will have more control over that asset than someone who leases it and will therefore have greater flexibility as to how the asset is used.

- 29 EFRAG believes that, although the whole asset approach works well—and for example provides more comparability—for long-term leases that are in-substance purchases, it is fundamentally flawed conceptually for shorter leases because it implies the lessee has assets that it does not have (a right to use the leased item beyond the end of the lease). We also think the comparability of the whole of asset approach is overstated, because an entity that leases an asset will often not be in an identical position to an entity that has purchased it.

Right-of-use approach

- 30 We favour the approach the DP favours: the 'right-of-use' approach. We think it correctly reflects the rights the lessee has acquired and the obligations it has taken on in respect of those rights. We also think this approach will be more useful for predicting future cash flows because the obligation reflects the expected lease payments.

Question 5—The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises: (a) a single right-of-use asset that includes rights acquired under options (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees. Do you support this proposed approach? If not, why?

- 31 EFRAG members are currently split on this issue.
- 32 Some members support the proposal in the DP not to adopt a components approach and instead to incorporate estimates of how the options in leases will be used in determining the extent of the right of use and the amount of the lease obligations.
- (a) These EFRAG members believe that this approach will result in the most useful information being provided to users because it attempts to reflect the effect that the options could have on the lessee's asset and liability. This, they believe, means that the implications of the options will be more understandable.

For example, assume a lessee enters into a five year lease arrangement that involves the option of leasing for a further three years. Assume also that, at contract inception, it is slightly more likely that the lessee will exercise the option than it will not exercise it. Under the proposals in the DP, the lessee will be required to recognise an 8 year right-to-use asset and an obligation to pay 8 years of lease payments, even though it has an enforceable obligation only for the first five years of payments.

In effect, the DP requires the lessee to recognise the liability that is thought most likely to arise from the lease contract.

- (b) Most of these EFRAG members also have concerns about the practicability of the alternative approach (the components approach), which would involve recognising each of the options inherent in the lease in the statement of financial position and measuring those options at some sort of current value. These members note that the boards too are of the view that significant implementation issues would arise if this approach were to be required by the new lease accounting standard.

33 On the other hand, some EFRAG members believe a components approach should have been adopted, because they believe the approach proposed in the DP will give rise to a number of fundamental problems and inconsistencies.

- (a) Some of these EFRAG members are concerned about the apparent inconsistency between the proposals in the DP and the way that options and uncertainties are dealt with in other aspects of accounting. They note for example that the DP says that the IASB thinks a components approach is conceptually the correct approach and they note that elsewhere in accounting a components approach is generally adopted.
- (b) There is probably more than one way of implementing the non-components approach proposed in the DP, but these EFRAG members believe that the way in which the DP is proposing to implement could result in:
 - (i) the recognition as liabilities of amounts that do not meet the definition of a liability. In their view, this will result in the recognition of liabilities that are neither understandable nor comparable;

Consider the example given in the previous paragraph. A lessee with a five year lease and an option to extend for a further three years has a legally enforceable obligation (liability as defined) for only five years' payments, but would be required by the DP to recognise an obligation to pay 8 years of lease payments.

These EFRAG members argue that it is illogical to require a lessee that has such an option and will presumably exercise it only when it is to its advantage to do so to recognise a larger liability than a lessee that does not have an option to extend beyond the five years.

- (ii) a lessee that has the flexibility that an option creates being treated in exactly the same way as a lessee without any flexibility.

For example, in the above example, the DP's proposals require the lessee to account for the lease in exactly the same way as it would account for an 8 year lease with no option to end the arrangement after 5 years.

Similarly, consider a variation on the above example in which it is slightly more likely that the lessee will not exercise the option than it will exercise it. Under the DP's proposals the lessee will account for this lease in exactly the same way as it would account for a 5 year lease with no option to extend.

In fact, a lease with a renewal or purchase option generally provides the lessee with a greater degree of flexibility at the end of the lease term because it is able to renew the lease or purchase an asset usually at a pre-established lease rate or purchase price. In order to continue its ongoing activities, a lessee without such an option would probably need to enter into a new lease arrangement or to purchase

an asset; both of which would involve potentially less favourable terms than a lessee that has a contractual option in the lease arrangement.

Question to EFRAG's constituents

As the paragraphs above show, EFRAG members are divided on this issue. Some believe that the approach the DP proposes is the only practical approach and is also the most useful (it focusing on the expected cash outflows from the lease); whilst others believe that that approach will result in amounts being recognised that are not understandable or comparable and misrepresents the flexibility the lessee has.

We would therefore particularly welcome your views on the issue. Do you agree with the approach proposed in the DP? If not, what are your major concerns and why do you believe that the components approach is capable of practical implementation?

34 EFRAG also believes that:

- (a) the DP should be clearer on the practical issues that have caused the boards to decide tentatively not to adopt a components approach to accounting for complex lease contracts.
- (b) we think it is important that the boards explain, before finalising a lease accounting standard based on this approach, what they believe the consequences of this decision would be for similar issues on other projects, such as insurance.

CHAPTER 4: INITIAL MEASUREMENT

Question 6—Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate? If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Background notes for EFRAG constituents

- 35 *The DP notes that the lessee's obligation to pay rentals meets the definition of a financial liability in IAS 32 Financial Instruments: Presentation. IAS 39 Financial Instruments: Recognition and Measurement, which excludes lease liabilities from its scope, requires financial instruments to be measured initially at fair value.*
- 36 *The boards discussed whether to require the lessee to measure the obligation to pay rentals initially at fair value and noted that in most lease contracts it is not possible to observe the fair value of the obligation to pay rentals directly. Consequently, discounted cash flow techniques will be used to determine the initial measurement of the obligation to pay rentals.*
- 37 *The boards discussed the discount rate that should be used to measure the obligation to pay rentals using a discounted cash flow technique. The boards considered two possible rates:*

- (a) *the interest rate implicit in the lease*³ and
- (b) *the lessee's incremental borrowing rate*.⁴

- 38 *The boards took the tentative view that theoretically the interest rate implicit in the lease was the correct approach. However, they identified some practical problems in determining that rate. For example, in many instances the lessee will not know or be able to determine the implicit rate, particularly in the case of leases currently classified as operating leases where the residual value of the leased property has a very significant affect on the interest rate implicit in the lease, but can be difficult to estimate reliably—especially as the lessee in a relatively short-term lease may have little knowledge of the residual value of the leased asset at the end of the lease.*
- 39 *Because of these, the boards discussed whether to retain the approach used in the existing IFRS. That approach requires lessees to discount the lease payments using the interest rate implicit in the lease if it is practicable to determine that rate and, if it is not practicable to determine that rate, the lessee's incremental borrowing rate shall be used. The boards tentatively decided not to retain the approach to discount rates used in the existing IFRS because it would be more complex for preparers to apply and might reduce comparability for users.*
- 40 *As a result, the boards have tentatively decided to measure the lessee's obligation to pay rentals on initial recognition at the present value of the lease payments, discounted using the lessee's incremental borrowing rate. The boards also noted that in most leases the present value of the lease payments discounted using the lessee's incremental borrowing rate would be a reasonable approximation to fair value.*

EFRAG's response

- 41 We support the proposed approach because we agree that using the incremental borrowing rate is both easier to apply and enhances comparability.

Question 7—Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Background notes for EFRAG constituents

- 42 *The lessee's right-of-use asset is a non-financial asset. Most non-financial assets are initially measured at cost. For example, IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets require initial measurement at cost rather than at fair value.*

³ In IAS 17 the definition of 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) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor."

⁴ The IAS 17 definition of the lessee's incremental borrowing rate is "the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset." term, and with a similar security, the funds necessary to purchase the asset." Consequently, the incremental borrowing rate takes account of: (a) the credit standing of the lessee, (b) the length of the lease and (c) the nature and quality of the security provided (i.e. the leased item).

- 43 *The boards discussed measuring the right-of-use asset initially at cost. In a lease contract, the cost of the right-of-use asset will generally equal the fair value of the obligation to pay rentals. As discussed above, in most situations the present value of the lease payments discounted using the lessee's incremental borrowing rate will be a reasonable approximation to the fair value of the obligation to pay rentals. The boards tentatively decided to require the obligation to pay rentals be measured initially at the present value of the lease payments rather than at fair value.*
- 44 *Consequently, in discussing a cost-based measurement for the right-of-use asset, the boards concluded that cost would equal the present value of the lease payments discounted using the lessee's incremental borrowing rate. This is referred to in the DP as the linked approach (because the amount at which the asset is measured is linked to the amount at which the liability is measured).*

EFRAG's response

- 45 EFRAG agrees with the boards' tentative decision that, on initial recognition, the lease asset—in other words, the lessee's right-of-use asset—should be measured at cost, because that is the general measurement approach required in IFRS. That cost is of course the present value of the consideration paid or in this case the obligation to pay rentals.

CHAPTER 5: SUBSEQUENT MEASUREMENT

Question 8—The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach? If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

Background notes for EFRAG constituents

- 46 *The boards noted in the DP that an advantage of an amortised cost-based approach to subsequent measurement of the obligation to pay rentals is that it is consistent with the way many other non-derivative financial obligations are measured. The boards also noted that an advantage of an amortised-cost based approach of a right-to-use asset is that it is consistent with the treatment of other non-financial assets. However, adopting this approach does mean that the asset amount and liability amount will not be the same (i.e. it means that subsequent measurement is not linked).*

EFRAG's response

- 47 EFRAG agrees with the boards' tentative view to subsequently measure both the right-to-use asset and obligation to pay rentals on an amortised cost basis.

Question 9—Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

- 48 We do not believe there should be an option to measure a lease obligation at fair value. Firstly, we are in general opposed to options in accounting standards. Secondly, we think there would be inherent difficulties in measurement due to linked nature of the obligation and right-of-use asset, and the fact that there are contractual and non-contractual factors involved.

Question 10—Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.

If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

Background notes for EFRAG constituents

49 *The DP explains the advantages and disadvantages of revising the obligation to reflect changes in its incremental borrowing rate. The IASB tentatively decided that the obligation should be revised to reflect such changes, although it did not decide whether such reassessments should take place at each reporting date or only when there is a change in estimated cash flows. FASB tentatively decided not to require reassessment.*

EFRAG's response

50 We disagree with the IASB's tentative decision; we believe that the obligation to pay rentals should not be revised for changes in the incremental borrowing rate. Our reasoning is set out below.

51 Although the DP argues that an advantage of revising the measurement for changes in the incremental borrowing rate is that such an approach would be consistent with the approach required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the DP makes a number of other proposals as to the accounting treatment of the lease liability that are not consistent with IAS 37, thus implying that consistency with IAS 37 is not an objective. Indeed, as discussed more fully in our response to Question 11, the lease obligation has some characteristics of an IAS 39 liability and some of an IAS 37 liability.

52 Some commentators would probably argue that revising the obligation to pay rentals to reflect changes in the incremental borrowing rate will result in more relevant information being provided to users of financial statements because the amount at which the liability is measured will reflect current information. However, EFRAG notes that, as lease payments generally do not fluctuate with changes in market conditions, they are analogous to fixed rate borrowings and, when accounting for fixed rate borrowings, amounts are not remeasured to reflect changes in the incremental borrowing rate.

53 EFRAG is also concerned that revising the obligation to pay rentals to reflect changes in the incremental borrowing rate will result in changes in the lessee's credit worthiness impacting on the amount at which the liability is measured. EFRAG also does not believe changes in the credit risk of the entity should impact subsequent remeasurement.

54 Finally we have concerns about the costs and the complexity for preparers of revising the obligation to reflect changes in its incremental borrowing rate.

55 However, if the IASB decides to retain its current proposal, EFRAG believes that for pragmatic reasons revisions should be made to the obligation to pay rentals to reflect changes in the incremental borrowing rate only when there is a change in estimated cash flows. We think only in those circumstances will there be sufficient benefits to justify the costs involved. Furthermore, limiting the frequency of such

changes would also limit the added complexity for preparers that would otherwise occur.

Question 11—In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the boards? If you disagree, please explain why.

- 56 We agree that a lessee's obligation to pay rentals meets the definition of a financial liability. However, it seems to us that many lease obligations also have characteristics of IAS 37 obligations because of the interrelationship of the lease obligation with the right-of-use asset and terms specific to leases. Therefore, EFRAG supports the board's proposed approach, which is to specify separately the required accounting for the obligation to pay rentals (in other words, to treat them as falling neither within IAS 37 nor IAS 39).
- 57 We believe the alternative approach (leaving lease accounting to other IFRSs) would have caused confusion for both preparers and users and resulted in a less consistent application with respect to the accounting for leases.

Question 12—Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.

- 58 EFRAG accepts that treating the decrease in value of the right-of-use asset as rental expense may make some sense in certain situations, because it can be seen as the lessor's charge for the use of the leased asset. However, EFRAG thinks reflecting that decrease as depreciation is necessary to achieve consistency with the chosen approach to subsequent measurement of the right-to-use asset (an approach that EFRAG supports).

CHAPTER 6: LEASES WITH OPTIONS

General EFRAG comments

- 59 The DP discusses at some length leases with options, contingent rentals and other factors that mean that the amount of lease payments made under the lease arrangement is uncertain or the amount at which the obligation to make those lease payments is recognised initially might need to be revised. EFRAG believes that conceptually changes in the expected rental obligations that result from a change in the economic substance of the 'asset' need to be distinguished from other changes in the obligations, because they should in principle be accounted for differently. For example, a revision to the estimated duration of the lease will affect both the asset and the obligation, and the accounting should reflect the fact that the asset has changed. On the other hand, some other changes due to financial factors affect only the liability. We think that, had the DP's analysis of the issues more clearly distinguished between the two types of changes, the correct approach to adopt in respect of a number of the issues addressed in the questions below on options and contingencies would have been self-evident.

Question 13—The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Background notes for EFRAG constituents

60 *The DP proposes that the uncertainty that lease options can create as to the lease term should be dealt with through recognition. In particular, the DP proposes that, when a lease arrangement involves an option for the lessee to terminate the lease early or extend the length of the lease, the lessee shall decide what the most likely lease term is, and account for the lease on that basis. The proposals in the DP can be illustrated by considering the following two examples (which were used earlier in the response to question 5):*

Example 1: Assume a lessee enters into a five year lease arrangement that involves the option of leasing for a further three years. Assume also that, at contract inception, it is slightly more likely that the lessee will exercise the option than it will not exercise it. Under the proposals in the DP, the lessee will be required to recognise an 8 year right-to-use asset and an obligation to pay 8 years of lease payments.

Example 2: The situation is exactly the same as Example 1, except that it is slightly more likely that the lessee will not exercise the option than it will exercise it. Under the DP's proposals the lessee will recognise a 5-year right-of-use asset and an obligation to pay 5 years of lease payments.

EFRAG's response

61 As we explained in our response to Question 5, EFRAG is divided on the boards' tentative decision that a components approach should not be applied when accounting for leases with options. A key reason for this was a difference of view on the proposal described in this question. To briefly summarise:

- (a) Some members support the proposal in the DP, believing it to result in the most useful information being provided to users because it attempts to reflect the effect that the options could have on the lessee's asset and liability. The DP's approach does this by requiring the lessee to recognise the asset and liability thought most likely to arise in practice, regardless of what enforceable lease payment obligations the lessee has.
- (b) Some EFRAG members disagree with the proposal in the DP, believing it requires lessees to recognise as liabilities amounts that are not liabilities (because they are not enforceable obligations) and misrepresents a lessee's their financial position (particularly the flexibility inherent in that position).

The detailed arguments are set out in our response to question 5.

Question to EFRAG's constituents

As the paragraphs above show, EFRAG members are divided on this issue. We would therefore particularly welcome your views on the issue. Do you agree with the approach proposed in the DP? If not, what are your major concerns? And what approach would you favour instead?

62 Having said that, even those EFRAG members who support the DP's proposal on this issue have some concerns about their possible implications. In particular:

- (a) They wonder whether there may be some unintended consequences in using such a binary approach as the one proposed in the DP. For example, some lease agreements may be structured so that the initial term of the lease is of a short duration and there are options to extend again and again and again. In such a circumstance, focusing on the most likely lease term might not fully reflect the underlying economic position.

For example, assume a lease is structured as a one year lease, with fourteen renewal option periods. Although the renewal options are for different periods, all of them would mean that the lease term would be extended to at least two years. There is a 20% possibility that none of the renewal options will be exercised; in other words, that the lease term will be just one year. Although a lease term of just one year might be the single most likely event, there is an 80% possibility that the lease will last at least two years.

Under the proposals, the lease would be accounted for as a one year lease. Although this is a natural consequence of selecting a 'most likely approach' over, say, a 'probability weighted approach', the EFRAG members supporting the DP's proposals are in principle nevertheless not completely comfortable with the consequence. We know that some users are also concerned that in practice the most likely lease term could often end up to be the shorter/shortest of the possibilities considered. We would encourage the boards to consider whether there is anything that could be done to make this less of an issue.

- (b) The IASB has tentatively decided that a probability weighted approach of expected outcomes of contingent rentals should be used to measure the lease obligation. It is not clear to us that that decision is consistent with the decision being discussed here to use a 'most likely approach' (rather than say a probability weighted approach'; see under Question 17 and paragraphs 7.13-7.21 in the DP).
- (c) The EFRAG members supporting the DP's proposals in principle are nevertheless not sure what the IASB sees as the wider implications of its decision here to focus on the most likely outcome rather than adopt a probability weighted approach. For example, is it envisaged that the same approach would be applied in IAS 37? And if that is not the intention, are there conceptual reasons for the difference or is it purely pragmatism. It is not that we are against pragmatism, but we think it is important that these sorts of issues are explained clearly.

63 Many of the questions that follow are based on the assumption that the respondent agrees with the basic approach being proposed (i.e. including the adoption of a non-components approach and focusing on the 'most likely' outcome when options are involved). We are divided on those proposals but, in order to be constructive, have nevertheless tried to respond to the remaining questions as if we did agree with those aforementioned proposals. Please therefore read our responses to questions 14 onwards in that context.

Question 14—The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why. Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

- 64 EFRAG agrees with both proposals.
- 65 We support the proposal that the lease term should be reassessed at each reporting date on the basis of any new facts or circumstances because we think such an approach is likely to provide users with more relevant information. For example, a lease term that is based on assumptions made many years ago needs to be updated to ensure that assets and liabilities are fairly presented. EFRAG notes that the proposed approach is consistent with the way uncertainties are addressed in reaching the best estimate under paragraph 42 in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.⁵
- 66 Having said that, we think there needs to be more clarity as to what, if anything, the lessee needs to do if there are no obvious indications that there have been changes.
- 67 Earlier we mentioned that our view was that conceptually changes in the expected rental obligations that result from a change in the economic substance of the 'asset' need to be distinguished from other changes in the obligations, because they should in principle be accounted for differently. That is why we support the proposal that changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset. This change in the expected lease obligation has a direct link to the expected value of the leased asset. If a lease obligation is remeasured from a 10 year obligation to a 15 year obligation, the entity has a different right of use to the one it originally thought it had due to the extended period time the entity expects to use the asset.
- 68 As noted in the DP (paragraph 6.52) such an approach is also consistent with IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* when the carrying asset is adjusted for changes in a decommissioning liability.

Question 15—The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

- 69 EFRAG agrees with the boards' reasoning that a purchase option is in-substance similar to a renewal option for the remainder of the asset's life. As we think that there should be similar accounting for similar circumstances, we support the boards' proposal.

⁵ The risk and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision [IAS 37.42].

CHAPTER 7: CONTINGENT RENTALS AND RESIDUAL VALUE GUARANTEES

Question 16—The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you recommend and why?

Background notes for EFRAG constituents

- 70 *The DP explains that the boards considered two approaches to the recognition of contingent rentals.*
- 71 *The first approach was to follow the existing lease accounting standards. Under those standards, contingent rentals that are based on usage or the lessee's performance are generally excluded from the calculation of minimum lease payments and are thus expensed as they are incurred. Contingent rentals that are based on an existing index are included in the minimum lease payments on the basis of the current level of the index.*
- 72 *The DP notes that supporters of the existing approach argue that the lessee has no present obligation to pay contingent rentals until the future event occurs. Therefore, to recognise a liability for contingent rentals would involve overstating the lessee's liabilities. On the other hand, the IASB lists (in paragraph 7.8 of the DP) several disadvantages of excluding the obligation to pay contingent rental from the measurement of the liability:*
- (a) It may underestimate the asset of the lessee. For example, for a lease in which rentals are completely contingent on sales from the leased property, the lessee would recognise no asset for the right to use the property even though that asset could be valuable.*
 - (b) It is inconsistent with the boards' preliminary views on the recognition of options to extend or terminate a lease. The obligation to pay rentals in an optional period is contingent on the lessee's exercising its option to extend the lease. However, the boards tentatively decided that, in some situations, the lessee's obligation to pay rentals should include rentals payable in the optional period.*
 - (c) It would be possible at the start of the lease to minimise both the right-of-use asset and the obligation to pay rentals by including a significant element of contingent rentals in the lease contract.*
- 73 *The second approach the boards considered was to reflect the obligation to pay contingent rentals in the measurement of the liability. The DP argues that this approach has several advantages.*
- (a) It is consistent with the boards' preliminary views on the recognition of options to extend or terminate the lease.*
 - (b) Although the lessee's rental payments are contingent, excluding them could lead to an understatement of the right-of-use asset.*
 - (c) It improves comparability for users because it is consistent with other asset acquisitions that include contingent payments.*

EFrag's response

- 74 EFRAG agrees that excluding the obligation to pay contingent rentals from the measurement of the liability would have the disadvantages the boards have listed. For that reason, we support the proposals. In our view, the issue here is more about uncertainty as to the amount of the liability rather than a contingency. In other words, the discussion is not about whether there is a liability, but about the amount of that liability.
- 75 Having said that, we are concerned about the subsequent accounting for certain contingent rentals that are in-substance profit sharing arrangements. For example, a lease of retail space may have contingent payments based upon turnover. The initial measurement and recognition of the lease obligation and related right-of-use asset may be based on the expectation that turnover will increase significantly in the future. However, since that expectation would be included in the measurement of the right-of-use asset, the initial amortisation costs will, in our view, be disproportionate in the early periods.

Question 17—The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Background notes for EFRAG constituents

- 76 *The DP explains that measuring the obligation to pay rentals by including a probability-weighted estimate of contingent rentals payable has the following advantages.*
- (a) *When combined with reassessment of the lease term, it provides relevant information to users of financial statements because it reflects that the lessee has entered into an agreement to pay rentals of an uncertain amount.*
 - (b) *The measurement of the obligation to pay rentals reflects the fact that the probability distribution of the rental payments may be skewed.*
 - (c) *It is consistent with the way some liabilities of uncertain amount are measured (e.g. liabilities measured in accordance with IAS 37).*
- 77 *The disadvantages of the approach are that:*
- (a) *it may be complex and costly for preparers to apply;*
 - (b) *it may be difficult for the lessee to determine the probabilities involved, and as a result the measurement of the liability may not be any more reliable than other less complex approaches; and*
 - (c) *in some cases, it could result in a measurement that reflects an outcome that will never happen.*

- 78 *The DP also argues that measuring contingent rentals on the basis of the most likely rental payment has the following advantages.*
- (a) *It is simpler to apply than the probability-weighted approach.*
 - (b) *It will not result in a measurement of the obligation to pay rentals that reflects an impossible outcome.*
- 79 *On the other hand, the disadvantages of this approach are that:*
- (a) *the measurement of the obligation does not reflect the fact that the lessee has agreed to make a payment of an uncertain amount. Instead, it attempts to predict the most likely outcome; and*
 - (b) *it ignores the fact that the probability distribution may be skewed.*

EFRAG's response

- 80 EFRAG believes that the DP has correctly identified the advantages and disadvantages of the two approaches, except that perhaps it does not give enough emphasis to the difficulty of applying a most likely outcome approach to contingent rentals that are in effect a continuum (rather than a series of discrete outcomes), nor does it discuss the usefulness of a most likely outcome approach in such circumstances.
- 81 EFRAG believes that these advantages and disadvantages are fairly evenly balanced, although we have a slight preference for the most likely outcome approach because we think consistency with other aspects of the approach is very important if the resulting information is to be understandable.

Question to EFRAG's constituents

We would particularly welcome views on this issue. Do you think the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable or should be on the basis of the most likely rental payment?

Question 18—The FASB tentatively decided that, if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Do you support the proposed approach? Please explain your reasons.

Background notes for EFRAG constituents

- 82 *The FASB's tentative view is that, if lease rentals are contingent on changes in an index or rate (such as the consumer price index or the prime interest rate), the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Changes in amounts payable arising from changes in the indices would be recognised subsequently in profit or loss.*
- 83 *Although the use of the existing index or rate in the initial measurement is not limited to the most likely rental payment approach supported by the FASB, the IASB did not express a preliminary view on this issue.*

EFRAG's response

84 EFRAG supports FASB's tentative view which, we understand, is consistent with existing US GAAP. When a contingent rental payment is based on a price or an index then a determination needs to be made to define the contingency. One might view the contingency as the absolute price or index. The alternative view is that the contingency is the change in the price or the index. The first view may result in a hypothetical default measurement of zero being used, which we believe would be an unrealistic measurement approach. We think viewing the contingency as the change in the price or index better reflects the economic substance of the obligation because it represents current market conditions.

85 We would, however, suggest that the initial measurement may include an existing forward curve if that provides better information than a spot index rate.

Question 19—The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.

Background notes for EFRAG constituents

86 *Both IAS 17 and SFAS 13 generally do not require reassessment of contingent rental arrangements, and contingent rental payments are normally expensed as incurred. The DP acknowledges that a requirement to reassess the obligation to pay rentals will result in a more complex accounting standard. However, the boards also listed several advantages to requiring reassessment. Those advantages are:*

- (a) remeasurement of the obligation will better reflect current conditions and result in more relevant information,*
- (b) it is consistent with expected cash flow changes of other liabilities under IFRSs, and*
- (c) it is consistent with the boards' tentative decision to require reassessment of the lease term.*

EFRAG's response

87 EFRAG supports the boards' tentative decision mainly on the basis that it is consistent with the tentative decision to require reassessment of the lease term.

Question 20—The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments: (a) recognise any change in the liability in profit or loss, or (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset. Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

Background notes for EFRAG constituents

88 *The IASB believes that changes in the obligation to pay rentals are effectively changes to the original assessed cost of the right-of-use asset and tentatively decided to require changes in the measurement of lease obligation due to*

changes in an estimated contingency be recognised as an adjustment to the carrying amount of the related right-of-use asset. The IASB points out that this is consistent with its tentative decision on how to account for changes in the estimated lease term.

- 89 *The DP indicates (in paragraph 7.31) that the FASB arrived at a different tentative decision. The FASB believes changes in the measurement of lease obligation due to changes in an estimated contingency should be recognised in profit and loss because this approach is both easier for users to understand and less complex for preparers.*

EFrag's response

- 90 As already mentioned, EFRAG believes that there is a substantive difference between a remeasurement that results from a change in the estimated lease term and a remeasurement that results because of changes in estimated contingent rental payments.
- (a) A change in the estimated lease term directly affects the asset the lessee has. Rather than say a 5-year right-of-use, it has a 6-year right-of-use or a 4-year right of use. Thus it involves a change in the asset.
 - (b) A change in the estimated lease obligation for certain changes in an estimated contingent rental payment on the other hand does not involve any change in the right-of-use asset. For example, if a lease obligation were remeasured for contingent rental payment associated with an interest rate increase, the increase in the lease obligation is not indicative of a change in the right of use asset or a better measurement of the right-of-use asset. EFRAG also notes that if a similar asset were purchased rather than leased, and financed through a variable rate borrowing, the purchased asset would not be remeasured when the interest rate on the loan resets.
- 91 EFRAG thinks the theoretically correct approach would be to distinguish between those changes that affect the right of-use asset and those that do not, and to account for the former by adjusting the amount of the asset and the latter by debiting or crediting profit or loss.
- 92 If such an approach would introduce too much complexity, we would accept that a pragmatic approach should be applied that treats all changes in the estimated rental obligation in the same way. In that case our preference would be to treat all changes in the estimated contingent rental payments as an adjustment to the carrying amount of the 'right-of-use' asset. Such an approach would, for example, also be consistent with treatment of changes in obligation due to the change in expected optional periods.

Question 21—The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Background notes for EFRAG constituents

- 93 *The boards reasoned that payments under residual value guarantees, like contingent rental payments, are conditional on future events. However, the obligation to make a payment if the specified future events occur is unconditional. Consequently, the boards have tentatively decided to treat residual value guarantees in the same way as contingent rental payments in all respects. Therefore, a lessee's obligation should include payments to be made under a residual value guarantee and the residual value guarantee should be included as part of a measurement reassessment.*
- 94 *Both boards agreed that the measurement approach and the treatment of remeasurement changes related to a change in the estimated payment for a residual value guarantee should be treated the same as a change related to remeasuring a contingent rental payment. However, as mentioned above, the IASB and FASB tentatively differed on the measurement approach (probability-weighted vs. the most likely approach) and on the recognition of the affects of the remeasurements and the accounting treatment for those changes.*

EFRAG's response

- 95 EFRAG supports the boards' decision that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same.

CHAPTER 8: PRESENTATION

Question 22—Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

Background notes for EFRAG constituents

- 96 *The tentative views expressed in the DP on the presentation of the lessee's obligations to pay rentals are that such obligations are financial liabilities and should be presented as such in the statement of financial position. However, although there are some differences between these liabilities and other financial liabilities, the lessee's obligations to pay rentals should not be required to be presented separately from other financial liabilities on the face of the statement of financial position.*
- 97 *EFRAG notes that the tentative views on presentation expressed by the boards are based on existing presentation requirements and that the boards' joint project on Financial Statement Presentation could have an effect on those tentative views.*

EFRAG's response

- 98 The proposed accounting for obligations to pay lease rentals described in the DP differs from the way most other financial liabilities are accounted for. As such, EFRAG agrees that a good case could be made for presenting such liabilities separately from other liabilities in the statement of financial position. However, on balance, we would not be in favour of such separate presentation on the face of the statement of financial position because we think the difference is not so significant that it should be allowed to risk obscuring the key messages of the

primary financial statements. We would though support this kind of information being presented in the notes.

Question 23—This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons. What additional disclosures (if any) do you think are necessary under each of the approaches?

Background notes for EFRAG constituents

99 *The boards have discussed (in paragraph 8.9) three possible ways to present the right-of-use asset in the statement of financial position:*

- (a) *according to the nature of the underlying lease,*
- (b) *as an intangible asset, or*
- (c) *on the basis of classification.*

100 *The boards tentatively decided that the right-of use asset should be presented, separately from own assets, in the statement of financial position on the basis of the nature the leased item. For example, a right-to-use an item of plant would be included in property, plant and equipment.*

EFRAG's response

101 EFRAG supports the boards' tentative decision to require separate presentation according to the nature of the underlying lease on the face of the statement of financial position. Such a presentation would, as the DP argues, ensure that the nature of the leased asset is made clear, and would be consistent with the treatment of rights acquired by owning the underlying item.

102 Having said that, we notice that the DP tends to talk of leased assets as intangible assets, and we think it is questionable whether that label is consistent with the adoption of a right of use approach to lease accounting. That is because, if one agrees with the right of use approach, one accepts that even for purchased assets what one is recognising on the statement of financial position are the rights of use. Thus, although one might wish to distinguish between leased assets and purchased assets, one should not do it by calling purchased assets tangible assets and leased assets intangible assets because they are all just rights of use. On the other hand, it could be argued that, when one purchases an asset one usually has all the rights of ownership rather than just the right of use, and this justifies treating purchased assets as tangible assets and leased assets as intangible assets.

Question to EFRAG's constituents

We would welcome your views as to whether describing a lease asset as an intangible asset is consistent with adopting a right-of-use approach.

CHAPTER 9: OTHER LESSEE ISSUES

Question 24—Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

Service arrangements and leases

- 103 The proposed accounting for leases in the DP will make the distinction between service and lease arrangements much more important than hitherto. We think it will be important in the forthcoming ED and standard to ensure that those areas where there are practical difficulties in distinguishing between the two are addressed. While IFRIC 4 addresses some situations, we understand there are still difficulties with some capacity lease contracts (for example, leasing fibre optic lines or leasing a specific tonnage of ships).

Leases and executory contracts generally

- 104 At the moment when a lease arrangement is entered into, it is—just like any other fully unperformed contract—an executory contract. Then the lessor delivers the property item that is the subject of the lease to the lessee and it is no longer viewed as an executory contract, because the lessor is treated as having fully performed. That 'enables' the lessor and lessee to recognise new assets separately from new liabilities.
- 105 However, we are not convinced that the delivery that is widely viewed as having taken place in a lease arrangement is really quite as significant an event as the accounting would suggest. For example, the DP argues that, at the beginning of the contract, when the lessor delivers all the rights inherent in the property item that is the subject of the lease to the lessee, all the rights other than the right of use for the lease period are held by the lessee as custodian for the lessor. However, another way of looking at it is to say that the lessee holds all the rights inherent in the property item as custodian and those rights only become the lessee's as it pays for them. Under that view, the contract would remain an executory contract to the extent that lease payments have not been made; and would thus be accounted for more like any other service contract.
- 106 This is not to say that EFRAG favours treating lease contracts as executor contracts, because we do not; we think such an approach would not provide useful information to users of financial statements for significant lease contracts. Our concern is that the dividing line between leases and executory contracts generally is based on a very fine distinction that might not be robust enough to cope with the burden it will have to bear under the proposals in the DP.

CHAPTER 10: LESSOR ACCOUNTING

Question 25—Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Question 26—This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor. Which of these two approaches do you support? Please explain your reasons.

Question 27—Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

Question 28—Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Question 29—Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

- 107 The DP focuses on lessee accounting and, although there is one short chapter in the DP on lessor accounting, the boards have not yet reached any preliminary views on any of the issues involved. We understand that this approach has been taken because the boards did not believe it would be possible to address lessor accounting as well as lessee accounting in time for a standard to be issued in 2011 and, as there are many more lessees than lessors, the view was taken that lessee accounting should be given priority. We understand why this approach has been taken. However, we are very concerned that the boards are proposing to take fundamental decisions about the future direction of lease accounting having considered the subject from only one perspective (the lessees'). We think that, had the subject been considered from both perspectives, some of the proposals in this DP about the future direction of lease accounting might well have been different.
- 108 Bearing all that in mind, we do not think it appropriate to comment on the issues raised in questions 25 to 29 without there being a more thorough analysis of the issues involved beforehand. It also means that, until that more thorough analysis has taken place, we regard our comments on the issues raised in the DP as tentative.