COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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Date: 29 November 2010
Ref.: CESR/10-1518

RE: the IASB's Exposure Draft *Leases*

The Committee of European Securities Regulators (CESR), through its Standing Committee on Corporate Reporting (CESR-Fin), has considered the IASB's Exposure Draft *Leases*. We thank you for this opportunity to comment on this Exposure Draft.

For our comments, we would like to refer to the appendix attached to this letter where we provide a copy of our comment letter to EFRAG on its draft response to the IASB on the Exposure Draft.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of CESR's Corporate Reporting Standing Committee

COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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Date: 29 November 2010
Ref.: CESR 10-1468

RE: EFRAG's draft response on the IASB's Exposure Draft *Leases*

The Committee of European Securities Regulators (CESR), through its Standing Committee on Corporate Reporting (CESR-Fin), has considered EFRAG's draft comment letter on the IASB's Exposure Draft (ED) *Leases*.

We thank you for this opportunity to comment on your draft letter and we are pleased to provide you with the following comments.

CESR appreciates the joint efforts of the IASB and FASB to develop new literature on how to account for lease contracts that should ensure that more assets and liabilities arising from lease contracts are recognised in the financial statements.

It is our understanding that the principle that a bundle of rights may constitute an asset is new to IFRS and has not been used by the IASB in any other standard so far. We consequently would welcome some further background information from the Board on this new principle and whether it intends to use this concept more widely by introducing it in other projects (e.g. financial instruments).

As we believe that it would result in most decision-useful information for users of financial statements CESR supports, like EFRAG, a right-of-use approach for all leases contracts. We would not consider a performance obligation model to be relevant as it results in double counting of the underlying assets and is in contradiction with the lessee's model.

Although we note that a line has to be drawn between service and lease contracts we are not sure that the proposals set out in the ED would achieve a satisfying result. We consider that the proposed criteria might leave room for structuring opportunities and believe that the Board should further analyse the boundary between these contracts in order to offer an effective improvement to the existing IAS 17 – *Leases*.

CESR would also encourage the Board to think further on the alternative view set out by a Board member on the treatment of options and contingent rentals.

Our detailed comments on EFRAG's draft response are set out in the Appendix 1.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of CESR's Corporate Reporting Standing Committee

APPENDIX 1 – CESR'S DETAILED ANSWERS TO THE QUESTIONS IN THE ED

Question 1
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?
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?

CESR believes that the existing model in IAS 17 – *Leases* has shown its limits in practice and welcomes therefore the effort of the IASB and FASB to develop new accounting literature for the treatment of lease contracts.

Like EFRAG, CESR believes that the right-of-use model the IASB proposes would result in decision-useful information and would satisfy the needs of users of financial statements about recognition of assets and liabilities from leases.
We agree that it is relevant when applying a right-of-use model for the lessee to recognise amortisation of the right-of-use and recognise interest on the lease liability.

Having said this, CESR has some concerns about some aspects of the proposed model. We would like to refer to our detailed responses to the questions asked in the ED as set out below.

Question 2
Do you agree that a lessor should apply the performance obligation approach when the lease exposes the lessor to significant risks and benefits associated with the underlying asset, and a derecognition approach otherwise? Why or why not? If not, what alternative model would you propose and why?
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 support the view set out in EFRAG draft comment letter that the IASB should try to avoid a hybrid model (i.e. the existence of two different models based on exposure to the risks associated with the underlying asset: derecognition or performance obligation). Indeed, the application of current IAS 17 proves that distinguishing between operating and finance lease is difficult in practice and leaves room for arbitrage.

Like EFRAG, CESR believes that the proposed derecognition model might be more relevant for the following reasons:

— The performance obligation approach double counts the underlying assets: the lessor continues to recognise the whole asset and also recognises a receivable representing part of the future cash-flow that this asset will generate; and

— The performance obligation model is in contradiction with the lessee's model. Indeed, the IASB considers that an asset is a bundle of rights. Hence, as the lessee always recognizes a right-of-use, the lessor's should always be able to derecognise a part of the asset.

CESR supports EFRAG's comment of the apparent inconsistency between paragraph BC18 which states that under the proposals in the ED *Revenue Recognition* the lessor would recognise lease income continuously during the lease term, and BC 7 which justifies the right-of-use model by saying that "*When the lessor provides access to the underlying asset, the lessee has an unconditional right to use the underlying asset and therefore an unconditional liability to make lease payments. At that point the lessor cannot prevent the lessee from using the underlying asset nor can the lessee avoid*

payment without causing a breach of contract." BC7 could be understood as meaning that the performance obligation is satisfied on the date of commencement of the lease. If that is the case, the entire revenue should be recognised at inception.

Question 3
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?

CESR believes that the model described in paragraph 65 is relevant for the lessor. Hence, as we favour a symmetrical treatment for lessor and lessee, we encourage the IASB to develop a simplified model for lessee accounting based on the model developed for the lessor. Indeed, the simplified model proposed by the ED offers a real simplification for lessors' accounting whereas the simplifications proposed for lessees' accounting does not offer much relief (discounting does not seem to be the most burdensome part of the model).

The ED does not explicitly state how lease payments for short-term leases under the simplified approach would be reported in the income statement (i.e. as rent expenses or amortisation expenses). We believe that the IASB should clarify this further to guarantee consistent application in practice.

Moreover, we share EFRAG's concerns that in order to increase comparability the simplified approach should apply to all short-term leases and should not be chosen on a lease-by-lease basis.

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 for distinguishing a lease from a purchase or sale in paragraphs B9 and B10? Why or why not? If not, what alternative criteria would you propose and why?

We agree with the IASB's proposals to not introduce a distinction between core and non-core assets in the scope of the propose standard.

As EFRAG, CESR is concerned that the criteria mentioned should be consistent with the ones proposed in the ED *Revenue from Contracts with Customers*. In that ED it is stated in paragraph 25 that "*revenue shall be recognised when an entity has transferred a promised good or service to a customer*". As far as distinguishing between a sale and a lease, CESR notes that paragraph B9 of that ED also mentions that "*a contract represents a purchase or a sale if (…) an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset*". It seems to us that the proposed definition in

the ED *Leases* is slightly different from the one proposed in the ED *Revenue from Contracts with Customers* (paragraphs 25 to 31). A difference which might lead to inconsistencies in practice between the two standards once finalised.

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

We share EFRAG's concerns that the criteria for distinguishing between leases and services contracts are not clear enough in the ED. We believe that more guidance should be provided as it will be difficult to draw the line between these two type of contracts in practice.

For instance, a car park contract may be established for a specific parking spot or may indicate that any spot of the car park can be used. If any spot of the car park can be used, there is a possibility that at some point in time the car park is overbooked. These contracts are very similar in their effects. CESR's understanding of the ED's proposals is that they would both be considered as lease contracts even if the asset is precisely identified in one case and not in the other.

In the same way, it is CESR's understanding that, according to the definition of a lease provided in the ED, a season's box in a stadium (for a football club for instance) is a leasing agreement and not a service contract as the asset is implicitly[1] specified.

CESR would encourage the Board to provide clear and robust criteria to distinguish a service contract from a lease contract in order to not leave room for structuring opportunities.

Question 5
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?

CESR notes that some intangible assets are currently included in the scope of IAS 17 and does not see conceptual reasons why intangible assets should be scoped out of the proposed standard. We would encourage the Board to explore the issue further with constituents that are concerned by such transactions. This feedback might lead the Board to reconsider its initial proposal.

Question 6
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:
The FASB proposes that the lessee and lessor should apply the lease accounting requirements to the combined contract.
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

[1] Paragraph B2 states that "an asset is implicitly specified if it is (a) infeasible or impractical for a lessor to provide alternative assets in place of the underlying asset during the lease tem or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice"

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?

First of all, CESR would have preferred a joint solution from the FASB and IASB and considers that the Boards should work further on this issue.

Generally CESR supports a symmetrical treatment to account for lease contracts by the lessee and lessor. We understand that information to separate the components are always known from the lessor whereas this information is difficult to obtain for the lessee when services cannot be purchased separately. Hence, we concur with EFRAG that the two components should always be accounted for separately by the lessor. As far as the lessee is concerned, we agree with EFRAG's proposal to assess the predominant component of the contract and then treat the whole contract accordingly.

Question 7
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 agree with EFRAG that there is no conceptual reason to treat options to extend or to terminate the lease and options to purchase the underlying asset differently. The example provided by EFRAG in its draft response shows that treating these different options differently will in some circumstances not be relevant.

Question 8
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?

CESR disagrees with the approach to include optional lease periods in the recognition and measurement of the lessee's right-of-use asset and the lessor's receivable based upon the longest period more likely than not to occur. We concurs with the Alternative View set out by Stephen Cooper in paragraphs AV4 that "*including all optional lease periods in the recognition and measurement of the lessor's receivable (under both the performance obligation and derecognition models) will result in a risk that investors may underestimate the business risk of the lessor.*" Indeed, paragraph AV 4 also states that "*the overstatement of the receivable implies exposure to credit risk when the reality is an exposure to underlying asset risk.*"

We follow the reasoning of Stephen Cooper when he continues in paragraph AV2 of the ED that "*optional lease periods should be reflected in the measurement of recognised assets and liabilities only when the arrangement includes an incentive to extend the lease period such as penalties payable on cancellation or reduced rentals in the optional period, or where costs of customisation or installation make renewal likely. However, if the exercise of options to extend merely depends on future business conditions it is inappropriate to reflect this in the measurement, even if extension or renewal of the lease is likely.*"

Question 9
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?

As set out in our response to question 8, we concur with the Alternative View set out by Stephen Cooper that "*reflecting all expected contingent rentals in the measure of the lessee's liability and the lessor's receivable do not provide relevant information about the economics of such leasing arrangements*".

Consequently we consider, like EFRAG, that contingent rentals and expected payments under term penalties and residual value guarantees should be measured based on the most likely outcome approach.

Question 10
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?

CESR agrees with 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.

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?

CESR notes that the use of sale and lease-back transactions, often characterised by very specific features, is widespread in practice.

As set out above in our detailed response to question 4 b), CESR thinks that the criteria used to distinguish between a sale transaction and a lease contract should be consistent with the ED *Revenue from Contracts with Customers*.

Additional Guidance
When acknowledging that the Board has provided more examples in paragraph B31 of the ED that should help entities to classify these transactions, we disagree with EFRAG. In particular, we are not supportive of EFRAG's proposal to move the guidance provided in paragraph B31 (to analyse of the transaction is a sale) to paragraph B9 so that it would apply to all transactions. We believe that sale and lease-back transactions have conditions that are not common or do not arise in other transactions. We therefore believe they warrant specific application guidance.

Derecognition
As CESR considers the performance obligation model not appropriate we believe, like EFRAG, that the derecognition model should also apply to sale and lease-back transactions.

We believe that EFRAG should further explain its approach and why a specific model, derived from the derecognition model proposed by the ED, should be applied for sale and lease-back transactions.

Question 12
(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?

CESR agrees with the proposals set out in the ED.

(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?

CESR agrees with the proposals set out in the ED. Referring to our detailed response to question 2, we do however not support the performance obligation model.

(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?

CESR agrees with the proposals set out in the ED.

(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?

CESR agrees with the proposals set out in the ED.

Question 13
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?

CESR agrees with the proposals set out in the ED.

Question 14
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?

CESR

CESR agrees with the proposals set out in the ED and believe that they will result in decision-useful information for users of financial statements.

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?

CESR, like EFRAG, agrees with the proposals set out in the ED. We particularly welcome the disclosure requirement proposed in paragraph 71 of the ED that "*an entity shall consider the level of detail necessary to satisfy the disclosure requirements in paragraphs 73–86 and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics*".

Question 16
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?
Do you think that full retrospective application of lease accounting should be permitted? Why or why not?
Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

In general, CESR would favour a full retrospective application but we agree that this might be onerous for long-term leases. Consequently we agree with the proposals set out in the ED.

However, we believe that it is unclear how the transitional provisions would apply to sale and lease-back transactions. We would encourage the Board to clarify this further.

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?

As an organisation of enforcers of IFRS and securities regulators CESR does not feel in a position to provide further information on this question.

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

We would like to refer to a comment which we made earlier when the Board published its discussion paper *Leases: Preliminary Views*. CESR would encourage the Board to:

— to provide reporting entities with more guidance on the determination of the incremental borrowing rate in order to enhance comparability for the users of financial statements; and

— to consider requiring appropriate disclosures in the notes to the lessees' financial statements as regards the type of interest rate used (i.e. the incremental borrowing rate or the rate the lessor charges the lessee). If the incremental borrowing rate were to be used, we believe that the entities should disclose the assumptions and criteria taken into account in the determination of this rate.