COMMENTS IN REPLY TO THE IASB QUESTIONNAIRE ON THE EXPOSURE DRAFT ON THE IMPROVEMENT OF EXISTING STANDARDS

IAS 17 - LEASES

Question 1

Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements ~~a~~ lease of land and a lease of buildings ?
The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs3-10 of IAS 17.

For a lease relating both to land and buildings, it is proposed that the land and buildings shall be considered separately for the classification of the lease, unless there is a plan to transfer the ownership of both elements at the end of the lease contract.

This change is designed to take into account the case of land with an unlimited economic lifespan.
The other changes made at the end of article 11 a, 11 b, 11 c draw the consequences from the case where a separation is actually made between the land element and the building element for the classification of the lease as provided for above.

The proposed change is probably influenced by the environment relating to the system of ownership of land in some States (United Kingdom, in particular).

In most cases, in French practice, the transaction has a unicity: land and buildings follow the same treatment from a legal point of view and one never considers that ownership of buildings may be finally transferred without the ownership of land also being transferred.

Therefore, the text should be improved to take account of the very high probability of the transfer of both elements to which the transaction relates at the end of the contract**,** by providing that the transfer of the ownership provided for should concern:

- non only the a of paragraph 8 of the IAS 17 standard (which concerns in fact lease purchase contracts)

- but also the case of b of the same paragraph 8 under the terms of which the lease contract must be classified as a finance lease contract when it grants the lessee the option of buying the assets at a price which should be sufficiently lower than fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

Question 2

Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term ? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable ?

In the interest of simplification and harmonisation, the IASB envisages eliminating the choice between the immediate accounting of the initial costs of negotiating and arranging finance lease contracts as income or the accounting thereof as expenses spread over the lease contract live.

The initial costs must be posted as assets (increase of the finance lease receivable) and the amount of the income recorded over the term of the transaction must be reduced.

In the operating lease, the choice between immediate accounting of these costs in the profit and loss account and spreading thereof over the term of the contract pro rata the rents posted would also be eliminated. The costs should be added to the amount of the leased asset (accounting as an expense spread over the duration of the contract in proportion to the rent income).

External costs, which as a rule can be easily attributed, but also internal costs, would be concerned by the above choice.

For internal costs, one has to face serious difficulties of application:

What is a marginal cost? It seems that one must also use the concept of significantness, which entails a risk of subjectivity.

Which internal costs are directly attributable? There is a real problem of identification. A cost may be attributable, but solely in part, to a given property. One would need to embark on very complex calculations of allocation keys.

IAS 40 – INVESTMENT PROPERTY

Question 1

Do you agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease provided that :

(a) the rest of the definition of investment property is met ; and
(b) the lessee uses the fair value model set out in IAS 40,

<u>Question 2</u>

Do you agree that a lessee that classifies a property interest held under an operating lease as investment property should account for the lease as if it were a finance lease ?

<u>Reply to question 1 and question 2:</u>

With respect to the IAS 40 standard, the IASB proposes:

1. to change the definition of an investment property in order to include an investment property held under an operating lease contract on the twin proviso that the rest of the definition of the investment property is respected and that the lessee uses the fair value models provided for in the IAS 40 standard (§ 27 to 49).

2. to consider allowing a lessee, which classifies an investment property as an operating lease contract under the heading investment property, to post the contract as if it were a finance lease.

The two changes envisaged seem to be designed to allow a lessee, under an operating lease, to adopt the investment property approach so as to allow him to value the asset at its fair value.

For this purpose, a lessee under an operating lease is given the possibility of recognising the asset as if it were held under a finance lease.

This is clearly totally inconsistent with the principle governing the IAS 17 standard.

For this reason, we are very much against these two proposals, which, indisputably, are much more than a simple improvement of IAS standards.

<u>Question 3</u>

Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course ?

We are in agreement with the IASB’s third proposal, which consists of not eliminating the choice between the cost model and the fair value model as the IAS 40 standard currently provides for.

IAS 16 – PROPERTY, PLANT AND EQUIPMENT -PARAGRAPH 46 - COMMENT

Paragraph 46 of the IAS 16 standard changes the definition of the residual value that must be deducted from the purchase price of the asset to determine the depreciable amount of an asset. Henceforth, the residual value of an asset is the *"estimated amount that the entity would currently obtain from disposal of the asset after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life"(cf.paragraph 6).*

This new definition gives rise to an obligation to review the residual value at the end of each accounting year, which may modify the amount of future depreciation**.**

Until now, the residual value was defined as "the net amount which the enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal".

We wish to stress the difficulties of application arising from the new definition of the residual value which, in particular, result in considerable work for some activities such as the lease activities which under the new text would be bound to systematically review the residual value of their stock of leased assets (which may be reckoned in thousands) at the end of each accounting year

Moreover, in general, the implementation of the valuation of residual value implies references that are easy to consult and the existence of markets corresponding to the various assets in all the specificities provided for (condition of age, etc). So, we consider that it should be specified that if there are no such references or markets, the residual value corresponds to the amount that a company expects, on the internal level, to obtain from the asset at the end of its period of usefulness**,** after deducting the costs of disposal.

PdL/MAB – 12 septembre 2002