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International Accounting Standards Board
30, Cannon Street
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16 September 2002

TS/MS/SD
2/4.10

**Re: Comments regarding the Exposure Draft of Proposed Improvements to International Accounting Standards – IAS 17 Leases**

Dear Madam, Dear Sir,

We have the honour and pleasure to enclose the official comments of Leaseurope to the Exposure Draft of the Proposed Improvements to International Accounting Standards – IAS 17 Leases.

Leaseurope is the European Federation of Leasing Company Associations, with currently 25 National Member Associations covering more than 1,150 individual leasing companies in Europe. According to Leaseurope statistics, new leasing businesses accounted for over 193 billion EURO in real estate and equipment in the year 2001.

Please find below our answers to the two questions set out by the Board concerning the Limited Revision of IAS 17.

*Q1. 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 building element is classified as an operating or finance lease by applying the conditions in paragraphs 3 to 10 of IAS 17.*

**No, we do not agree that a real estate lease should generally be split into the land and building element. Lease accounting should reflect the substance of a lease transaction taken as a whole.**

In most European countries, the land with the respective building thereon are treated as an integral package from the legal point of view since one never deems that ownership of buildings can be transferred without the ownership of the land. We are also concerned about the fact that, in many cases, a distinction between land and buildings could only be arbitrary. Hence we do see a breach of the fundamental 'substance over form' principle, that is recently also proposed for an amendment of the Fourth European Accounting Directive. According to the substance over form principle it is necessary that transactions are represented faithfully, i.e. they should be accounted for in accordance with their economic reality.

The proposed split is in apparent contradiction with the principle set out in SIC-27-3 (consensus) which states that: "*A series of transactions that involve the legal form of a lease is linked and should be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence*." This reference to linked transactions being accounted as one also finds its foundation in practice. Indeed, from the perspective of the lessor, the pricing for example, only makes sense when viewed in its entirety while the lessee will only be concerned with the overall cost of leasing a building (including the land element) so that the separate elements would rarely be subject to separate negotiation. Moreover, some contracts require rent reviews at market price, which would be difficult to realise if the rental were separated into land, building and contingent rental components.

The practical problems related to a split between the land and building element is already captured by the current phrasing of paragraph 11B. Furthermore, paragraph 11B raises a couple of other confusing issues.

*"If the lease payments cannot be allocated reliably between these two elements [i.e. the land and building element], the entire lease is proposed to be classified as a finance lease ..."*

**We do not agree with the assumption, that classification as a finance lease shall result in case of non-reliable allocation.**

The only consequence of a non-reliable allocation of the lease payments should be that the lease of land and buildings is treated as one transaction and thus be classified according to the normal classification criteria.

*"... unless it is clear that both elements are operating leases (for the buildings elements, this may be the case for example when none of the situations in paragraphs 8 and 9 above exists), in which case the entire lease is classified as an operating lease."*

Indeed, it would be rather difficult to test for operating lease classification of both elements separately, since, as is assumed beforehand, allocation of lease payments cannot be made reliably. Furthermore, the phrase in brackets does not recognise the distinction between the examples in paragraph 8 and the indicators in paragraph 9. Indeed, the latter gives much less persuasive evidence for a classification as a finance lease than the examples in paragraph 8. Also it is said that an operating lease classification might result where "*none of the situations in para. 8 and 9 above exists*". This is certainly against the fundamental approach of IAS 17 that does not embody a so-called checklist approach but rather more the evaluation of the substance of the transaction as a whole.

In other words, we suggest to consider the lease of lands and building as one transaction when the distinction between land and building in a lease transaction cannot be done reliably. This view is in complete accordance with consensus already agreed by SIC interpretations (see above).

Paragraph 11 C states that: '*For a lease of land and buildings in which the value of the land element at the inception of the lease is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification…*'.

Referring to our comments above, we do not see that a split represents economic reality in the first place. However, just commenting on the phrasing of paragraph 11C, we think that the word 'immaterial' is not appropriate, since only in very rare circumstances would one find the land portion being immaterial. Hence we suggest to use instead a criterion like: *'... in which the value of the land element at the inception of the lease is not substantial in comparison to the value of the entire lease*'. This would also allow to be somehow in line with the current US-GAAP provisions, without adopting the bright-line test used under US-GAAP, i.e. keeping the principle-based approach.

*Q2. 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?*

**No, we do not agree that initial direct costs should generally be capitalised and recognised as an expense over the lease term.**

The proposed changes are made in two instances, i.e. in a finance lease and an operating lease situation from the perspective of the lessor. Dealing with the finance lease situation

it seems a bit bizarre since the lessor capitalises a "*receivable at an amount equal to the net investment in the lease*". The net investment, on the other hand, obviously comprises the minimum lease payments and any unguaranteed residual value accruing to the lessor. Where initial direct costs are included in the minimum lease payments, an additional capitalisation requirement would not be necessary. However, when incurred, the costs would usually be expensed, since a finance lease is treated as a sale or a financing and only the financing income would accrue over time.

Additionally, in our view, consistency between IASs is essential. Therefore, when the costs incurred in negotiating a lease are primarily incurred to conclude a contract with a customer, they can be considered as selling costs, and should not be capitalised (cf. IAS 2.14(d)). At the same time there might be an inter-period issue, i.e. respective costs are incurred in one period, while the date of inception of the lease is in a subsequent period. Here, IAS 11.21 should be followed, i.e. *"when costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period"*.

Additionally, costs dealt with in the proposal would be external as well as internal ones. However, identification of internal costs that are directly attributable to contracts poses numerous practical problems.

Furthermore, we believe that immediate expensing would moreover lead to greater consistency and comparability. For example, in a large enterprise, lease contracts are likely to be written by the in-house legal department while in smaller enterprises, external lawyers may well prepare lease contracts. This would lead to inconsistent results, as the larger enterprise would not capitalise the costs (as they are not incremental and clearly identifiable), while the smaller enterprise would (as they are clearly incremental and directly attributable).

Finally, Leaseurope finds that it is essential that the concept of *incremental costs* should be clarified by including a definition.

We hope that you find our comments helpful and we remain at your disposal for any questions related to the above or further information you might need.

Yours sincerely,

Dr. Thomas Schröer
Chairman of Accounting and Taxation Affairs Committee

Marc Baert
Secretary General