Association pour la participation des entreprises françaises à l'harmonisation comptable internationale

Mouvement des Entreprises de France
MEDEF

es

IASB
30 Cannon Street
London EC4M 6XH
UK

Paris, 25 May 2011

Re: Lease – Comments on project update

Dear Sir David,

As stated in our recent letter addressed to the IASB Chairman, we acknowledge all the work the Board and its staff have carried out since the end of the commentary period on the *Leases* exposure draft and their evident efforts to take into account our and other stakeholders' comments on this project.

Whilst we recognise that the outreach process have helped clarify and resolve a number of matters, we believe that this activity cannot replace the thorough examination that proposals would receive through a re- exposure process. We therefore think that the future standard can not be judged properly without a review of the complete text together with the future *Revenue Recognition* standard, for internal and "cross-cutting" consistency. In our view, simultaneous re-exposure of both future standards is essential for quality assurance.

The purpose of this letter is not to re-open the conceptual debate on whether or not a fundamental review of current standards is appropriate, but to contribute constructively to the redeliberation process and to assist the Board to achieve a standard of high quality which represents a good compromise between conceptual rigour and cost-effectiveness. The attachment thus provides the reactions and views of our members to certain of the tentative decisions which have been taken during the period of redeliberation and illustrate the need for reexposure.

Once again, we would like to emphasise that our members would be happy to participate in further consultation exercises on this topic.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

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Patrice MARTEAU	**Alexandre TESSIER**	**Agnès LEPINAY**
Chairman	Director General	Director of economic and financial affairs

Attachment: Based upon the Board's tentative decisions made up to and including the April 2011 joint meeting.

Definition of a Lease

The definition of a lease is now, more than it has ever been a crucial key to the application of the future standard and thus it needs to be robust and unambiguous.

Whilst some aspects of considered changes have been tested by the targeted outreach process, we believe that it is crucial to re-expose the final definition for comment and field-testing to prove that it is robust enough to provide the base for the standard.

- ***A 'specified asset' refers to an asset that is explicitly or implicitly identifiable.***

  In our view, the ability to identify the underlying asset is an essential pre-requisite for the determination of a lease contract: if the asset cannot be identified then its use is unlikely to be the primary reason for the contract's existence. We do think, however, that identification of an asset is not sufficient for a definitive conclusion to be drawn about whether the contract is a lease. Assessment of the exchangeability or fungibility of the asset is also required.

  We believe that a key distinguishing feature between leases and services is the exchangeability or fungibility of the underlying asset. The arrangement is primarily intended to provide a service when the underlying asset is just an element of the supplier's process in providing that service. In such arrangements, the lessee/customer is mainly interested in receiving a service and is indifferent to the asset used.

  Furthermore, we do not share all the conclusions that the Board has drawn in the appendix to the agenda paper 1D presented to the Board in April 2011:

  For example, photocopiers are deemed to be specified assets because they cannot be substituted without the consent of the renter. We do not reach the same conclusion, because we believe that the key feature is whether or not the asset used is easily exchangeable or replaceable by another that can provide substantially the same good or services. In the illustrative example, the fact that the lessor needs the lessee's consent to replace a photocopier should be viewed only as a <u>protective right</u> provided to the customer in order to guarantee the level of its services.

- ***Non-physically distinct portions*** *of assets (i.e. portions of capacity) are not a specified asset.*

  We support this tentative decision and welcome the clarification. We share the concerns expressed by some participants in outreach sessions who think that widening the definition to possibly capture non-physically distinct portions of a larger asset would have added a great deal of complexity when assessing whether a contract contains a lease.

The inclusion of non-physical portions would require preparers to analyse all service contracts and analyse whether they have the right to use and control the assets used in delivering any services received. In our view the analysis work required would represent a great burden and decisions would be very arbitrary. We are not sure that the conclusions drawn would be consistent enough across entities to provide reliable comparable information.

- ***The right of control is*** *transferred only when the client has the ability to direct the use and obtain substantially all the benefits from the use of the underlying.*

  We also support this tentative decision to align the notion of control with that currently developed for revenue recognition purposes. This decision will bring more consistency in the application of the proposed leases standard and will avoid the risk of entities drawing different conclusions for similar transactions, especially in the case of lessors. Furthermore, we believe that this definition of a lease draws a more appropriate line between services and leases (based on the conclusion stated in appendix to agenda paper 1D – April 2011).

- ***Assets that are "incidental"*** *to the delivery of services: If the asset is not separable from the provision of the services specified in the contract, the arrangement does not contain a lease.*

  We also welcome this tentative provision that permits one to identify contracts where the underlying asset, even if specified, is just an element of the supplier's process in providing a service.

  In our view, the focus should be made on the fact that an incidental asset is "a mechanism for providing a specified service requested by the customer", such that the use of the asset was an inseparable part of the overall service (first criteria in the proposed text drafted for the February 2011 Board Paper 5D, Appendix paragraph A5). We therefore agree that when service is not separable from the underlying assets, the whole contract should be accounted for as a service contract.

  However, before we can conclude on this issue we require further details on the criteria to be considered for assessing whether an element in a contract qualifies as a separable item for the purposes of lease accounting. We are not sure whether the Board intends to replicate exactly the criteria developed in the *Revenue Recognition* project. If it does, we fear that some of these may not be appropriate. For example, criteria relating to the ability of the seller (lessor) to sell/ lease the asset separately should not be considered in assessing the "separability" of the service component in a specific contact. We think that instead the focus should be put on the customer's / lessee's ability to use the asset on its own and whether or not the asset and services were negotiated separately in the specific contract under assessment, irrespective of the lessor's arrangements with other customers.

The definition of a lease is fundamental to the future standard. Whilst some aspects of this have been tested by the targeted outreach process, we believe that it is crucial to re-expose the final definition for comment and to field-testing to prove that it is robust enough to provide the base for the standard.

Scope exclusion

- ### Short-term leases

One again, **we welcome the latest tentative decision** made by the Boards to allow the option proposed in the ED for lessor accounting to be extended lessees to as well, and thus to use accrual accounting for the income statement without recognising an asset on the balance sheet of the lessee.

Nonetheless, given the scope of the proposed exemption, we do not expect a lot of contracts to be eligible for this treatment. In the view of our members, in practice there are few leases with a maximum possible term, including any options to renew, of 12 months or less. We therefore do not consider that this proposal will substantially alleviate the cost burden generated by the new standard.

Furthermore, we do not agree with the Board's tentative decision not to align this scope exemption with the new definition of a lease term, which includes only renewal options with a significant economic incentive making them likely to be renewed. Let's take as an example a lease with a minimum contractual term of 6 months, with two renewal options for 6 months each, but with no significant economic incentives to renew: because of the two renewal options, this contract could not be treated simply under the option for short-term leases, and therefore should be accounted for using the full lease accounting approach. However, because the options are not economically attractive, only payments over the next 6 months would be recognised as an asset and a liability. We therefore have real reservations about the usefulness of information provided in this case and the cost / benefit balance.

Finally, In the interest of comparability, it would be better to make these simplified approaches mandatory rather than optional for both lessors and lessees.

- ### Investment properties

We are not aware that there have been any redeliberations about accounting for investment properties. May we remind the Board that we raised the following issue in our response to the Exposure Draft? We think that the cost model for investment property is the most appropriate approach to reflect the business model of lessors whose primary objective is to hold and manage investment properties in order to generate cash inflows from rentals rather than from capital appreciation. The rental terms are fairly short, particularly when compared to the life of the assets, but usually more than twelve months in length.

The performance obligation approach of the ED would lead to an inappropriate weighting of yields towards the early periods of a lease with a corresponding decrease in later periods, and the number of such arrangements in existence can make the accounting onerous. Accounting for such rental income on an accruals basis (as in current IAS 17) provides the best reflection of the economic nature of such arrangements, in our view.

We therefore suggest **that the Board also exclude from the Leases standard investment properties that are measured by the lessor after initial recognition using the cost model,** unless it is made clear from the drafting of the future standard that these items are never or very rarely specified assets. We believe that the latter would be the case when a lessor can reasonably expect to rent easily the investment property to any lessees other than the current one. As an alternative approach, the maintaining of the current IAS 17 approach to the accounting for operating leases by lessors would provide a suitable compromise between costs for preparers and usefulness to users.

We will be pleased to organise a specific outreach session on this issue if it would help the Board to better understand our concerns.

The accounting model for lessees

Once again, we are pleased to note that the Board has taken into consideration the main concerns expressed by us and many others commentators. We are strongly convinced that, in order to respond appropriately to the different economic circumstances of different arrangements, all lease contracts should not be accounted for in the same way: the lease is a legal form that encompasses a lot of different economic transactions and is not always a financing transaction. Because the Board has already conclude in its exposure draft, that two economic models should be reflected in the lessor's financial reporting, it sounds logical to reach the same conclusions for lessees.

We therefore welcome the tentative decision to make **a distinction between finance leases and other leases.**

We also welcome the Board's decision to **base the differentiation on the current criteria for distinction** in IAS 17, as they are well understood and have been applied in practice for a long time.

In respect of the accounting model for leases other than finance leases, we agree entirely with the proposal that the net income effect will be equivalent to that calculated today for an "operating lease", although the way the Board currently proposes to arrive at this outcome (the difference between the interest charge and the rental payment being treated as amortisation) is perhaps not the simplest.

We think that a better approach would be for the standard not to specify any prescriptive accounting scheme but to state the objective that the lease payments should be recognised as an expense on a straight-line basis, and that initially and subsequently the lease liability should be measured at present value of the lease payments, and the right of use asset measured at the same value. Entities should be required to use an appropriate method to achieve this.

Finally, even if this issue has not been re-deliberated yet, we would like to draw your attention to the fact that this distinction between finance leases and other leases **should also be reflected in the presentation of the statement of financial position and the statement of cash-flows**: the lease liability arising from finance leases should be presented within financing debt whereas the lease liability arising from other leases should be presented within operating payables.

Purchase and renewal options

- **Renewal options :**

  As mentioned in our comment letter in response to the exposure draft, we strongly disagreed with the initial approach to renewal options which:

  - Contradicted the conceptual framework's requirement that there be a present obligation;
  - Denied that options to extend are negotiated to provide the lessee with flexibility (benefit) and do not represent obligations of the lessee; and
  - Impaired comparability by leading to the same accounting outcome for two companies that have entered into two different contracts and have different obligations in economic terms.

  We are pleased to note that the Board has considered very seriously all comments and suggestions that have been addressed to it during the comment period and we welcome its tentative decision to include only amounts due under options that give a significant economic incentive to exercise them. We also believe that specific guidance would be useful in order to ensure a shared understanding of this new notion and how it should be applied.

  However, we are still concerned that this approach may not ensure that the future leasing standard will properly respond to the definition of a liability and the criteria for it to be recognised in line with the conceptual framework. In view of the objective stated in the ED to "report relevant and representationally faithful information...about the amounts, timing and uncertainty of the cash flows" and the phrase often used during the Boards' discussions, that the aim is to represent "committed cash flows", we think that a high threshold should be applied to the recognition purposes.

The threshold used in the current IAS 17 for the recognition of the effect of an option being exercised, "reasonably certain", seems to us to be an appropriate hurdle which corresponds well with the framework's criteria and therefore fulfils the objectives of the reporting of leases.

Finally, in respect of the use of entity-specific factors, or business factors, to assess whether a significant economic incentive exists, we think it is important for the proposals to remain consistent with other standards, such as current IFRS 3 (paragraph 11) and IAS 37 (paragraph 19), which clearly prohibit the accounting for liabilities which remain subject to the entity's future actions or decisions, even if there is an expectation that the entity will take a particular course of action. While disclosure of the existence and effect of such options does provide useful information, the accounting for them results, in our view, in unreliable and misleading information

- **Purchase options:** we agree that options to purchase should be treated in the same way as those to extend a lease term.

Measurement

- **Contingent rentals**

This topic is may be one of the most challenging for the Board as it crystallised the need for consistency between the *Revenue Recognition* and *Lease* projects and consistency between those future standards and the current framework.

We still believe that the question of contingent rentals is overall a recognition issue and not a measurement issue in both projects. In this respect:

- On the lessee side, under current IFRS literature liability should be recognised to account for a contingent price only to the extent that the occurrence of the future event is outside the control of the buyer. The Lease standard should therefore exclude from its scope lease liabilities that are within the control of the payer.

- On the lessor / seller side: under current IFRS literature as well, revenue and assets should be recognised only when these items can be measured reliably and have a sufficient degree of certainty (it is probable that any future economic benefit associated with the item will flow to or from the entity).

We therefore welcome the following decisions taken by the Board (although we do not share the view of those Board members who see these as a practical expedient only as they are still convinced that this is a measurement issue, not a recognition issue):

- Limiting the revenue that could be recognised to the amount reasonably assured to be received
- Incorporating in the lessee / lessor obligation and assets only those variable rents which are in fact "disguised minimum lease payments"

In respect of this last point, we hope that we will soon be able to have sight of the proposed guidance for identifying such in-substance disguised fixed minimum lease payments and be able to test its applicability. We noted the Chairman's comment in the debate on this topic during the April Board meeting – that this provision is concerned with targeting "phoney" variability and not genuine variable arrangements such as those in JV's or profit-sharing agreements – and we agree entirely with this. The drafting of this area of the future standard will be difficult but crucial to ensure that only reliable and relevant amounts appear on the balance sheet, and that these items are fully compliant with the conceptual framework.

Finally, we also wait for more precision concerning index-based contingent rents or revenue, as it is not clear for us today whether the Board intends to retain consistent treatment of such items in both the lease and revenue projects:

- The Board has recently decided to limit revenue recognition in circumstances where there are some factors outside the influence of the entity, such as volatility in the market. We therefore wonder what will be the consequence of this decision on the Lease project: should liability / assets based on indices also be limited when subject to high volatility?

- On the other hand, we note that the Board has decided in its lease project to integrate index- or rate-based rents in the asset / obligation measurement initially using a spot rate (rather than a forward rate). Does this imply that index-based revenue should also be estimated by reference to the spot rate (even when this index is highly volatile)?

- Is a market price for a commodity deemed to be an index or rate?

- **Contracts that contain both services and lease components**

We agree that as a principle, the service component should always be estimated and tracked separately for both lessors and lessees. We therefore agree with some of the latest proposals for the lessee, but not all of these.

To be clear, although we accept the first two methods proposed (allocation on a "relative purchase prices basis" and a "residual method), we believe that the third one (no observable purchase price) is not appropriate.

We believe that in many cases, when there is no observable purchase price, this is surely a good indicator that the asset could not be separated from the service and thus the arrangement should be accounted for as a service contract, according to the tentative decision made on separable components.

It thus seems to us to be inconsistent with the decision about the separation of assets from services to require the allocation of the whole consideration to the lease component. In our opinion, in such cases, the lessee should determine whether the contract is predominantly a contract for services or a lease of an asset, and account for the whole arrangement on the basis of the predominant element. To do this, the entity should develop criteria for distinguishing service contracts from leases based upon its own business model and apply them consistently.