EFRAG
European Financial Reporting Advisory Group

14 October 2013

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: Exposure Draft Leases

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the revised Exposure Draft *Leases* ('the ED'). This letter is intended to contribute to IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

EFRAG agrees with the IASB that more lease arrangements than today's finance leases are in-substance purchase of assets, albeit for a term that is less than the full useful life of the asset. For this reason, EFRAG remains supportive of the IASB's Leases project and believes that the right-of-use model applied to the right population of leases has the potential to bring useful information to users about financing arrangements that are kept off balance sheet today.

EFRAG also notes that the ED incorporates a number of our previous recommendations, reflects significant improvements in the accounting for leases in accordance with the right-of-use model and includes a better approach to the distinction between lease and service arrangements.

However, in our answers to both the Discussion Paper published in 2009 and the first Exposure Draft published in 2010, as well as in other communications such as our regular EFRAG-IASB meetings, we have emphasised the need to ensure that constituents have a good understanding of the objectives of the project and what economic phenomena the IASB intends to depict in the primary financial statements. We do not think that this understanding exists today and we do not think that it is adequately explained in the Basis for Conclusions.

In its communications, the IASB has emphasised that the project is intended to recognise financial liabilities that are currently kept off balance sheet. Focussing on this objective seems to have been the primary driver behind the development of the right-of-use model. This model is based on a notion that an asset is a bundle of rights, one of them being the right-of-use. This is a new approach, which has not been sufficiently debated on a conceptual level and we are not convinced that the focus on liability recognition has led to capturing the right population to which the right-of-use model should be applied.

EFRAG is concerned that without a proper debate on the underlying concepts and the related transactions, the right-of-use model will not be understandable for constituents and this will add to the perception that this proposed IFRS is unduly complex.

Based on these observations, EFRAG recommends that the IASB take advantage of the discussion on the Conceptual Framework to refine the definition of the right-of-use, distinguish this right from the other rights which are bundled in the asset, consider the implications of the unbundling of the leased asset in the lessor's accounts and refine the guidance to identify what activities convey the ability to direct the use of an asset and how this links with the business models of lessors (providing finance or managing assets).

This lack of clarity in the conceptual model, in addition to the significant concerns below, means in EFRAG's view that the current proposals will not lead to improvements in financial reporting:

- the dual measurement approach should be abandoned as Type-B measurement is inconsistent with the right-of-use model and adds to the complexity;

- the receivable and residual model poses additional questions, in particular how the transfer of a right out of a bundle affects the accounting of the underlying asset when control over that asset has not been surrendered. These questions need to be investigated before lessor accounting is finalised; and

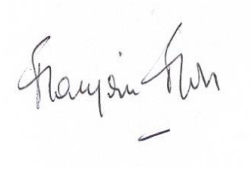
- overall, the proposals are far from reaching an appropriate cost/benefit trade-off. Significant simplifications are needed, such as exempting small ticket lease arrangements from the requirements in the standard, providing relief from continually re-assessing the lease term and introducing a portfolio approach as an estimation technique for groups of similar arrangements.

We believe that all of the above need to be addressed to have a robust standard. Therefore we do not recommend that the IASB finalises the Standard on the basis of the current Exposure Draft.

In the appendices we have included further comments and recommendations, with the objective of achieving greater internal consistency, and reducing complexity and inherent costs.

If you wish to discuss our comments further, please do not hesitate to contact Filippo Poli, Robert Stojek or me.

Yours faithfully,



Françoise Flores
EFRAG Chairman

Appendix 1 – Right-of use model

1 EFRAG agrees that leasing is important for many entities and hence that users of financial statements should obtain a complete and understandable picture of an entity's leasing activities. There has been criticism of the existing accounting model, mostly for lessees, and EFRAG agrees that there is room for improvement in reporting for leases.

2 At the beginning of the project there was a concern that existing lease accounting allowed significant financial liabilities to stay off balance sheet, and this was what the IASB should have addressed. The IASB has however assumed that all lease arrangements provide asset financing to the lessee, but EFRAG is not convinced that this is the case.

3 The proposals represent a significant change from existing requirements. IAS 17 *Leases* was aimed only at those transactions that are substantially identical to purchase financing for the whole asset. Now the IASB proposes recognition of a right to use an identified tangible asset, which is based on a notion that an asset is a bundle of rights. This notion has not been sufficiently debated at a conceptual level.

4 In our answers to both the Discussion Paper and the first Exposure Draft, as well as in other communications such as our regular EFRAG-IASB meetings, we have outlined the need to fully explain the project from a conceptual perspective, so that constituents would have a good understanding of what economic phenomena the IASB intends to depict in the primary financial statements. The Basis for Conclusions makes a considerable effort to explain that a right of use meets the definition of an asset and that currently users adjust the balance sheet to obtain a more complete picture of the actual leverage of the entity, but it does not explain when recognition of leases would result in useful information or what the information content of the right-of-use asset is.

5 EFRAG believes that the right-of-use model has potential to bring useful information to users in respect of those financing arrangements that are kept off balance sheet today, if constituents will be able to understand what information results from the application of the model. It is important that preparers and users understand what rights are brought onto the balance sheet (and what rights are not) and when recognition is the most appropriate way to provide information that is relevant and decision-useful.

6 EFRAG commends the Board's significant efforts to reach out to constituents and respond to the many views expressed. However, the decision to introduce a dual measurement approach and to adopt asymmetrical accounting treatments for lessors and lessees has increased the complexity of the proposals as well as the likely costs associated with their implementation and represents a further impediment to the understanding of the right-of-use model.

7 Having a dual measurement approach and optional requirements (such as the option to apply fair value in certain circumstances, or an exemption for short-term leases) may affect users' ability to understand which rights are and which are not recognised and how they are measured. The inclusion of a dual measurement approach indicates that the right-of-use model may not fit all the arrangements in scope of the proposals. The IASB should address these questions at a conceptual level rather than trying to achieve consensus through a compromise solution.

8 Simultaneously, the ongoing Conceptual Framework project provides the best context to refine the definition of the right of use, to distinguish this right from the other rights that are bundled in an asset, to consider the implications of unbundling of the leased asset in lessors' accounts and to refine the guidance to identify what activities convey the ability to direct the use of an asset and how this links with the business models of lessors (providing finance or managing assets).

Appendix 2 – Cost benefit balance

1 Overall EFRAG believes that the proposals are far from reaching an appropriate cost/benefit trade-off. Significant simplifications are needed, such as exempting numerous small ticket lease arrangements from the requirements in the standard and strengthening the application of materiality when accounting for leases.

2 The IASB has proposed as a practical relief that an entity needs not account for leases with a maximum possible duration of twelve months. Based on EFRAG's analysis and information obtained from constituents, this exemption would not be very effective, nor would any exemption up to three years. On the contrary, these findings reflect that 50% in number of all lease arrangements have a lease term between one and five years. We recommend the IASB to consider how an extension of the short-term exemption could provide an effective relief for small ticket lease arrangements, whilst maintaining the right-of-use model for major items.

3 The ED should state explicitly that materiality is not intended to be applied on a collective basis, so that entities are allowed to rely on a certain individual threshold appropriate in their specific circumstances, in a manner similar to that commonly applied for recognition of owned property, plant and equipment.

4 The 2011 ED on Revenue Recognition includes a practical expedient to allow entities to account for a portfolio of contracts rather than individual contracts. Application of the requirements on a portfolio level is allowed provided that the portfolios are homogeneous and that the entity does not expect material differences compared to the result obtained when applying the requirements to individual contracts.

5 The same portfolio approach should be made explicitly available for leases. This would alleviate the accounting for entities that have a large number of contracts at individually small amounts when considering for instance:

(a) Separating lease and service components;

(b) Assessing the discount rate; and

(c) Assessing the lease term.

Appendix 3 – Responses to the questions in the Exposure Draft *Leases*

Question 1: identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

EFRAG's response

EFRAG thinks that the current guidance still does not draw the appropriate distinction between leases and services, and that the absence of an observable price for an asset should lead an entity to reassess whether the contract really includes a lease.

Identification of a lease

1 EFRAG believes that the definition of a lease must not be so widely drawn as to scope in service contracts. This is difficult to achieve because the provision of services often involves some use of assets, and a 'service' is not a defined term in IFRSs. Developing a definition of 'service' could help in drawing a proper distinction.

2 We agree with the decision of the IASB to give more emphasis to the notion of control when identifying a lease. Further, the guidance on identifying a lease should draw on notions such as the distinction between substantive and protective rights and the distinction between acting as a principle or an agent.

3 In many circumstances a contract does not only provide unconditional use of an asset, but also involves provision of additional services and conditions around the way the asset is operated. EFRAG believes that there are cases where these features of the contract effectively prevent the customer from the ability to direct the use, and therefore do not grant more than an unconditional access to the underlying asset. We are concerned that the guidance in the ED will require the entities to identify a lease in some of these cases, for instance when the contract restricts the customer's ability to control the operating capacity of the asset.

4 We also believe that applying the proposed criteria will require significant judgment, which may result in application issues. It may be difficult to assess 'control' for instance when the asset is not directly managed by the lessee.

Interaction between definition of a lease and separation of components

5 EFRAG agrees that a contract does not include a lease when the underlying asset is only a vehicle for the delivery of consumables (such as the coffee consumables in Illustrative Example 2) or services provided only by the supplier. In this case, the essential component is the consumable or the service, which does not qualify as an identified asset in a lease.

6 EFRAG believes that paragraphs 19 and 20 of the ED may confuse preparers, as the condition in paragraph 20(a) – the asset being dependent from other resources that are readily available to the lessee – appears to be very similar to the condition in paragraph 19(a). However, we understand that the two conditions are used to assess two very different issues: paragraph 19 assesses if the contract includes a lease, while paragraph 20 assesses if the lease contract (already identified in accordance with paragraph 19) includes one or more lease components.

7 EFRAG believes that the IASB should reconsider the wording of paragraphs 19 and 20 to ensure that they are relevant only to the specified issue that they are intended to solve.

Accounting for contracts that contain service components and lease components

8 EFRAG agrees with the requirement to identify and account separately for lease and non-lease components. We think that it is consistent with the principles in the ED on revenue recognition and with the right-of-use model.

9 With reference to the guidance, EFRAG agrees that observable prices should normally be used when they are available for all components. Some adjustment may however be needed when observable stand-alone selling prices are not fully meaningful in the context of a lease transaction, because for example of different tax effects.

10 However, EFRAG disagrees with the IASB proposals when there are no observable prices for any component of the contract.

11 Firstly, we believe that a separate price will generally be observable when an asset can be used without goods or services that only the supplier can provide. In our view, the absence of an observable price for an asset should lead an entity to reassess whether the contract really includes a lease.

12 Secondly, EFRAG believes that in these rare cases when a contract contains a lease, but observable prices do not exist, an entity should be able to use estimates to account for the lease and non-lease components. Allocating all payments to the lease component could undermine the relevance of the information.

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

EFRAG's response

EFRAG disagrees with a dual measurement model. Once the appropriate population of arrangements is identified and recognised as a lease, we continue to support a single measurement model for all lease arrangements.

13 As mentioned in our reply to Question 1, the definition of a lease and its application should capture the appropriate population of contracts. Once this is achieved, EFRAG supports a single measurement for all lease arrangements.

14 By choosing a right-of-use model the IASB intends to portray leases as a purchase of an asset. However, in Type-B measurement the carrying amount of the right-of-use asset depends on the interest charge calculated on the lease liability and is in fact a balancing figure. We believe this to be inconsistent with the right-of-use model and consider that it does not provide relevant information on the asset side. Furthermore, it introduces complexity and adds an impediment to understanding the model. For example, it is not clear how users will be able to calculate meaningful ratios based on carrying amounts of such right-of-use assets.

15 We further have practical concerns about the Single Lease Expense approach. We think it creates issues when assessing impairment of the right-of-use asset or when the lease term is reassessed. In addition, this approach will likely require changes in systems because amortisation of the right-of-use asset must be calculated as the complement of the interest charge.

16 We understand that the IASB introduced a dual measurement in response to the argument that for some leases it is useful to maintain the current expense recognition pattern. The IASB sees the dual measurement as a reasonable compromise between different views, and Type-B as a way to provide relief around recognition of expense.

17 However, we believe that the benefits of the Single Lease Expense are undermined by the complexity of implementation of the requirement. Therefore, it should not be pursued.

Question 3: lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

EFRAG's response

EFRAG believes that unbundling the underlying asset raises a number of conceptual and practical questions. Therefore, we believe that the receivable and residual model needs more work at this stage before being introduced.

EFRAG has always supported a model that would treat all leases alike and in a manner consistent with lessee accounting. In this respect the receivable and residual model may hold promise in providing relevant information. However the unbundling of the underlying asset into a receivable and a residual raises a number of conceptual and practical questions. In particular, it is too complex for assets, such as properties, airplanes, or ships that may be leased multiple times over their economic lives.

An additional question concerns the proposed inclusion of optional payments in the measurement of the lease receivable. While it may be argued that including these payments in the lease receivable is not appropriate (since the lessor is not yet legally entitled to these payments) not including them may overstate the measurement of the residual asset. When the exercise of the option is highly likely, the payments to be received in the optional period may be lower than the portion of the underlying asset's cost allocated to the residual.

For the reasons explained above, EFRAG believes that the receivable and residual model needs more work at this stage before being introduced. Work being done in the revision of the conceptual framework should help. We note that the main objective of the Lease project was to bring the lessees' hidden leverage to the balance sheet. There is no similar issue with

lessors. This is also confirmed by the fact that users do not seem to have a concern about existing lessor accounting, especially for lessors of real estate.

Back-to-back leases

18 Should the IASB proceed with its dual model for lessors, EFRAG has a specific concern about the application of the proposed Type-B accounting in the context of back-to-back leases. If an entity is a lessee in a headlease of Type-B and it subleases the same asset, the sublease shall be also a Type-B. The entity shall therefore recognise and maintain a right-of-use asset in its statement of financial position.

19 The outcome would be different if both the headlease and the sublease were Type-A – in that case (assuming the same terms of the two leases) the entity would not present a right-of-use asset, but only a receivable and a payable. We think that this is a more faithful representation of a back-to-back lease.

20 In the event that the development of robust requirements for lessor accounting would require more time than needed to finalise satisfactory lessee accounting, the receivable and residual model should be applicable to back-to-back leases. As these arrangements involve rights of use being acquired and subsequently transferred, difficulties encountered in the unbundling of assets would either not apply, or apply to a much lesser extent.

Question 4: classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

EFRAG's response

21 EFRAG does not express a view on the question because, as mentioned above, EFRAG disagrees with using the proposed dual measurement approach. EFRAG concluded that the principle and the criteria proposed to classify leases contribute to our assessment that the dual measurement approach was adding significant complexity and would result in information that would be difficult to understand.

Question 5: lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

EFRAG's response

EFRAG agrees with the proposals to include certain optional periods in the lease term. However, we recommend maintaining the existing 'reasonably certain' threshold and introducing a rebuttable presumption that the lease term is unchanged.

22 EFRAG's initial position had been to support a component approach under which options are recognised and measured separately. EFRAG has since concluded that this was not feasible for these types of options. Neither would it have been acceptable to use intrinsic values; this assessment would still be too complex since it requires projecting future market rates for the underlying asset during the optional periods, and would create an exception to measurement requirements in the other Standards.

23 Therefore, EFRAG now supports that lease payments due under options should be recognised under certain circumstances. Not recognising options that are likely to be exercised could, in some circumstances, distort the depiction of performance of the entity. When the terms are advantageous to the holder, the value of the option is likely to have been incorporated in the payments for the initial term, which will then be higher relative to the payments for the optional period. Excluding the payments for the optional periods then results in recognising a higher cost of the lease in the first non-cancellable period.

24 We welcome the fact that the Board has accepted EFRAG's recommendation that the lease term should not be based on the longest term more likely than not to occur, as was suggested in the 2010 ED. However, we recommend maintaining the current notion of 'reasonably certain' in IAS 17.

25 EFRAG believes that the current practice of accounting for lease options works well. In paragraph 140 of the Basis for Conclusions, the Board agrees with this assessment and notes that applying the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably certain' in existing IFRS.

26 We understand that the Board would prefer a more objective threshold than the threshold based solely on management intent. However, we believe that the current 'reasonably certain' threshold better conveys the concept that the threshold for recognition is meant to be high. We recommend maintaining the current definition, which is well understood by preparers and users. The analysis of economic factors developed by the Board in paragraph B5 is useful as application guidance to guide the assessment in a more objective way. To emphasise that the assessment is not only based on management intent the Board could use the phrase 'reasonably certain based on available evidence'.

27 It is important to emphasise that an entity needs to consider all economic factors relevant to that assessment. The fact that an option is in the money should not be conclusive in isolation. For this reason, we recommend revising Illustrative Example 16 which, as drafted, may suggest that an entity has a significant incentive to exercise a purchase option only because the exercise price is lower than the current market value of the underlying asset. The example should remind constituents that all relevant factors need to be considered to reach that conclusion.

Reassessment of lease term

28 Significant concern was raised about the requirement to re-assess the lease term at each reporting date. The requirement would become burdensome if it is understood that an entity needs to perform an extensive analysis for each contract.

29 Since the threshold for recognition is high, EFRAG believes that the ED suggests that a modification of the term is expected to occur infrequently and an entity should be able to perform the assessment in a simple way. We recommend limiting the instances where a detailed analysis is required. This could be achieved by introducing a rebuttable presumption that the lease term has not changed.

Exemption for short-term leases

30 EFRAG welcomes the fact that the IASB has accepted the recommendation to extend the exemption for short-term leases to lessees. The cost of recognising these leases would outweigh the benefit. However, we believe that the exemption should still be further improved.

31 Under the proposals the significant economic incentive affects differently the assessment of a lease term and the use of the short-term option. Assume a contract

has a fixed term of less than one year and an option to extend it for another year; if the entity concludes that the option does not offer a significant economic incentive, then it accounts for a lease term of less than one year but it is not able to use the exemption. If the contract cannot be treated as a short-term lease it may seem illogical to measure it as one.

32 This different application seems to be mostly driven by concerns of potential abuse, that if the assessment of the significant economic incentive was also relevant to apply the exemption, then an entity could try to achieve non-recognition by having a fixed term of less than one year and multiple one-year extensions, and arguing that the options do not provide incentive.

33 Although we acknowledge that this is a possibility, EFRAG does not support mere anti-abuse provisions in accounting Standards. We would propose applying the exemption to all leases with a lease term is no longer than one year, including lease terms which include options for longer periods where those options do not provide a significant economic incentive (or, following our suggestion in paragraph 24 above, where options for longer periods that the lessee is not reasonably certain to exercise are included).

Definition of a non-cancellable period

34 The IASB proposes that the lease term is determined as the non-cancellable period of the lease together with both of the following:

(a) periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

35 The non-cancellable period is defined as the period for which *the contract is enforceable.* Some constituents take issue with that and argue that when the lessee has the option to terminate from its perspective the contract is cancellable. To improve clarity we recommend replacing the term ‘non-cancellable lease’ with another term.

Question 6: variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

EFRAG’s response

EFRAG agrees with the proposals on the measurement of variable lease payments but believes that the notion of in-substance fixed payments should be clarified.

36 EFRAG welcomes the IASB’s decision to exclude usage and performance-based variable lease payments from the measurement of the lease liability and lease receivable.

37 We support inclusion of variable payments based on an index or rate, but are concerned that the notion of ‘in-substance fixed payments’ is not fully clear. The IASB has not provided a principle to identify in-substance fixed payments so the application of this notion will be based mostly on the Illustrative Examples.

38 Examples cannot replace principles-based requirements and may be interpreted in different ways. Example 17 requires recognition of an amount that is due irrespective of the level of sales. In our view, this amount would qualify as a fixed payment.

39 If this is the only type of payment that the IASB wants to capture, there is no need to introduce a notion of in-substance fixed payments. If there are other payments that qualify (for instance when the contingency is not genuine, or a significant payment is triggered by an extremely low threshold), then the IASB needs to provide a clear principle – in our view Example 17 would not provide a robust basis to require the inclusion of these payments in the measurement of the liability.

40 We fully agree that variable lease payments should not be recognised only because they are highly probable. Example 18 is quite useful in making clear that if payments are based on future sales, no payment is recognised regardless of the fact that the entity will certainly generate sales in future.

41 The issue of variable payments is surfacing in other projects; for instance contingent consideration is addressed in the revenue recognition project and the IFRS Interpretation Committee is currently discussing contingent payments on the acquisition of tangible and intangible assets. We recommend that the IASB should reach consistent conclusions on the treatment of contingent and variable payments across different projects.

Question 7: transition

Paragraphs C2-C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not what transition requirements do you propose and why?

Are there any additional transition issues that the boards should consider? If yes, what are they and why?

EFRAG's response

EFRAG generally agrees with the transition requirements and suggests some limited amendments

42 EFRAG is generally in favour of full retrospective application. However, lease arrangements may have long durations and lessees may not have the information to apply new requirements fully retrospectively. We agree with granting practical reliefs that lead to the reduction of implementation costs, and for this reason we also agree with the proposal to carry forward the amounts recognised before the transition date for leases previously classified as finance leases.

43 Paragraph C4 of the ED requires that an entity adjusts equity at the beginning of the earliest comparative period presented. However, paragraph C8 of the ED requires the use of the lessee's incremental borrowing rate at the effective date. EFRAG believes that it would be more consistent to require the use of the lessee's incremental borrowing rate at the beginning of the earliest comparative period.

44 EFRAG believes that entities should not be required to recognise lease liabilities and right-of-use assets for leases previously classified as operating leases, if the term has ended before the end of the period in which the new Standard is applied.

Question 8: disclosures

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what change do you propose and why?

EFRAG's response

EFRAG recommends including a clear statement that not all disclosures listed are required in all circumstances.

45 EFRAG welcomes the requirement in paragraphs 59 and 99 of the Exposure Draft that an entity should consider how much emphasis to place on each requirement to satisfy the objectives. The list of requirements is extensive and we believe that it should be clearly stated that not each of them will be needed in all circumstances.

46 Presentation requirements in the ED will allow lessees to present the impact of leases in different lines of the statement of financial position, statement of comprehensive income and statement of cash flow. This is partly the effect of the dual measurement approach (which EFRAG does not support as mentioned in the discussion above) but also the effect of the exemption allowed for short-term leases.

47 EFRAG thinks that users would benefit from a requirement to disclose in one location comprehensive information about total rights and obligations and related income and cash flow effects inherent in lease contracts of which the entity is part of.

48 Paragraph 64 of the ED requires a reconciliation of balances of lease liabilities separately for Type-A and Type-B leases. EFRAG does not see a clear rationale for this requirement, since the measurement of lease liabilities is the same for Type-A and Type-B.

49 Paragraph 118 of the ED states that the lessee may elect not to apply the requirements of paragraph 25-35 and 37-57 to short-term leases, but the exemption does not explicitly extend to the disclosure requirements in paragraphs 58-67. EFRAG believes that to ensure the internal consistency of the proposals the exemption should be extended to disclosure requirements.

Question 12: consequential amendment to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property. Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

EFRAG's response

EFRAG agrees with the proposal but believes that the guidance on fair value needs some clarifications when applied to right-of-use assets.

50 EFRAG agrees that a right-of-use asset of an underlying investment property should be measured in accordance with IAS 40.

51 However, we believe that the guidance in IAS 40 and IFRS 13 *Fair Value Measurement* should be amended to assist preparers in dealing with options. Under the current requirements, IAS 40 is usually applied only to interests in investment property held under a finance lease. As noted in paragraph 312 of the Basis for Conclusions of the ED, finance leases typically do not include variable lease payments or unrecognised optional lease payments. So the application of fair value model generally does not have to deal with these components.

52 This issue will become more important following the proposed amendment, because existing operating leases of investment property are more likely to include options or variable payments. Applying IAS 40 measurement requirements would involve measuring the market value of the options. As noted in paragraph 137 in the Basis for Conclusions, options may be difficult to be measured reliably.

53 If a lessee classifies a right-of-use asset as an investment property and applies the fair value model as its accounting policy for investment properties EFRAG understands that it should not amortise the right-of-use asset in accordance with Type-B measurement model. In our view, paragraph 52 of the ED needs to state this explicitly.

Additional issues

Interaction between variable lease payments and the rate the lessor charges the lessees

54 The proposals in the ED imply that a lessor has an option to either incorporate an expectation of variable lease payments in the discount rate or not. The ED then requires a different measurement of the residual based on the choice taken.

55 EFRAG recommends that the ED defines the conditions under which a lessor would be required to include or exclude an expectation of variable lease payments when assessing the discount rate.

Costs to return the asset in a specified condition at the end of the lease

56 Paragraph 40 of the ED requires initial measurement of the right-of-use asset initially at the amount of the initial measurement of the liability plus any lease payments made before commencement, less any lease incentive received by the lessee and plus initial direct costs. According to paragraph B10, initial direct costs include payments made to existing tenants to obtain the lease.

57 EFRAG is pleased that the IASB has explicitly addressed payments made by and to the lessee to enter into the lease arrangements. However, we note that a lessee may incur costs to return the underlying asset in the specified conditions and location at the end of the lease term. The ED does not address these costs, although the related amendment to IFRIC 1 has been proposed. EFRAG recommends an explicit mention of these costs in paragraph 40 of the ED, as an element of the initial measurement of the right-of-use asset.

Accretion of residual asset

58 If the IASB retains their proposals on lessor accounting, EFRAG maintains its support for accretion of the residual but notes that unwinding of the discount on non-financial assets carried at cost is generally not permitted under IFRS. We therefore recommend a clear statement that entities are not allowed to apply such accounting treatment by analogy.

Nature of the right-of-use asset

59 The ED does not specify what the nature of the "right-of-use" asset (i.e. whether it is tangible or intangible) is, although paragraph 44 of the Basis for Conclusions refers to the 'loaned' asset as a tangible rather than a financial asset. EFRAG supports presenting the right-of-use assets in the same way that the entity would present the underlying asset if it was owned (which we understand is what paragraph 55 of the ED allows to do).

60 EFRAG believes that clarification of the nature of the right of use might improve the understanding of the model and its consistent application and could also assist regulators in setting prudential rules.

Presentation of Type-B leases

61 EFRAG believes that the presentation of lease liabilities should be consistent in the statement of financial position and in the statement of comprehensive income. Therefore if the IASB confirms that amortisation of the right-of-use asset and unwinding of the discount for Type-B leases are presented as a Single Lease Expense then it should clarify that these liabilities are not financial liabilities.

62 The presentation of a Single Lease Expense seems to be in conflict with the requirement to present the amortisation of right-of use assets (paragraph 61 of the ED) and the unwinding of the discount (paragraph 64 of the ED) as separate items in the reconciliation of opening and closing balances.

63 EFRAG also believes that it would be appropriate to reconsider whether the current requirements in IAS 7 *Statement of Cash Flows* applicable to leases provide the most useful information – namely, around presenting a lease as a cash or non-cash transaction at commencement, and presenting lease payments as repayments within financing activities or as payments to acquire property, plant and equipment within investing activities.

Presentation of lease assets in the lessor's statement of financial position

64 Assuming that the IASB retains their proposals on lessors' accounting EFRAG questions that the lessor should be allowed to present the lease asset as a single amount in its statement of financial position. EFRAG notes that:

(a) The lease receivable and the residual asset are different in nature. The lease receivable is a financial asset – although some of the measurement requirements may be different from requirements in IAS 39; the residual is a non-financial asset, as confirmed by paragraph 257 of the Basis for Conclusions;

(b) The lease receivable and the residual are intended to be recovered in different ways and are subject to different risks.

65 EFRAG believes that the aggregation of items in the main statements should be based on shared qualities. Although the lease receivables and the residual are recognised as the result of the same transaction, we do not think that this is sufficient to aggregate them in a single amount.

66 Moreover, we question if it is not more appropriate to identify the 'receivable' rather as a 'lease asset'. The amount may not qualify as a receivable as the lessor's legal title to collection does not depend only on the passage of time. In the ED on revenue recognition, these amounts are identified as 'contract assets'.

Variable lease payments in interim reports

67 Paragraph B7 of the Illustrative Examples in IAS 34 states that contingent lease payments are an example of a legal or constructive obligation that is recognised as a liability. An entity should recognise contingent lease payments based on a certain level of annual sales, if that level of sales is likely to be achieved and the entity has no realistic alternative to make the payment.

68 It is not clear if this requirement creates a conflict in the current literature. IAS 17 is silent about the treatment of variable payments. In July 2005, the IFRS Interpretations Committee noted that the standard would allow alternative treatments for variable payments, but decided not to issue an interpretation because there was no evidence of diverging practices – most preparers recognise variable payments only when they are due.

69 The IASB is now proposing that variable lease payments linked to future performance or use would not be included in the measurement of lease assets and lease liabilities. EFRAG believes that paragraph B7 of IAS 34 – that many perceive as an exception to the requirement to use the same accounting policies for interim reports as in annual reports - will now create a conflict with the proposals in the ED.

70 Assume a scenario where an entity pays a variable lease payment if at the end of a two-year period it reaches a certain revenue threshold. If at the end of the first six months it expects to attain the threshold, paragraph B7 of IAS 34 would require accruing a portion of the variable lease payments; but at the end of the first year, the entity would have to reverse the accrual even if it has not changed its expectation, because under the ED those payments are recognised only after reaching the threshold.

71 EFRAG believes that IASB should align the treatment of variable lease payments in interim reports to the proposals in the ED.

Consequential amendments to IFRS 3 Business combinations

72 EFRAG notes that under the proposed amendment, the acquirer would not be able to recognise the acquiree's leases with a remaining term of less than 12 months even if the acquiree had an option to purchase the underlying asset. This would lead to a strange outcome – the acquirer would be forced not to recognise the contract at acquisition, but would then recognise the underlying asset if the acquiree exercises the option at the end of term. We do not think this is appropriate.

73 Therefore, we recommend that the revised paragraph B54B of the IFRS 3 *Business Combinations* should refer to 'leases that if assessed at acquisition date would meet the definition of short-term leases' rather than 'leases that have a remaining maximum possible term under the contract of 12 months or less'.

74 EFRAG also believes that the acquirer should be allowed not to recognise those contracts, but not prevented from doing so. Allowing an option to the acquirer would simplify the adjustment process for consolidation purposes.