FEEDBACK REPORT

Exposure Draft Leases

Results of the additional public consultation on lessee accounting carried out by EFRAG, ANC, ASCG, FRC and OIC

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Executive Summary

Background

1 In May 2013, the IASB and the FASB ('the Boards') published a revised Exposure Draft *Leases* ('the 2013 ED'). The core principle of the ED is that lessees shall recognise assets and liabilities for all leases (other than short-term leases). In January 2014, the Boards started to re-deliberate the proposals for leases.

2 Before and after the publication of the 2013 ED, constituents in Europe have repeatedly expressed concerns that the definition and criteria to identify a lease may capture arrangements that are in substance services. However, no consensus has emerged on an alternative definition or criteria to identify a lease during the comment period or in the extensive outreach performed by the Boards.

3 Moreover, in March 2014, the Boards diverged and tentatively decided to support two different approaches for lessees. A more detailed description of the approaches can be found in Appendix III of this document.

4 EFRAG and the National Standard Setters of France, Germany, Italy and the UK decided, therefore, to conduct an additional public consultation to obtain constituents' views on:

(a) examples of transactions that would qualify as leases under the proposals, but that in the constituents view are in substance services; and

(b) which of the two alternative approaches is more appropriate and/or less costly to apply.

These questions were included in two questionnaires: one specifically designed for preparers and the second specifically designed for users. This report summarises the results received from both questionnaires.

5 Reports on the two prior outreach activities to consult constituents on the 2013 ED proposals, including reports on a field test and a report on a limited survey on possible simplifications to the accounting model for lessees are available at:

(a) ED_Leases_2013_-_Report_on_leases_field-test.pdf

(b) EFRAG_limited_survey_on_the_simplifications_to_ED_Lease.pdf

Main findings

Number of respondents

6 44 respondents from 10 countries and 6 international organisations responded to the additional public consultation for preparers. A large majority of the respondents were European listed groups. The industries mostly represented were leasing companies, automotive, telecommunication, and transport and logistics. A breakdown of the respondents by country and by industry is provided in paragraph 15 below.

7 16 respondents from 8 countries and 3 international organisations responded to the consultation for users. A breakdown of respondents by country and by category is provided in paragraph 32 below.

Public consultation for preparers

8 Respondents provided several examples of transactions that would qualify as leases under the 2013 ED proposals, but in the constituents' view should not be recognised on a lessee's balance sheet. The main reasons given by those respondents to justify that the transactions should be accounted for as services were the following:

(a) the client cannot prove if the supplier can benefit from the replacement of the asset;

(b) the supplier is legally responsible to replace the asset in case of destruction or malfunctioning;

(c) the supplier is responsible for maintenance and repair;

(d) the contractual restrictions on the use of the asset impairs the control over the asset;

(e) the client's purpose of the transaction is to obtain a service; and

(f) the service component in the arrangement is predominant.

9 Participants were asked to express their preference between the IASB's approach and the FASB's approach. A majority of the respondents (27), however, expressed their general concern with the leases project and explicitly supported keeping or improving the existing requirements.

10 Out of those respondents who indicated a preference between the two approaches, 14 supported the IASB's approach whilst 12 supported the FASB's approach (including 3 non-European respondents). Some respondents (16) indicated that they would support neither approach. More granular information on this issue is provided in paragraph 23 below.

Public consultation for users

11 Respondents to the consultation for users generally expressed their support for the core principle of recognition of leases. Only 2 respondents explicitly indicated that the Boards should improve current requirements and not bring all leases onto the balance sheet.

12 Additionally, a majority of the respondents (11) indicated their preference for the IASB's approach.

Detailed findings

Public consultation for preparers

13 The report uses the following terms to summarise the findings:

(a) *A few*: less than 25% – 3 up to 11 respondents;

(b) *Some*: between 25% and 50% – 12 up to 22 respondents;

(c) *Majority*: between 50% and 75% – 23 up to 33 respondents; and

(d) *Large majority*: more than 75% – 34 respondents or more.

14 44 respondents from 10 countries and 6 international organisations responded to the additional public consultation for preparers. A large majority of the respondents were European listed groups.

15 The table below presents the number of respondents by country and by industry:

Number of respondents by country and by industry

Respondents by country:		*Respondents by industry:*	
Germany	12	Preparers	
France	9	Transport and logistic	8
UK	8	Automobile & Parts	3
Italy	3	Technology sector	3
Austria	1	Oil & Gas	3
Brazil	1	Utilities	2
Denmark	1	Media & Telecoms	2
Hong Kong	1	Insurance	1
Japan	1	Pharmaceutical	1
USA	1	Basic resources	1
International	6	Tourism	1
		Conglomerate	1
			26
		Other participants	
		Professional organisations and National Standard Setters	7
		Leasing companies	6
		Financial Sector	3
		Preparers' association	2
			18
	44		**44**

Service agreements versus leases

16 When explaining when certain transactions should not be recognised on the balance sheet, respondents provided the following arguments:

(a) the supplier maintains continuing involvement with the management of the asset by providing services such as maintenance and repair;

(b) the client's objective in the transaction is to indicate an output to be received. This does not equate to controlling the right to use, which involves decision-making rights on how the asset is used;

(c) the client does not have the information to conclude if the supplier can benefit from the replacement of the asset. The ED requires the entity to make this assessment to determine if the asset is identified, which is one of the criteria to identify a lease transaction;

(d) the supplier is legally responsible to replace the asset in case of destruction or malfunctioning as the risk and rewards of ownership are not transferred;

(e) the contractual restrictions on the use of the asset impairs the control over the asset; and

(f) the transaction should be considered as a service in its entirety because the service component in the arrangement is predominant.

17 Examples of transactions that were provided as being more akin to service arrangements are as follows:

(a) time charter of vessels;

(b) IT storage contracts; and

(c) 'wet' leases of aircraft (i.e. transactions where a supplier provides an aircraft, complete crew, maintenance, and insurance).

18 For the time charter of vessels, it was noted that the supplier is still liable for the vessel's mechanical problems and accidents at sea and does not transfer these risks to the client. Therefore, the client's obligation to pay is conditional on the proper operation of the vessel.

19 For IT storage contracts, it was noted that the supplier keeps the responsibility to maintain and repair the assets and ensure that they work properly.

20 In relation to 'wet' leases of aircraft, it was noted that the main purpose of the transaction is to obtain a service and should be treated as such. Generally, these wet lease arrangements form a small proportion of an airline's activities but play a vital role in protecting the route network by allowing suitable aircraft to operate a series of routes that would otherwise fall empty allowing competitors to weaken the competitive position of the airline.

21 One respondent pointed out that service contracts and collaborative arrangements such as public-private non-concession partnerships, are arrangements that should be scoped out of the standard. For this user, right-of-use implies unrestricted access and control over the asset's activities and functions whereas right-to-operate is more narrow and directed by the operating or service agreement. Service agreement sponsors often dictate how the asset can be used, who it must be operated by, how it must be maintained, etc. This user stated that several collaborative agreements may look like a lease but when such leases are bundled with other agreements it is often seen how the underlying assumptions in the lease agreement have changed due to the risk-sharing arrangements that usually evolve or change over the extended life of the PPP which could be upwards to 99 years in some cases.

IASB versus FASB approach

22 The respondents were asked to provide information on the following topics:

(a) assuming that the Boards confirm the scope of application and the guidance to identify a lease, which of the approaches would be preferable; and

(b) which of the two approaches you believe to be less complex and costly to implement? Please explain the reasons for your views.

23 A summary of the preferred approaches by respondents is presented below. The summary distinguishes between respondents who are preparers and respondents from other types of organisations, as well as distinguishing between European and non-European respondents.

	Explicit indication of support of IAS 17	No reference to IAS 17	No answer	Total respondents
European constituents				
Support the IASB Approach				
Preparers	3	7	-	10
Others	2	2	-	4
Support the FASB Approach				
Preparers	2	3	-	5
Others	4	-	-	4
Support neither approach				
Preparers	7	-	-	7
Others	9	-	-	9
No answer				
Preparers	-	-	1	1
Others	-	-	-	-
	27	12	1	40
Non-European constituents				
Support the IASB Approach	-	-	-	-
Support the FASB Approach				
Preparers	-	2	-	2
Others	-	1	-	1
Support neither approach	-	-	-	-
No answer				
Preparers	-	-	1	1
Others	-	-	-	-
	-	3	1	4
Total				
Support the IASB Approach				
Preparers	3	7	-	10
Others	2	2	-	4
Support the FASB Approach				
Preparers	2	5	-	7
Others	4	1	-	5

	Explicit indication of support of IAS 17	No reference to IAS 17	No answer	Total respondents
Support neither approach				
Preparers	7	-	-	7
Others	9	-	-	9
No answer				
Preparers	-	-	2	2
Others	-	-	-	-
	27	**15**	**2**	**44**

24 A majority of the respondents indicated that their preference would be to maintain or improve current requirements. These respondents considered that recognition based on exposure to risks and rewards properly depicts the economic substance of different transactions.

25 Of those that indicated a preferred approach, 14 respondents (10 preparers and 4 from other types of organisations) supported the IASB's approach. The respondents provided the following arguments:

(a) the IASB approach is conceptually more robust;

(b) separate recognition in the profit or loss statement of amortisation of the right-of-use assets and the interest charge on the lease liabilities properly reflects the nature of the transactions. In addition, the IASB approach represents an appropriate reflection of the pattern of consumption of the economic benefits embedded in the leased assets and of the financing character of the majority of lease liabilities; and

(c) the IASB approach is less complex and judgmental because it removes the classification test.

26 12 respondents (7 preparers and 5 from other types of organisations) supported the FASB's approach for the following reasons:

(a) the distinction between leases that are in effect purchases of the underlying asset and other leases reflects the economic reality of these transactions in the balance sheet in a simple and effective way;

(b) the FASB approach appropriately reflects the nature of the cost of some leases by requiring lessees to present the cost as an operating expense in the income statement;

(c) the IASB approach results in front-loading of the cost in the income statement. The IASB assumes that for an entity with a portfolio of leases in different stages (some at the beginning of the term and others closer to the end) the impact will not be significant. This might be the case for large companies, but small and mid-size entities might have only one or two significant operating leases. In these cases, the IASB approach will increase volatility in reported results; and

(d) for leases that are not in-substance purchases, a straight-line recognition pattern of the cost reflects that the entity receives the same benefit from the lease transactions in the different periods in the lease term.

27 16 respondents (7 preparers and 9 from other types of organisations) supported neither the IASB's approach nor the FASB's approach. The respondents provided the following arguments:

(a) the Boards have not justified why leases should be treated differently from service arrangements and executory contracts, and why their recognition improves the relevance of financial information;

(b) the definition of, and criteria to identify a lease are not clear and complex to apply;

(c) both approaches increase complexity and give rise to significant and unnecessary costs; and

(d) The asymmetry in the lessor and lessee accounting model is not justified conceptually and creates application problems when an entity is, at the same time, a lessee in a main lease and a sub-lessor for the same asset (or portion of it) or when an entity eliminates intercompany leases in consolidation or segment reporting.

28 The majority of respondents (20) reported that they consider the IASB's approach to be less complex and costly to implement. 12 respondents identified the FASB's approach as less complex and costly. 6 respondents believed that both approaches are complex and costly.

29 The main advantage noted by respondents in favour of the IASB's approach is that the single model in this approach will reduce complexity and cost of implementation. In addition, some respondents argued that current IT systems could be used and therefore implementation costs will be lower.

30 Respondents that preferred the FASB's approach noted that the FASB model maintains the same cost recognition pattern. These respondents considered that it is unlikely to result in the need to change the IT systems and therefore implies a reduction of the costs.

Public consultation for users

31 16 respondents from 8 countries and 3 international organisations took part in the additional public consultation for users.

32 The table below presents the number of respondents by country and by category:

Number of respondents by country and by category			
Respondents by country:		*Respondents by category:*	
UK	4	Credit analyst	4
Italy	3	Buy side investors	2
France	1	Sell-side equity analyst	2
Norway	1	Retail investor	2
Spain	1	Investor association	1
Belgium	1	Users' organisations	6
The Netherlands	1		
Sweden	1		
International	3		
	16		**16**

IASB versus FASB approach

33 Contrary to the respondents to the preparers' questionnaire, a large majority of the respondents to the users' questionnaire support the core principle of recognition of all leases on a lessee's balance sheet. Only 2 respondents explicitly indicated that the IASB should improve current requirements and not bring all leases onto the balance sheet.

34 A majority of the respondents (11) indicated a preference for IASB's approach. For these respondents, the IASB's approach provides more relevant information, is easier to understand and improves comparability. Additionally, these respondents supported their view with the following arguments:

(a) the leased assets should be considered as part of the operating capital employed, therefore the lease liability should be considered and treated as a financial liability in nature;

(b) one respondent stated that a lease represents an investment decision that embodies a long-term commitment that should be discounted. Hence, to separate the interest component of the present value calculation was considered necessary;

(c) another respondent supported the IASB's approach since it is internally consistent for all leases once the definition of the right-of-use asset and the associated financial obligation are accepted. In his view, the IASB's approach should be easier to apply for companies;

(d) one user stated that the FASB's approach adds complexity. This user pointed out that for food retailers with many investment properties and operating lease expenses, the FASB's approach offers room for structuring operations and could result in different accounting treatments of similar arrangements; and

(e) some respondents stated that investors need a clear picture of a company's obligations. Therefore, clear classification of lease assets/liabilities on the balance sheet and the impact of leasing in the income statement were pointed out as a key feature in assessing a company's operating performance and financial position.

35 3 respondents supported the FASB's approach using the following arguments:

(a) one respondent supported the FASB's approach, considering that not all leases represent financing transactions. For this respondent, financing might be a tool for companies rather than the driving reason for signing a lease; and

(b) the other two respondents noted that the FASB's approach better depicts the economic reality of leases due to the distinction between financial leases and operating leases. In their view, both types of leases should not have the same accounting treatment. Additionally, one respondent pointed out that the leases distinction introduced in the FASB's approach improves comparability and hence assessment of managerial decision-making.

Examples of transactions

36 Some respondents would exclude from recognition those agreements where the supplier is responsible to provide an alternative asset in case of a malfunction of the asset, because the client's obligation to pay is not unconditional and the supplier retains the risk of asset availability.

37 One respondent would exclude for practical reasons short-term leases and leases of small items, or items that will be replaced before the expiration of the contract because they are subject to very quick technological changes (computers, printers, etc.)

38 One respondent also noted that, in many cases, a client would not have the information to allocate the total payments between lease and service components because the contracts are negotiated as a whole.

Appendix I – List of respondents to the additional public consultation – Preparers

Respondent's name	Country	Industry
AFRAC	Austrian	National Standard Setter
Petroleo Brasileriro, S.A. PETROBAS	Brazil	Oil and Gas
AP Möller Maersk	Denmark	Transport and logistic
SNCF (French railway company)	France	Transport and logistic
PSA Group	France	Automobile & Parts
Sanofi	France	Pharmaceutical
IMERYS	France	Basic resources
ALD Automotive	France	Leasing companies
Arval BNP Paribas	France	Leasing companies
Lease Plan Europe	France	Leasing companies
GDF Suez	France	Utilities
Accor Group	France	Tourism
Bundesverband Deutscher Leasing-Unternehmen	Germany	Leasing companies
TUEV Sued	Germany	Technology Sector
Daimler	Germany	Transport and logistic
Deutsche Post	Germany	Media & Telecoms
Deutsche Telecom	Germany	Media & Telecoms
Linde Group	Germany	Oil and Gas
Pro7Sat1	Germany	Media & Telecoms
Siemens	Germany	Technology Sector
Volkswagen AG	Germany	Automobile & Parts
Volkswagen Financial Services AG	Germany	Financial Sector
Allianz SE	Germany	Insurance
RoeverBroennerSusat GmbH & Co. KG	Germany	Professional organisations
The Hong Kong Shipowners' Association, Ltd	Hong Kong	Transport and logistic
International Air Transport Association (IATA)	International	Transport and logistic
Leaseurope	International	Leasing companies
International Chamber of Shipping	International	Transport and logistic
Federation of European Accountants	International	Professional organisations
BUSINESSEUROPE	International	Professional organisations
ANIASA	Italy	Leasing companies
ENEL	Italy	Utilities
UNIPOLSAI	Italy	Financial Sector
NYK Line	Japan	Transport and logistic
UK Respondent 2	UK	Preparer association
UK Respondent 3	UK	Professional organisations
UK Respondent 4	UK	Preparer association
UK Respondent 6	UK	Conglomerate
UK Respondent 7	UK	Transport and logistic
UK Respondent 5	UK	Professional organisations
UK Respondent 8	UK	Financial Sector
UK Respondent 9	UK	Media & Telecoms

Respondent's name	Country	Industry
UK Respondent 10	UK	Oil and Gas
Domenic Savini FASAB	USA	Federal Government Accountant

Appendix II – List of respondents to the additional public consultation – Users

Respondent’s name	Country	Category
Serge Pattyn	Belgium	Sell-side equity analyst
Société Française des Analystes Financiers (SFAF)	France	Buy side Investor
Moody’s Investors Service	International	Credit Analyst
European Federation of Financial Services Users	International	Retail Investor
EFFAS	International	Users’ organisations
Italian Respondent 1	Italy	Credit Analyst
Italian Respondent 2	Italy	Credit Analyst
Italian Respondent 3	Italy	Users’ Organisation
Norges Bank Investment Management	Norway	Credit Analyst
Felipe Herranz	Spain	Retail Investor
Amsterdam CPA	The Netherlands	Users’ organisations
Jed Wrigley (FIL)	UK	Buy side Investor
UK Respondent 1	UK	Investor association
Peter Malmqvist	Sweden	Sell-side equity analyst
Financial Reporting and Analysis Committee (FRAC) FCA UK	UK	Users’ organisations
CRUF	UK	Users’ organisations

Appendix III – Description of the approaches

Common features

39 Including the tentative decisions made at the June 2014 meeting, the two Boards are converged on the following aspects in relation to lessee accounting;

(a) the definition of a lease;

(b) the recognition of all leases (other than the exemptions noted below) on a lessee's balance sheet;

(c) the criteria and guidance to identify if an arrangement contains a lease;

(d) the requirement to separate lease and non-lease components, and guidance to allocate total consideration;

(e) the initial measurement of the lease liability (present value of the future lease payments) and right-of-use asset (the amount of the lease liability plus initial direct costs);

(f) the guidance on discount rates, options and variable lease payments;

(g) the requirement to present or disclose right-of-use assets and lease liabilities separately from other assets or liabilities;

(h) the possibility to use a 'portfolio approach'; and

(i) an exemption for (and definition of) short-term leases.

40 The Boards have agreed not to specify how to present lease liabilities, although both Boards agree that lease liabilities meet the definition of financial liabilities.

41 The approaches of the two Boards differ in relation to;

(a) the subsequent measurement of the right-of-use asset for those leases that, in the FASB model, are not in substance purchases of the underlying asset;

(b) the presentation of the lease expense in the income statement;

(c) the presentation of the lease payments in the statement of cash flows; and

(d) an exemption for 'small' assets (e.g. laptops and office furniture).

IASB approach

42 The IASB approach requires a lessee to recognise a right-of-use asset and a lease liability at the commencement date of each lease. An entity may elect not to recognise assets and liabilities in relation to;

(a) short-term leases; and

(b) leases of 'small' assets.

43 After commencement, a lessee shall measure the lease liability at the present value of future lease payments and amortise the right-of-use asset over the lease term in

accordance with the requirements in IAS 16 *Property, Plant and Equipment*. This results generally in a straight-line amortisation of the right-of-use asset and a declining interest expense on the lease liability.

44 A lessee shall present the interest expense on the lease liability within finance (interest) costs and the amortisation of the right-of-use asset typically within the same line item as depreciation on items of property, plant and equipment (i.e. within operating expenses). Without further guidance regarding presentation, lessees applying IFRS would apply the requirements in IAS 1 *Presentation of Financial Statements*. This is likely to result in a lessee (that applies IFRS) presenting lease liabilities either as a separate line item or together with similar financial liabilities.

FASB approach

45 The FASB model distinguishes between leases that are in substance purchases of the underlying asset (written as leases) and leases that are not in substance purchases of the underlying asset. The distinction is based on the principle used in IAS 17 *Leases* to distinguish finance leases from operating leases.

46 A lessee shall recognise a right-of-use asset and a liability for all leases, whether they are in substance purchases or not. An entity may elect not to recognise assets and liabilities for short-term leases.

47 For leases that are in substance purchases, a lessee shall account for the transaction in the same manner as any other financed purchase. After commencement, this results generally in a straight-line depreciation of the asset and a declining interest expense on the lease liability.

48 After commencement, leases that are not in substance purchases are accounted for using a single approach that recognises a single lease expense measured generally on a straight-line basis over the lease term. The lease liability is measured at each reporting date at the present value of future lease payments, while the right-of-use asset equals the lease liability (as adjusted for any prepaid/accrued rent).

49 The single lease expense shall be presented within operating expenses. Liabilities arising from leases that are in substance purchases shall not be presented together with liabilities arising from leases that are not in substance purchases. The FASB staff noted that for example, in the United States, current operating lease obligations are not considered debt in the event of bankruptcy, which may suggest that characterization of the obligation as operating rather than debt-like in nature would be appropriate.

Rationale for the approaches

50 Under both approaches, the commencement of a lease gives rise to an asset and a liability. Both boards concluded that the lessee has obtained control of the right to use the underlying asset when the lessor makes the underlying asset available for use by the lessee. The lessee has a liability because it has a present obligation to make lease payments, arising from the lessor's transfer of the right of use at lease commencement.

51 The IASB approach views a lease as providing a lessee with a non-financial asset that it typically uses over time and for which it pays over time. Accordingly, the IASB approach requires a lessee to account for the right-of-use assets consistently with other non-financial assets and lease liabilities consistently with other similar financial liabilities. Such an approach removes the need for a lease classification test,

compared to the existing requirements in IAS 17 and the FASB approach. A lessee could use its existing systems for finance leases, or its existing systems for fixed assets or financial liabilities when applying the proposed accounting. Alternatively, it could use its existing systems used to produce operating lease disclosures as the starting point for measuring the lease liability.

52 The FASB approach views a lease as a single unit of account. A single lease expense is recognised generally on a straight-line basis because it represents the generally equal benefit the lessee receives each period throughout the lease term, as well as the periodic cost of the access to that benefit. If payments are equal over time the lease asset and lease liability should decline at the same rate over time. Under the FASB approach, the effect of leases on the income statement (i.e., the cost recognition pattern and presentation of lease expense) would be unchanged from existing guidance.

53 Because of how the single lease expense, the right of use asset and the lease liability are calculated under this approach, lessees can apply this approach using their existing systems and processes for producing the straight-line lease expense and existing lease disclosures in the notes with little incremental change. At each reporting date, lessees would only need to record the right of use asset and liability using information already produced and tracked by existing systems.