

**Mr. Hans Hoogervorst
International
Accounting Standards
Board
30 Cannon Street
London
EC4M 6XH**

The IASB's Exposure Draft *on Leases*

Dear Mr Hoogervorst,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's due process with regards to the Exposure Draft Leases 2013/6 (ED). ESMA is pleased to provide you with the following comments with the aim of improving the transparency and decision-usefulness of financial statements and the enforceability of IFRSs.

ESMA agrees with the IASB that IAS 17 - *Leases* fails to provide complete and useful information regarding the financial position of lessees as it does not require a lessee to recognise assets and liabilities arising from operating leases. We also agree that improvements to lessor accounting are necessary in particular to reflect better the risks that a lessor incurs with the ownership of a leased asset.

Therefore, ESMA welcomes the IASB's efforts to improve financial reporting for both lessees and lessors as we believe that the model and principles proposed under the ED will result in a more faithful representation of the financial position of entities that enter into lease contracts. By requiring the recognition of assets and liabilities arising from all lease contracts except for short-term leases, we believe that financial statements will serve as a better basis for determining financial ratios (i.e. leverage), thus contributing to increased transparency for users of financial statements.

ESMA agrees with the IASB's decision to propose a dual model for accounting for leases as this better reflects the significant differences in the economics of leases depending on the substance of the contract and we consider it an improvement to the 2010 ED. In addition, we believe that the lessor accounting model has been improved so that most equipment lessors will recognise a lease receivable and a retained interest in the underlying asset and we agree with withdrawing the performance liability proposal. However, ESMA is concerned that structuring opportunities and issues of enforceability might occur for the lessees, as further explained in paragraph 9 in the Appendix to this letter.



ESMA notes that the IASB has proposed some practical solutions like the unwinding of the residual asset and the determination of the amortisation of the right-of-use asset by the lessee for a type B lease. These solutions have in common that they will be easier for issuers to apply, but they are not consistent with the principles in other IFRSs and lack conceptual justification. Therefore, ESMA urges the IASB to ensure that entities are not allowed to apply these solutions by analogy to other possible situations not specifically addressed by the IFRSs.

In order to promote consistent application and limit the potential issues of enforceability that might arise, ESMA encourages the IASB to develop additional guidance on the assessment of the right to control the use of an asset or when protective rights prevent a lessee from being able to direct the use of the asset. In addition, we would like to ask the IASB to clarify further the notions of “substantially all”, “major part” and “insignificant”.

ESMA welcomes IASB’s and FASB’s commitment to achieving the goal of convergence between the two sets of standards and encourages both Boards to continue their efforts to achieve a single set of accounting requirements.

Our detailed comments on the ED are set out in the Appendix to this letter. Please do not hesitate to contact us should you wish to discuss any of the issues we have raised.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'S/M' with a flourish.

Steven Maijoor
Chair
European Securities and Markets Authority

APPENDIX – ESMA’s detailed answers to the questions in the IASB’s Exposure Draft ED/2013/6 - 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.

Identifying a lease

1. ESMA agrees with the proposed definition of a lease and welcomes the changes introduced in order to make it consistent with the concept of control as defined in IFRS 10 - *Consolidated Financial Statements* and the Exposure Draft *Revenue from Contracts with Customers* (ED Revenue).
2. Further ESMA agrees with the explanation provided in paragraph 105.d) of the Basis for Conclusions (BC) that states that a customer should only be able to recognise an asset (right-of-use) if it has not only the right to obtain substantially all of the economic benefits from the use of an asset over the lease term (the “benefits” element) but also the ability to direct the use of that asset (the “power” element). ESMA would encourage the IASB to make sure that there is sufficient guidance to assist preparers in assessing whether they have the right to control the use of an identified asset.
3. Also, while ESMA agrees that protective rights in isolation would not prevent an entity from having the ability to control the use of the asset, the ED does not include any guidance for determining when protective rights are deemed to be substantive and prevent a lessee from controlling the use of the asset. As this area might involve significant judgment, ESMA encourages the IASB to ensure that relevant guidance is provided in this area.

Separation of contract's components

4. ESMA agrees with the requirement to identify separately lease and non-lease components. We have some concerns in relation to paragraph 23 (c) of the ED which requires a lessee to combine the components of a lease contract and account for them as a single lease component if there are no observable stand-alone prices for any component of the contract. ESMA understands the rationale behind this requirement; however, we encourage the IASB to ensure that application of this paragraph will not result in accounting for a contract as a lease when the lease component in the contract is insignificant.

Leases of intangible assets

5. In its comment letter on the 2010 Exposure Draft on Leases (2010 ED)¹, ESMA invited the IASB to reconsider the decision to scope out intangible assets. Although we understand the practical reasons for excluding intangible assets from the scope of the ED as explained in paragraph BC 81 of the ED, ESMA still believes this decision lacks a conceptual basis. However, ESMA can accept this decision as a temporary solution provided that the IASB is planning a comprehensive revision of the accounting for intangible assets in the near future and will consider this as part of the final standard on Revenue.
6. Paragraph 5 of the ED introduces the option for lessees to apply its provisions to leases of intangible assets. ESMA has doubts about the usefulness of granting such an option as in the absence of specific IFRS requirements, issuers have to develop an accounting policy on the basis of the principles in IAS 8 - *Accounting policies, Changes in Accounting Estimates and Errors*, which require that the application of the accounting policy developed results in information that is both relevant and reliable.

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?

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

¹ http://www.esma.europa.eu/system/files/10_1518.PDF

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?

7. ESMA agrees with the IASB’s decision to propose a dual model for accounting for leases as there are significant differences in the economics of leases depending on the substance of the contract and the expected consumption of the economic benefits in the underlying asset.
8. We agree with the IASB that in the case of a property lease the consumption of benefits embedded in the underlying asset is in most situations insignificant. However, there may be exceptions to this principle, such as when for instance a lease contains an element related to a property other than land. Therefore, ESMA agrees that in the case of a property lease both models could be applied.
9. However, ESMA is concerned that structuring opportunities and issues of enforceability may occur in relation to leases of non-property assets. Although the IASB has defined very low thresholds for type A leases by indicating criteria as “insignificant part of the economic life” or “insignificant present value of payments compared with the fair value”, ESMA believes that entities may structure contracts in order to benefit from differences in presentation and measurement between the two models. It is ESMA’s opinion that entities should classify a lease of an underlying asset other than property as a type B lease only if both criteria defined in paragraph 29 of the ED are met.
10. We concur with the paragraph 5 of the Alternative View (AV) which raises concerns about the application of the proposed classification model without providing additional guidance on the key concepts used. We encourage the IASB to develop more guidance on the notions of “substantially all”, “major part” and “insignificant” in order to help entities to apply the principles of the ED correctly.
11. Finally, ESMA understands the method proposed in the ED for determining the amortisation of the right-of-use asset by a lessee for a Type B lease constitutes a practical way of reflecting the lease expense in the statement of comprehensive income faithfully. However, this method is not consistent with the depreciation and amortisation principles in either IAS 16 – *Property, Plant and Equipment* or IAS 38 – *Intangible Assets*. ESMA encourages the IASB to clarify that the method proposed constitutes a practical expedient only for type B leases and that should not be applied by analogy in other cases.

Classification and presentation of the right-of-use asset in the statement of financial position of the lessee

12. Regarding classification of right-of-use assets, ESMA would encourage the IASB to clarify it further in the ED and explain its rationale in the BC, given this classification is important to the economic decisions of users of financial statements.

13. Paragraph 54 of the ED states that right-of-use assets and lease liabilities should be presented either in the statement of financial position or disclosed in the notes. ESMA believes that these assets and liabilities should be identified separately in the statement of financial position because of their different nature compared to the other components of the statement and therefore the ED should not give the option to have these disclosed only in the notes.

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?

14. ESMA supports the IASB's proposed accounting treatment for lessors and considers it a significant improvement on the current requirements in IAS 17. ESMA believes that applying a full derecognition approach to leased assets for which only an insignificant portion of the embedded economic benefits is expected to be consumed (type B lease) would not faithfully represent the risks lessors incur with these assets. Therefore, although ESMA believes that a symmetrical model between lessor and lessee would be easier to understand and apply, we agree with the dual approach for lessor accounting.
15. The model proposed in the 2010 ED did not allow a lessor to re-measure the residual asset during the lease term other than for impairment. This ED proposes that a lessor should unwind the discount embedded in the initial measurement of the gross residual asset over the lease term, and recognise the unwinding of the discount as interest income. As explained in paragraphs BC 246 and 247 of the ED, we understand this change is a response to the comments on the 2010 ED that the residual asset would otherwise be measured at an artificially low amount during the lease term.
16. ESMA acknowledges the initial measurement of the residual asset is somewhat different from other non-monetary assets and could accept the proposed subsequent measurement only as a practical solution to accommodate the concerns expressed in responses to the 2010 ED. However ESMA is concerned this practical solution might be applied by analogy to other non-monetary assets in situations not specifically addressed by the IFRSs. We encourage the IASB to ensure that entities are not allowed to apply this pragmatic solution by analogy and that the IASB does not allow its use in future standards.
17. Finally, ESMA notes some inconsistency regarding the lessor discount rate in paragraph 69(a) which refers to B8 and B9 as these paragraphs seems to be relevant only for a lessee. We believe a lessor is

always aware of the rate it charges the lessee. Further, the terminology used in B8 and B9 of the ED is not consistent with the terminology used in the Illustrative Examples 19 and 20.

18. In addition, if the final standard definitely allows the lessor to apply a discount rate different to the discount rate implicit in the lease, we would ask the IASB to revise the method for allocating profit proposed in paragraphs 73 to 75, as these paragraphs assume the discount rate is equal to the rate implicit in the lease.

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?

19. ESMA believes that the ED will more faithfully reflect the reasonably expected effective duration of a lease, and consequently the rights and obligations that arise from lease contracts, as it will include in the contractual lease term only those options which an entity has a significant incentive to exercise.
20. ESMA agrees that the IASB should set a high threshold for recognising options because setting a lower threshold, based on the simple expectation of the lessor or the lessee, could lead to misstatement of assets and liabilities in the financial statements of both lessees and lessors.
21. ESMA also agrees with the reassessment principles for the lease term as proposed by the IASB as we believe that changes in the lease term or lease payments should lead to the leases being reassessed. In particular, ESMA agrees that the right-of-use or the residual asset should be adjusted to reflect changes in the lease liability and/or the lease receivable, including reassessment of the options available in the contract.

Cancellable leases

22. ESMA is aware that there are jurisdictions where lease terms are open “until further notice”. The IASB discusses such contracts in BC 107-110, but assumes that there is no economic incentive for lessors or lessees to agree to these kinds of contracts. However, in practice, lessees may have considerable economic incentive to continue such leases for years, e.g. because moving their production site elsewhere would be difficult or expensive. ESMA is of the view that such leases should always be considered “long-term” and that the IASB should add clarification to this effect in the final standard.

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?

23. ESMA agrees in general with the proposal on the measurement of variable lease payments. Nevertheless, ESMA would encourage the IASB to clarify how to determine whether variable lease payments are “in-substance fixed payments”, as we believe the principle in the ED and the Illustrative Examples may not be sufficient to capture all possible types of variable payments that might qualify as “in-substance fixed payments”. ESMA fears that lack of guidance in this area could lead to inconsistent application and raise issues of enforceability.
24. Further, ESMA is concerned that the provisions in the ED may lead to structuring contracts in which “in-substance fixed payments” are represented as variable payments (e.g. by inserting an artificial threshold related to performance or sales that is easily reached) in order to avoid recognising liabilities in the statement of financial position. ESMA believes that these types of payments should be considered “in-substance fixed payments” on initial recognition of the lease, but doubts that this conclusion can be easily drawn from the content, the BC or the illustrative examples of the ED. We would therefore ask for this to be clarified in the final standard.

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?

25. ESMA agrees with the transition requirements proposed in the ED. Although we are generally supportive of a full retrospective approach because it increases comparability between entities and transactions, we understand the need for the practical reliefs in the ED as these will most likely provide significant savings on implementation costs for both lessees and lessors.

Question 8: disclosure

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?

26. ESMA supports the ED proposals on disclosures and welcomes the introduction of disclosure objectives as part of those requirements, as we believe that this will help to ensure that the most relevant information is provided to users of financial statements. Indeed, requirements related to the disclosure of significant assumptions and judgements made by entities allow users to understand better the analysis performed by an entity on lease contracts.
27. ESMA also believes that reconciliations constitute useful information for understanding the effects of various re-measurements performed over the reporting period and agrees with the proposal in the ED that these are provided separately for type A and type B leases.

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?

28. ESMA agrees with the requirement to include the right-of-use arising from a lease of a property within the scope of IAS 40, provided that the leased property meets the definition of an investment property.