13 December 2010

International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
United Kingdom

(By online submission)

Dear Sirs

RESPONSE TO EXPOSURE DRAFT ON LEASES

The Accounting Standards Council (ASC) appreciates the opportunity to comment on the Exposure Draft on Leases (the ED) issued jointly by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (collectively the Boards) in August 2010.

We support the Boards' efforts to improve the existing guidance in IFRSs and US GAAP by developing a single lease accounting framework to ensure that all assets and liabilities arising from lease contracts are recognised. We believe that the proposals would address the main criticisms of the existing accounting model of leases under IAS 17 *Leases*, which relate to the off-balance sheet treatment of long-term leasing arrangements involving core operating assets by lessees.

However, we are not convinced that the ED proposals would necessarily provide more decision-useful information on the expected future cash flows of lessees and lessors due to the substantial subjectivity and judgement involved in applying the proposals. In addition, we note that certain aspects of the ED proposals are inconsistent with the *Framework*. Furthermore, the major overhaul in the leases requirements would impose significant costs and operational burden on preparers, and we are not persuaded that a robust cost-benefit analysis has been performed by the Boards.

As such, our recommendations to the Boards have been crafted with the objective of improving the decision-usefulness of information reported in financial statements. The recommendations centre on the use of principle-based approaches which reflect the underlying substance of the contracts, and aim to reduce arbitrary judgements and complexities in the application of the

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c/o Ministry of Finance, 100 High Street, #10-01, The Treasury, Singapore 179434.
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standard, taking into consideration the overall benefits of the resulting information should justify the costs of obtaining it.

Our broad views on the key aspects of the ED that require further refinement by the Boards are as follows:

(a) Lessor accounting model

We support a single, rather than a hybrid, model for lessor accounting as the latter would replicate the artificial line between operating and finance leases which the Boards are seeking to remove in the first place. In this regard, we recommend that the derecognition approach be adopted for lessor accounting as it better reflects the economic substance of a lease arrangement and is conceptually consistent with the proposed lessee accounting model.

(b) Short-term leases

We laud the Boards' efforts to mitigate concerns about implementation costs by providing simplified requirements for short-term leases. However, we are not persuaded that these simplified requirements provide perceptible relief to preparers in view of the following:

- There are many short leases of non-core assets (i.e. assets that are not a fundamental part of an entity's business, e.g. a leased photocopier would not be fundamental to an airline's business whilst a leased aircraft would be fundamental to its business) with lease term of more than 12 months in practice, particularly leases of investment properties in the Asia-Oceania region which are typically of very short tenure of 2 to 3 years as they are viewed as "pay as you go" arrangements. To truly achieve cost-benefit balance (i.e. the overall benefits of the resulting information should justify the costs of obtaining it), we urge the Boards to broaden the simplified requirements to all leases of non-core assets with lease term of not more than 3 years. Such leases should be considered and accounted for as "pay as you go" arrangements.

- Lessees would still be required to recognise lease assets and liabilities in their financial statements at inception of the lease under the simplified requirements. Similar to the simplified requirements accorded to lessors, we believe that a lessee that has a short-term lease should be allowed not to recognise assets and liabilities arising from the lease in the financial statements.

(c) Investment properties (IP)

We support the IASB's proposal to scope out leases of IP measured at fair value from the leases standard and to amend IAS 40 *IP* to require lessors that use the fair value model to recognise lease income on a straight-line basis over the lease term. However, we believe it would not be desirable or appropriate to adopt different methods to account for leasing arrangements that have similar economic phenomena simply because of the different bases used to measure the underlying assets. We are concerned that the different accounting methods would diminish the comparability of financial statements of entities that are engaged in similar businesses. Accordingly, we recommend that the accounting for leases of

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IP measured at cost be aligned with the proposed accounting for leases of IP measured at fair value.

(d) Lease extension or termination options

We do not agree that extension or termination options should be taken into account in the measurement of lease assets and liabilities on the premise that the lessee/lessor would not have an unconditional obligation/right to pay/receive the lease payments until the option is exercised by the lessee (i.e. the definition of a liability/asset in the *Framework* has not been met).

(e) Contingent rentals and expected payments under term option penalties and residual value guarantees (lease payments)

We do not agree with the proposed mandatory requirement to apply the "expected outcome" technique to the measurement of lease payments. We believe the Boards should permit the use of the "most likely outcome" approach. This is similar to the concerns expressed by us on various other exposure drafts issued by the Boards/the IASB that propose to mandate the use of the expected outcome technique (e.g. ED *Revenue from Contracts with Customers* (ED *Revenue*), ED *Financial Instruments: Amortised Cost and Impairment of Financial Assets*, ED *Liabilities*, etc).

(f) Consistency of the notion of "control" across standards

The ED proposes that a contract that transfers the control of the underlying asset **and** all but a trivial amount of the risks and benefits associated with the asset represents a sale/purchase of the asset (i.e. both conditions must be satisfied). We believe this proposal is inconsistent with ED *Revenue* which only requires the transfer of control as a prerequisite to revenue recognition as well as the Boards' tentative decision in the Consolidation project that "risks and rewards" is an indicator of control. We urge the Boards to ensure the consistency of the notion of control across standards.

(g) Contracts that represent purchases or sales of the underlying assets

We think that it is not necessary to distinguish a lease from a contract that represents a purchase/sale of the underlying asset as there is no fundamental difference in the accounting outcome whether the contract is accounted for as a purchase/sale or as a lease. In addition, we are concerned with the extent of subjectivity involved in applying the fine line between the transfer of "all but a trivial amount of risks and benefits" which would be accounted for as a purchase/sale, and the transfer of "significant risks or benefits" which would be accounted for as a lease. We believe this fine line would lead to significant diversity in practice which could compromise the comparability of financial statements.

In view of the significant changes proposed, it is imperative that adequate consideration be given by the Boards to all feedback received, especially on lessor accounting which was hardly discussed during the Discussion Paper phase. In addition, there should be sufficient field testing to ensure that a robust lease accounting model which is consistent with the *Framework* is developed and that a thorough cost-benefit assessment is performed. In the meantime, an interim

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solution could be developed to address the most significant concerns of the existing IAS 17. Lastly, ample transition time should be given for preparers to implement the proposed changes and for tax authorities in various jurisdictions to review the existing tax laws relating to leases.

Our comments on the specific questions to the ED are as follows:

Question 1 Lessee accounting model

The exposure draft proposes a new accounting model for leases in which a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Subject to our comments under question 3 on the accounting for short leases:

(a) We agree that a lessee should recognise a right-of-use asset and a liability to make lease payments as the rights and obligations arising would meet the definitions of assets and liabilities in the *Framework.* A single right-of-use model would better reflect the substance of the rights and obligations between the lessor and the lessee and hence better meet the needs of users of financial statements.

(b) We agree that a lessee should recognise amortisation of the right-of-use asset, which is consistent with the accounting treatment for non-financial assets. We agree that a lessee should recognise interest on the liability to make lease payments, which is consistent with the accounting treatment for financial liabilities.

Question 2 Lessor accounting model

The exposure draft proposes a new accounting model for leases in which a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

(a) Lessor accounting model

We prefer a single model rather than a hybrid model for lessor accounting to ensure consistency in application. One of the objectives of the leases project is to eliminate the fine and artificial line between operating and finance leases. We are concerned that a hybrid model for lessor accounting retains this artificial line and the consequential potential arbitrariness in lease accounting, which the Boards are seeking to remove in the first place.

Between the two proposed lessor accounting approaches, we prefer the **derecognition approach** over the performance obligation approach. Under the derecognition approach, the lessor derecognises the leased asset only to the extent of the rights transferred to the lessee whilst retaining its residual rights (if any). This would better represent the economic substance of a leasing arrangement because the lessor would have satisfied its performance obligation upon delivering the asset to the lessee and giving up the right to use and control the asset during the lease term. If the total value of an asset represents the right of use over its useful life, then the fact that a part of the useful life has been leased away means that the value of the remaining asset should be the value of the right of use for the residual useful life of the asset after control of the asset is returned to the lessor. This approach is also consistent with the lessee accounting model because the lessor must have transferred an asset in order for the lessee to have acquired an asset from the lessor.

We are of the view that the performance obligation approach does not reflect accurately the economic substance of a lease because the lessor would continue to recognise the underlying asset and a "new" asset (i.e. the rights to receive rental payments), thereby artificially inflating the statement of financial position of the lessor. From an accounting symmetry perspective, both the lessor and lessee would appear to have the same asset on their statements of financial position under the performance obligation approach, even though there should only be one party having control over the economic benefits of the leased asset at one point in time. Furthermore, the recognition of the entire underlying asset is inconsistent with the definition of an asset in the *Framework*; where an asset is recognised when it is probable that future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. The portion of the underlying asset relating to the rights transferred to the lessee should not be recorded as an asset because the inflow of economic benefits is already being recognised in the form of the lease receivable. Furthermore, a liability is recorded by the lessor in relation to the leased asset, when

in reality there is no additional obligation taken on by the lessor. It is contradictory to say that the lessee receives an unconditional right to use the leased asset over the lease term when the lessor continues to have an obligation to permit that use. We believe the rather convoluted way of requiring the gross presentation of an additional asset and a corresponding performance obligation, followed by a net presentation to offset the effect, reflect the weakness of the performance obligation approach.

In adopting a hybrid approach for lessor accounting, the Boards would need to provide further clarification on the general principle in determining whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. Paragraph B26 of the ED states that the existence of one or more indicators is not conclusive in determining whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. This leaves preparers of financial statements with little guidance on how that judgement is to be made. We are concerned that this would result in inconsistencies in application and reduced comparability across entities.

Paragraph BC27 of the Basis for Conclusions explains that the two lessor approaches are differentiated based on the nature of the risk the lessor is exposed to. Where the principal risk associated with the business is credit risk, the derecognition approach is likely to be appropriate while the performance obligation approach is likely to be appropriate where the principal risk is asset risk. We are not persuaded by this reasoning as we believe that a single derecognition approach would also reflect the lessor's asset risk as the lessor's residual interest in the underlying asset is still recognised in the books.

Recognition of day-one gain

We understand that a main concern with the derecognition approach relates to the recognition of a "day-one" gain at the commencement of the lease (i.e. difference between the present value of the lease payments and the carrying amount of the underlying asset that is derecognised).

We are of the view that the recognition of such a gain is conceptually consistent with the derecognition approach as the lessor would have satisfied its performance obligation upon delivering the right-of-use asset to the lessee at the commencement of the lease. Therefore, consistent with the proposals in the ED *Revenue*, there is no conceptual justification to defer recognition of the gain that is not attributable to the financing component of the lease, solely because the service potential of the underlying asset has been conveyed to the lessee by way of a lease as opposed to an outright sale.

Other concerns with the hybrid model

Should the hybrid model be adopted, the Boards would need to address the accounting for a combined lease of land and building. For example, in the case of a lease of land with a useful life of 999 years with a building on it with a useful life of 50 years, the lessor may have to adopt the derecognition approach for the building and the performance obligation approach for the land. It

follows that the lease payments should be split into two components to account for the respective leases of the land and the building. The Boards would need to provide further guidance and illustrative examples in this area, similar to the guidance provided on the allocation of lease payments under the current IAS 17 for land and building and the accounting treatment thereof, including situations where reliable allocation between the land and building components is not possible.

In view of the above reasons, we urge the Boards to adopt a single derecognition approach for lessor accounting which would avoid the complexities arising from a hybrid model and/or the performance obligation approach.

(b) Recognition of assets, liabilities, income and expenses under the lessor accounting approaches

Subject to our comments under (a) above, we generally agree with the Boards' proposals for the recognition of assets, liabilities, income and expenses. However, we have the following comments:

- *Impairment assessment of assets under the performance obligation approach*

  Should the Boards retain the performance obligation approach, further clarification needs to be provided with respect to the interaction between the impairment assessment of the right to receive lease payments (i.e. lease receivable) and the unamortised performance obligation. Specifically, the ED does not discuss whether a corresponding adjustment to the unamortised performance obligation should be made against an impairment charge made on the lease receivable. Our view is that any impairment charge recognised on the lease receivable should be set off by a corresponding adjustment to the unamortised performance obligation as the lessor's performance obligation should be extinguished when the lessee defaults in payment. Otherwise, impairment loss could potentially be recorded twice by a lessor (i.e. an impairment charge to the lease receivable as well as to the underlying asset to the extent of the uncollectible lease receivable).

- *Subsequent measurement of residual asset*

  The ED proposes that a lessor shall not remeasure the residual asset unless reassessment in the lease term results in a change to the residual asset or the residual asset is impaired. However, we would expect that to the extent that the underlying asset is permitted to be measured at fair value, the residual asset should also be permitted to be measured at fair value and changes resulting from revaluation should be taken to profit or loss or other comprehensive income in the same manner as the accounting for revaluation changes of the underlying asset.

Question 3 Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We appreciate the Boards' efforts to mitigate concerns about the cost of accounting for short-term leases by providing simplified requirements for such leases. However, we have the following concerns:

- The simplified requirements are only accorded to leases with a maximum lease term of 12 months, including renewal or extension options. We believe this offers limited relief in practice as there are many short leases of non-core assets with lease term of more than 12 months, particularly in the case of investment properties. Leases of investment properties in Singapore as well as other countries in the Asia-Oceania (AO) region are typically of very short tenure (2 to 3 years) as compared to those in the western jurisdictions. This is largely due to the fact that lessees in these AO countries typically view the leases of investment properties as "pay as you go" arrangements, which are akin to service contracts as opposed to financing arrangements. Hence, to ensure that the benefits of the proposed leases standard outweigh the costs and operational burden imposed on preparers, we are of the view that the simplified requirements should be extended to all leases of non-core assets with lease term of not more than 3 years.

- We do not agree with the proposed simplified accounting for lessees as we note it would not be symmetrical with the proposed simplified accounting for lessors. In addition, we are not persuaded that it offers much relief to lessees. Hence, we recommend that a lessee that has a

short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from the short-term lease in the statement of financial position. Such lessees would recognise lease payments in profit or loss over the lease term. In this regard, we understand that criticisms of the existing accounting model of leases under IAS 17 primarily stem from the off-balance sheet treatment of long-term leasing arrangements involving core operating assets, rather than short-term leasing arrangements involving non-core assets. We therefore believe that our proposal is a pragmatic approach to achieve the Boards' objective of cost-benefit balance.

Question 4 Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

(a) We agree with the definition of a lease, which is fine-tuned from the existing definition in IAS 17.

(b) Leases versus contracts that represent purchases or sales

(i) Accounting for contracts that represent purchases/sales of the underlying assets

We think that it is not necessary to distinguish a lease from a contract that represents a purchase/sale of the underlying asset as there is no fundamental difference in the accounting outcome whether the contract is accounted for as a purchase/sale or as a lease.

In addition, we are concerned as to how one would distinguish between transfer of "all but a trivial amount of risks and benefits" which would be accounted for as a purchase/sale and transfer of "significant risks or benefits" which would be accounted for as a lease. This would

introduce yet another fine line between the "derecognition approach" and "in-substance sales", in addition to the artificial line between the performance obligation approach and the derecognition approach, and would result in significant diversity in practice which could compromise the comparability of financial statements.

Thus, we are of the view that it is not necessary to have separate requirements for in-substance purchases/sales as the complexity of distinguishing leases from in-substance purchases/sales outweighs the benefits.

(ii) Criteria for distinguishing a lease from a contract that represent a purchase/sale of the underlying asset

Should the Boards retain the proposal relating to in-substance purchases/sales contracts, we consider that the criteria set out in paragraphs B9 and B10 of the ED for distinguishing such contracts from leases are inadequate. In particular, we note that the two criteria indicated in paragraph B10 illustrate the transfer of control and not exposure to risks and benefits. Furthermore, the criteria are rather rule-based and could result in inconsistent outcome. For example, the inclusion of a bargain purchase option results in a contract becoming an in-substance purchase/sale while inclusion of other bargain clauses, such as bargain renewal clauses in perpetuity would not have the same result.

To strengthen the criteria for distinguishing in-substance purchases/sales from leases, we have the following suggestions:

- The criterion relating to bargain purchase options should be worded more broadly to include other bargain purchase or renewal clauses and circumstances where an entity is likely to exercise the purchase option.
- There is a need to provide further examples to aid in the consideration of what is "significantly lower" and "reasonably certain" in determining whether a purchase option is a bargain purchase option.
- Further illustrative examples would be useful to distinguish a contract accounted for as an in-substance sale as compared to a contract accounted for as a lease under the derecognition approach for lessor accounting.

(iii) Consistency of principles across standards

The ED proposes to assess whether "control and all but a trivial amount of risks and benefits" are transferred (i.e. both conditions must be satisfied) so as to determine whether a contract is an in-substance purchase/sale. We believe this proposal is inconsistent with ED *Revenue* which only requires the transfer of control as a prerequisite to revenue recognition as well as the Boards' tentative decision in the Consolidation project that "risks and rewards" is an indicator of control. We urge the Boards to relook into this apparent inconsistency to ensure that accounting standards developed by the Boards are principle-based and are internally consistent.

In this regard, we would like to reiterate the view expressed by us in our comment letter to the ED *Revenue* that risks and benefits/rewards cannot and should not be decoupled from control as they are not different approaches/mutually exclusive. Risks and benefits/rewards will generally derive from control, and thus provide a strong indicator of where that control lies.

Accordingly, should the Boards retain the proposal relating to in-substance purchases/sales, we suggest the final standard be amended such that "*a contract represents a purchase or sale of the underlying asset if, at the end of the contract, an entity transfers to another entity control of the entire underlying asset ~~and all but trivial amount of risks and benefits associated with the entire underlying asset~~*" and cite the transfer of risks and benefits as an indicator of the transfer of control.

(c) Yes, we think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts, which is largely brought forward from the existing IFRIC 4 *Determining whether an Arrangement contains a Lease* guidance, is sufficient.

Question 5 Scope and scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, **including leases of right-of-use assets in a sublease**, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

Subject to our comments below, we do not object to the proposed scope of the proposed IFRS set out in paragraph 5 of the ED. In addition, if "specified asset" in the definition of leases is intended to cover all types of assets, at some point in time, the Boards should reconsider the scope exclusions as part of their further projects.

(i) Intangible assets

We believe that there is no conceptual basis for excluding intangible assets from the scope of leases accounting. In the absence of further project on leases of intangible assets, lessors would use the guidance in the ED *Revenue from Contracts with Customers* to account for these transactions while there would be no accounting guidance for lessees of intangible assets. This would also lead to complexity in bifurcating tangible and intangible components in leases such as those in the IT industry.

(ii) Investment properties

We are supportive of the ED proposal that a lessor should apply IAS 40 rather than the proposed leases standard to leases of investment properties (IP) that are measured at fair value, but disagree with the ED proposal which requires a lessor to apply the proposed leases standard to leases of IP that are measured at cost.

We believe it would not be desirable or appropriate to adopt different accounting treatments for leasing arrangements that have similar economic substance simply because of the different bases used to measure the underlying assets (i.e. whether an IP is measured at cost or at fair value should not have any bearing on the accounting for leases of the IP). We are concerned that the different accounting treatments would render the financial statements/financial ratios of entities that are engaged in similar leasing businesses incomparable. For instance:

- An entity that holds an IP measured at cost would recognise an interest income element, whilst one that holds an IP measured at fair value would not. These entities would therefore produce very different Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) numbers even if both entered into exactly the same leasing arrangement.
- An entity that holds an IP measured at cost would have a front loaded income pattern, whilst one that holds an IP measured at fair value would have a constant income pattern (as income is recognised on a straight-line basis over the lease term).

To ensure consistency in application and comparability of financial statements of entities that are engaged in the same business, we propose:

(a) to scope out all IP (whether accounted for at fair value or at cost) from the leases standard and to address lessor accounting involving IP under IAS 40; and

(b) that IAS 40 be amended such that income arising from leases of IP is recognised on a straight-line basis over the lease term by all lessors of IP.

(iii) Service concession arrangements

We note that the scope of the proposed leases standard might overlap with IFRC 12 *Service Concession Arrangements.* Contractual terms of some public-to-private service concession arrangements would meet the definition of a lease under the proposed standard and also meet the scope criterion of IFRIC 12. Currently, IFRIC 4 scopes out arrangements that are public-to-private service concession arrangements within the scope of IFRIC 12. In addition, paragraph BC14A of the Basis for Conclusions on IFRIC 4 explains that the IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. Thus, we recommend that the Boards clarify that arrangements that are public-to-private service concession arrangements within the scope of IFRIC 12 are excluded from the scope of the proposed leases standard.

Address: The Secretariat, Accounting Standards Council,
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Question 6 Contracts that contain both service and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

- (i) a lessee should apply the lease accounting requirements to the combined contract.
- (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
- (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in *Revenue from Contracts with Customers*.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We are supportive of the ED proposal that a contract with distinct service and lease components should be bifurcated, i.e. a lessee or lessor should apply the proposals in ED *Revenue* to a distinct service component of a contract that contains service components and lease components.

However, we do not agree with the proposed principle for identifying distinct service components, which is based on the proposal in ED *Revenue*. We are of the view that only an entity's own business should be considered in applying the "distinct" concept as the businesses of other entities should not have a bearing on the goods or services which an entity has promised to provide under the contract with its customer. In addition, we believe that an entity's business model should be considered in applying the proposed principle for identifying separate performance obligations. Please refer to our comment letter to ED *Revenue* which was submitted to the IASB in October 2010 for further details.

For a contract where the service component is <u>not</u> distinct from the lease component, we do not believe that a lessee or lessor should bifurcate the service and lease components as bifurcation would not be possible. We note the Boards' rationale for requiring a lessor using the derecognition approach to bifurcate non-distinct services from the lease components – this is to ensure that income from the service component is not recognised before the lessor provides that service. However, if the service component is truly non-distinct, it is difficult to see how a lessor is able to bifurcate the service from the lease component. This is in any case inconsistent with the ED *Revenue*, which envisages different non-distinct services being accounted for as a single

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performance obligation. Thus the more fundamental issue would be for the Boards to ensure that the criteria for identifying distinct elements are appropriate and sufficient. We also propose that further clarification be made on the criteria to identify "distinct" services from the perspective of the lessee.

As currently drafted, the proposal presumes that where the service component is not distinct from the lease component, the entire contract has the underlying substance of a lease. For contracts with non-distinct service and lease components, we believe that the lessee or lessor should apply the leases requirements to the entire contract only if it has been specifically assessed that the underlying substance of the entire contract meets the definition of a lease and suggest that the Boards incorporate this requirement into the final IFRS.

Question 7 Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We support the ED proposal that a lessee or a lessor should account for purchase options only when they are exercised. A contract ceases to be a lease when an option to purchase the underlying asset is exercised and should be accounted as a purchase or sale as this essentially represents the termination of the right to use the asset and the lessee is being granted access to the underlying asset instead. Thus, the exercise price of the option is not a lease payment and should not be included in the measurement of assets and liabilities arising from a lease contract.

Question 8 Lease term

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

(i) Recognition of lease extension or termination options

We do not agree with the ED proposal to take into account the effect of any options to extend or terminate the lease in determining the lease term.

We think that rentals payable/receivable during an optional extension period which has not yet been exercised does not meet the definition of a liability/asset in the *Framework* as the lessee/lessor does not have an unconditional obligation/right to pay/receive the lease payment. Accounting for a 10-year lease in the same way as a 5-year lease with a 5 year-extension option would not provide useful information about the feature of lease options, which provide lessees with the flexibility to react to changing business circumstances. We believe that disclosure of the lease extension or termination options in the financial statements would achieve the objective of providing decision-useful information to users.

(ii) Measurement of lease term

In practice, we expect the determination of the lease term based on the ED proposals would pose significant challenges for many entities, especially those with large portfolio of leases. The objectivity and reliability of the estimated lease term is a concern, as there are typically many factors, both controllable and uncontrollable, affecting the exercise of the renewal or termination options (such as macroeconomic factors, competitors' and customers' actions) for which the lessee and/or lessor might not have reliable information at every reporting date.

In view of the above, should the Boards proceed with the ED proposal, we recommend that either:

- the Boards retain the current requirements in IAS 17 with respect to the determination of the lease term, which is based on the non-cancellable terms of the lease contract as well as the optional lease periods only when it is <u>reasonably certain</u> that the lessee would exercise the option. In addition, we suggest that the final leases standard should incorporate specific disclosure requirements relating to the options to extend and terminate leases, which is lacking in IAS 17. We believe that our proposed approach would better meet the needs of users of financial statements as it is less subjective and improves consistency in application. It would also result in fewer instances when remeasurements would be required, hence reducing the costs to preparers and increasing the usefulness of information provided; or

- measurement be based on the "<u>most likely lease term</u>" rather than the "longest possible lease term that is more likely than not to occur". This would be more consistent with the assessments that lessees are likely to make in negotiating a lease arrangement and whether to lease or buy the underlying asset. In addition, we believe that the resultant financial information would be more decision-useful to users of financial statements as it would enhance their ability to predict the future cash flows of the entity.

Question 9 Lease payments

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

(a) Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

(b) Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

(a) Contingent rentals, expected payments under term option penalties and residual value guarantees

(i) Contingent rentals

- *Recognition of contingent rentals and expected payments under residual value guarantees (RVG)*

  We agree that contingent rentals and expected payments under RVG should be included in the measurement of assets and liabilities arising from a lease.

- *Measurement of contingent rentals and expected payments under RVG*

  Similar to the concerns expressed by us on various other exposure drafts issued by the Boards/the IASB that propose to mandate the use of the probability-weighted approach (e.g. ED *Revenue*, ED *Financial Instruments: Amortised Cost and Impairment of Financial Assets*, ED *Liabilities*, etc), we do not agree with the proposed mandatory requirement to apply the expected outcome technique to the measurement of contingent rentals and expected payments under RVG.

  In the expected outcome technique, an entity would need to consider the existence of a continuum of outcomes, thus making the technique complex to implement in practice. Although the ED clarifies that the expected outcome approach is to be applied for a reasonable number of outcomes, this may also mean that the approach would be subject to abuse as the entity need not take into account every possible scenario. Whilst the use of a

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statistical method based on possible outcomes and probabilities typically works well for large homogeneous populations, we do not believe that it is generally appropriate for single item or small portfolios as there is often no or insufficient historical data. In many circumstances, the expected outcome approach would be no more accurate than a most likely rental payment estimate. We are therefore concerned with the objectivity and reliability of the estimated contingent lease payments and expected payments under RVG, which would require significant judgement. This is likely to compromise the decision-usefulness of the reported financial information.

Accordingly, we urge the Boards to permit the use of the "most likely" outcome approach if this approach results in more relevant and decision-useful financial information. This approach also has the practical benefit of minimising both the need for and potential magnitude of future remeasurements, and is thus simpler to apply.

(ii) Expected payments under term option penalties

We note that the ED is silent on the definition of "term option penalties" and suggest that the Boards incorporate this in the final standard.

If term option penalties refer to penalties that the lessee would have to pay if it terminates the lease early or fails to extend the lease into a secondary period, we do not agree with the ED proposal that expected payments under term option penalties should be included in the measurement of assets and liabilities arising from a lease. Similar to our comments under question 8, we believe that term option penalties arise from a future decision of the lessee. Hence, they do not meet the definition of liabilities/assets as defined in the *Framework* from the lessee's/lessor's perspective.

(b) Reliably measurable criterion

Subject to our comments under (a), we agree that lessors should only include contingent rentals and expected payments under term option penalties and RVG in the measurement of the right to receive lease payments if they can be measured reliably.

We note that the reliably measurable criterion is different from the proposal in the ED *Revenue* where a seller includes variable consideration in the transaction price only if it can be estimated reasonably. We suggest that the Boards clarify whether "measured reliably" and "estimated reasonably" are meant to be the same and if so, the wordings in the two EDs should be aligned. If they are meant to be different, we recommend that the Boards explain the rationale for the difference in recognition threshold.

In addition, we propose that the "reliably measurable" criterion should be applied by lessees in their measurement of contingent rentals and expected payments under term option penalties and RVG, to ensure symmetrical requirements for both lessees and lessors.

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Question 10 Reassessment

The exposure draft proposes that a lessee or a lessor should remeasure assets and liabilities arising from a lease on a basis that is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

We agree with the ED proposal. However we recommend that the Boards provide examples of indicators of a "significant" change that would trigger reassessment. We also wish to highlight that requiring a periodic reassessment could be very onerous for the preparers and believe that this requirement is more compatible with a most likely outcome approach and less compatible with an expected outcome technique to measure assets and liabilities arising from the lease.

Question 11 Sales and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

Subject to our comments under question 4(b), we have no objection to the criteria for classification as a sale and leaseback transaction.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42– 45, 60–63 and BC142–BC159).

Question 12: Statement of financial position - lessees

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

We think that disclosure in the notes would suffice so as not to clutter the statement of financial position. In other words, the lease liabilities and right-of-use assets can be included as part of financial liabilities and property, plant and equipment (or investment property) respectively on the face of the statement of financial position.

Question 12: Statement of financial position – lessors (performance obligation approach)

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

Subject to our comments under question 2, we think only the net lease asset or lease liability needs to be presented in the statement of financial position. This reflects the interdependency of the underlying asset, right to receive lease payments and lease liability and addresses concerns that presenting these components separately inappropriately overstates both assets and liabilities in the statement of financial position. The gross amounts of these components could be disclosed in the notes.

Question 12: Statement of financial position – lessors (derecognition approach)

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

We think that disclosure in the notes would suffice so as not to clutter the statement of financial position. In other words, the rights to receive lease payments and residual assets can be included as part of financial assets and property, plant and equipment (or investment property) respectively on the face of the statement of financial position.

Subject to our comments under question 5, we suggest that paragraph 60 of the ED and paragraph BC155 of the Basis for Conclusions should make reference to investment property, rather than only property, plant and equipment.

Question 12: Statement of financial position

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

We think that disclosing the sublease assets and liabilities in the notes would suffice so as not to clutter the statement of financial position.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We think that disclosing the lease income and lease expense in the notes would suffice so as not to clutter the statement of comprehensive income.

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

We think that the cash flows arising from leases should be separately presented on the statement of cash flows as the nature of these cash flows are different from the other cash flows. Such information would be decision-useful to users of financial statements.

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Question 15 Disclosure

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognised in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We agree with the disclosure objectives proposed under paragraph 70 of the ED which aim to provide decision-useful information to users of financial statements. However, we have the following comments on certain aspects of the disclosure requirements in the ED:

We note that it is the Boards' intention to require entities to consider the level of detail necessary to satisfy the disclosure objectives. Hence, we suggest that the Boards should make it clear that not all disclosures are mandatory. In addition, we encourage the Boards to relook into the necessity of all the prescribed disclosures which appear rather excessive and costly for the preparers to implement, and the benefits to be derived by the users would not necessarily outweigh such burden. Some suggestions are as follows:

- With regard to the ED proposal to disclose information about the lessor's exposure to the risks or benefits associated with the underlying asset used in determining whether to apply the performance obligation or the derecognition approach (paragraph 78 of the ED), we propose that such disclosures should be required only where there is significant judgement involved. If a single derecognition approach is used, such a disclosure requirement would not be necessary.

- Where disclosure requirements are similar to those under IFRS 7 *Financial Instruments: Disclosures*, we recommend that the level and extent of disclosures required should be similar to those under IFRS 7. For instance, in the maturity analysis of lease liabilities, the ED requires undiscounted cash flows to be disclosed on an annual basis for the first five years and a total of the amounts for the remaining years (paragraph 85 of the ED). We question the need for such detailed disclosures, as they are more onerous that the requirements in IFRS 7 which are more principle-based and do not prescribe the maturity buckets.

We also wish to highlight that disclosures can be cut down if the element of subjectivity and judgement can be reduced in the proposed standard. For instance, allowing the use of the most likely outcome approach for lease payments is likely to involve less judgemental estimates and

correspondingly less extensive disclosures compared to the use of the expected outcome approach.

Question 16 Transition

(a) The exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186– BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

(a) We agree with the ED's proposal on the transitional requirements, as we believe the cost of a full retrospective approach would be excessive and would outweigh the benefits provided by the resultant financial information.

(b) We believe that full retrospective application should be permitted.

(c) The Boards need to address how sale and leaseback transactions from prior periods should be evaluated as at the date of initial application.

Question 17 Benefits and costs

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Whilst we agree that a single/consistent lease accounting model would provide more decision-useful financial information and improve comparability, particularly in respect of leases of core operating assets, we are not persuaded that a robust cost-benefit analysis has been performed by the Boards.

Based on our outreach activities, many of our local constituents have expressed deep concerns over the major overhaul in the leases requirements. The ED proposals would result in tremendous administrative burden for many entities, especially those with a significant number of short leases of non-core assets, such as office space, photocopiers and motor vehicles. The need to develop scenarios and probabilities for each single lease, coupled with the need to continually reassess the lease estimates, could make the proposed requirements very challenging and time-consuming to implement. At a macro level, the costs of implementing the ED proposals

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could have unintended consequences of driving changes in leasing behaviour and possible knee-jerk reactions to structure leases to reduce lease terms and vary the terms of lease options and contingent rentals. Certain disclosure requirements on the assumptions used in computing the lease assets/liabilities (e.g. discount rate for amortisation and forecasted sales for contingent rentals) could result in the loss of bargaining power of lessees and affect leasing decisions. The proposals would also impact financial ratios and debt covenants compliance, which could possibly increase the cost of capital for some entities.

We therefore urge the Boards to perform sufficient field testing to better define the needs of the users and to relook into the proposals to ensure the benefits of the proposals to the users can justify the costs imposed on the preparers beyond doubt.

In addition, to reduce the cost and compliance burden on smaller entities, we recommend that the Boards consider if any of the ED proposals should be simplified in the IFRS for SMEs.

Question 18 Other comments

Do you have any other comments on the proposals?

Please refer to our comments in the cover note. In addition, we have the following comments:

Accounting for lease incentives

The ED is silent on the accounting treatment for up-front lease incentives such as cash. We believe that lease incentives should be deducted from the total lease payments over the lease term, so that it is representative of the time pattern of the lessee's benefit from the use of the leased asset and the lessor's actual return from the leased asset.

Accounting for payments made before the commencement of the lease

The ED does not discuss the accounting treatment for payments that are made before the commencement of the lease. Such payments are common where the underlying asset is being constructed specifically for the leasee. We believe that:

- the lessee should exclude the upfront payment from its liability to make lease payments, but should include the upfront payment in its initial carrying amount of the right-of-use asset; and

- the lessor should exclude the upfront payment from its right to receive rentals, but should include the upfront payment in its allocation of the carrying amount of the underlying asset between the amount to be derecognised and the amount to be reclassified as a residual asset, or in the measurement of its performance obligation.

Accounting for the right-of-use asset

Under IAS 16 *Property, plant and equipment*, a component approach of accounting is required where different components are depreciated separately, and depreciation expense can be capitalised in the carrying amount of another asset. Such issues are likely to be relevant to the accounting for the right-of-use asset but we note the ED is silent.

With respect to the above issues, we suggest that the Boards provide further clarification in the final standard.

We hope that our comments will contribute to the Boards' deliberation on this exposure draft. Should you require any further clarification, please contact the project manager Ms Chionh Chia Chia at chionh_chia_chia@acra.gov.sg.

Yours faithfully

Soh Siew Luie
Secretary, Accounting Standards Council