To the members of the International Accounting Standards Board
To the members of the Financial Accounting Standards Board

Submitted electronically

Subject: Eumedion response to IASB's and FASB's Joint Exposure Draft on leases

Ref: B13.33

The Hague, 13 September 2013

Dear Members of the IASB and FASB,

Eumedion welcomes the opportunity to respond to the IASB's and FASB's Joint Exposure Draft ED/2013/06 on leases. Eumedion is the dedicated representative of the interests of 70 institutional investors, all committed to a long term investor horizon. Eumedion aims to promote good corporate governance and sustainability in the companies our participants invest in. We regard accounting standards as a critical part of a global financial infrastructure, especially since our participants are dependent on the quality of accounting standards for the quality of their decisions on how to allocate capital. Together our participants invest over € 1 trillion of capital in equity and corporate non-equity instruments. Long term institutional investors in general are a major source of the capital that is used by listed companies to grow, create wealth and provide employment, which is vital to the long term development of the economy as a whole.

Eumedion acknowledges that proper accounting for leases is very important for investors. Improving disclosures is also very important, but not enough: lease obligations must be visible in the primary financial statements.

Eumedion already issued a public statement on 10th December 2012 in which we explained our strong support to the IASB for the then tentative thoughts on leases[1]. We are pleased that the Exposure

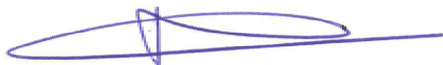
[1] http://www.eumedion.nl/nl/public/kennisbank/wet-en-regelgeving/2011-11_response_iasb_agenda.pdf

Draft is in line with those tentative thoughts and reiterate by reference all of our earlier arguments in support of this Exposure Draft.

As foreseen in our statement of support, this response does contain a number of suggestions for improvement. Our suggestions for improvement cannot cloud our overall assessment that the IASB and the FASB still are on the right track regarding leases, most notably by proposing a Dual Model based on the criterion of consumption, which indeed best reflects the underlying economics of the assets leased. We therefore fully support all the key elements of your Exposure Draft.

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Martijn Bos (martijn.bos@eumedion.nl, +31 70 2040 304).

Yours sincerely,



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Eumedion response to questions in Exposure Draft ED/2013/6 on Leases

We confine our response to comments on questions 1 - 8 only.

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) fulfillment 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.

Response: We concur with the proposed definition of a lease and the proposed requirements to determine whether a contract is a lease. We are comfortable with the introduced concepts of a 'right of use asset' and a 'residual asset' and find them quite intuitive. The definition excludes, and we believe should exclude, certain contracts: 'take-or-pay' contracts, since there is no right of use asset; and tolling agreements, since the asset is not controlled by the reporting entity. This is not because investors are not interested in understanding take-or-pay and tolling agreements. Investors are interested, but we do not regard these contracts as leases and therefore they should fall outside the scope of a new standard for leases. We also concur with the ED that whether or not a lessee consumes an insignificant amount of the asset leased is irrelevant for judging whether a contract is a lease for a lessee.

We concur with the Exposure Draft (ED) that identifiable service components remain excluded from the definition of a lease. We also concur with the hard criterion that a non-lease component can only be identified if there is an observable price for that component. We concur with the Exposure Draft that unless there is clear evidence that a component of a lease expense is not a lease, it should be regarded as a lease expense.

Further, we concur with the ED's notion that the lack of an observable price for the leased asset is no obstacle at all for a contract to be identified as a lease. An alternative view from EFRAG suggests to make observable prices for the asset leased a requirement for a lease to be recognized. This would mean that if a lessee concluded that an observable standalone price is not available, then no asset or

liability would be recognised. We oppose this alternative view since we see it as lacking a conceptual basis and we are convinced this would result in inferior reporting for investors. To illustrate this, one could consider a lessee that rents 8 out of 10 floors of an office building. Since there generally is no observable price for 8 out of 10 floors of an office building, the criterion of an observable price is likely to result in no lease obligation being recognised, whereas a the rental of all of the floors could be recognized as a lease. From an investor perspective, both renting 8 floors out of 10, and 10 floors out of 10 are leases that should be recognised, irrespective of whether there is a price observable for a floor, or even for the building as a whole.

Requiring observable prices would significantly increase the administrative burden for preparers since the observable price of the leased asset is not information that is necessarily known by lessees and in many cases not even available for the lessor. The one preparer may conclude they could not find prices, while another may spend more time to eventually find a price. Making lease obligations dependent on the varying ability and willingness to find observable prices is likely to lead to inconsistent application. It therefore would result in very unpredictable outcomes for investors. As a word of caution, the standard setter should not overestimate the willingness of some preparers to seek prices, since not finding a price under this alternative results in no recognition of a liability on the balance sheet.

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?

Response: We agree. Investors for their analysis need a split of the lease expense in two components: consumption expense from leases (i.e. a sort of 'cash depreciation') and interest expense from leases. It is essential for investors' valuation and leverage analyses that this split is based on the underlying economics of the assets. We see the Dual Model striking a fine balance between providing a basis for this split that adequately matches the underlying economics of leases for investment analysis, while only requesting information preparers can be expected to provide.

The main advantage of the Dual Model is that it enhances the insight in the income statement. Only a split based on the underlying economics, like the ED proposes, will allow investors to accurately and efficiently understand leverage, and year-on-year operating profit development of the reporting entity. The proposed split is also essential for making comparisons with other reporting entities that have very similar business models, but a different proportion of assets leased versus owned. This financial analysis can only be made if the lease expense is split between consumption and interest in a way that best reflects the underlying economics. Theoretically, there might be an even more accurate way to make a split between consumption and interest, but that would require amongst others that lessees need to gather information about the value and remaining life characteristics of the assets they lease;

even if this information were obtainable, the costs would be prohibitively higher for preparers, and therefore for investors who ultimately bear the cost of reporting.

We acknowledge that for any method of measurement of an individual lease contract, an example may be constructed that demonstrates that the measurement model deviates from a perfect reflection of underlying economics. However a standard for leases should not be primarily judged on how well it measures an individual lease. We believe that the measurement model should primarily be judged on how well it reflects the underlying economics of multiple lease contracts, since any material exposure to leases generally is the result of multiple lease contracts. In this light, we see the Dual Model reflecting the underlying economics very well. None of the recent alternative (singular) measurement models that the IASB and the FASB considered comes even close to reflecting underlying economics of a lease so well.

Taking everything into account, we regard the Dual Model as a very good model and the best available model as it is the only acceptable model that provides investors with information that is essential for their analysis, while limiting the cost for preparers. Any of the debated single model approaches will leave the investment community with a major unanswered question, for every individual company they consider investing in, to waste time and costs on making a judgment on how to re-estimate the split of the lease expense in consumption and interest to reflect the underlying economics. We urge the IASB and the FASB to finalise the standard with the Dual Model, and with the criterion of consumption.

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?

Response: We agree. Even though recognising a right of use asset and a residual value for both types of leases may be conceptually more elegant, we are convinced that keeping the properties leased on the balance sheet at lessors will result in reporting that is more useful for investors, at a lower cost. Investors in property lessors tend not to be interested in a breakdown of the property in a lease receivable and a residual value for properties, especially since investors prefer most property lessors to apply IAS 40 to value properties at fair value. The ED also very well reflects the investor preference on how to account for rents received on property leases: investors prefer property lessors to show the actual rents received, instead of the amortisation of a receivable.

We also agree that the approach for Type A leases for lessors differs from the approach for Type B leases for lessors. We regard the approach to Type A leases as the best thinkable approach for reflecting the underlying exposure to the residual value of the asset, which (unlike type B leases) by definition differs from the current book value, since consumption of the underlying asset is significant for Type A leases.

We are aware that the proposals may result in a book value of the leased asset at the lessor that differs from the book value of the leased asset at the lessee. This will not in any way negatively affect our ability to analyse either the lessor or the lessee.

Question 4: classification of leases

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

Response: Yes, we agree with the principle of consumption, since this principle best reflects the underlying economics of the assets leased. We find the criteria to be understandable and intuitive. We expect the specific requirements relating to properties to result in a categorisation that very well supports the overall purpose of assessing whether there is insignificant consumption of the underlying asset.

We understand for some stakeholders it may be tempting to prefer the well known existing IAS 17 criteria for distinguishing which leases are Type A and which ones are Type B. Unfortunately the IAS 17 criteria are inadequate for investors. The IAS 17 criteria were not developed to incorporate the principle of consumption, nor do they adequately reflect consumption. A typical example of leases that should be classified as type A, but would remain classified as Type B under the IAS 17 criteria are lease contracts that involve the lease of trucks for 4 years and planes for 10 years. Obviously, there is significant consumption of these assets during the lease and therefore they are Type A leases. Using IAS 17 criteria would result in categorising them as Type B leases and therefore the IAS 17 criteria do not reflect underlying economics adequately.

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?

Response: Yes, we agree. We agree with taking into account payments due under options. We prefer the proposed concept of 'significant economic incentive' over an alternative criterion like 'reasonably certain' since we expect the economic incentives to ultimately determine whether an option to terminate or extend is used, or not. We expect 'economic incentives' to be assessed with greater objectivity than a more general and subjective criterion like 'reasonably certain'.

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?

Response: Yes, we generally agree with including not all variable lease payments. We do fear that there is a risk that too many variable payments potentially are excluded from being a lease payment, and a risk that contracts may be easily amended to use this exclusion. If a lease payment is variable within a range, variable payments up until the lower bound of the range should be included. A broader definition of variable lease payments that are included may help solve this. Paragraph 39(c) could, for example, be rephrased to: "variable lease payments ~~that~~ insofar as these are in-substance fixed payments".

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 the boards should consider? If yes, what are they and why?

Response: We limit our response to noting that investors prefer the earliest possible effective date for the standard. Arguments that seem to justify a rather deferred effective date primarily relate to the impact of the standard on the primary financial statements and how these in some cases unintentionally affect existing credit ratios in covenants. Eumedion therefore suggests, similar to the suggestion of EFRAG, that the IASB and the FASB set the soonest possible effective date for the disclosure requirements, which may be significantly sooner than the effective date of the entire standard. Alternatively, the IASB and the FASB could provide concrete guidance what disclosure requirements are to be included in the section 'not yet effective' accounting standards.

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 changes do you propose and why?

Response: We support the disclosures proposed in the ED. However, there are a number of elements missing in the requirements which we highlight below:

1. We would like to see a 'total lease expense' table that also specifies those leases that were not capitalised:
   - consumption expense from leases (i.e. relates to capitalised leases)
   - interest expense from leases (i.e. relates to capitalised leases)
   - variable lease expenses, insofar not included in the above (not capitalised)
   - lease expenses relating to leases <1 year, insofar not included in the above (therefore not capitalised)
   - any other lease expenses

   The table should explicitly exclude those expenses that do not meet the overall definition of a lease, i.e. excluding services, take-or-pay contracts, tolling agreements, forward starting leases.

   This disclosure is very important, since investors want to know if this 'total lease expense' is much higher than the lease expenses recognized in the financial statements. If this difference is large or changing over time, analysts will want to understand why. It could be an indication of lease contracts being structured to remain excluded from recognition on the balance sheet. Such overview would also help address the risks identified in question 6.
2. Since the underlying assets of Type B leases are not derecognised, it remains invisible for the user what proportion of the asset base is under lease. Investor insight is enhanced if lessors need to disclose what the book value is of the assets that are under lease.

3. We would like the final standard to require disclosure of any material forward starting leases.

Eumedion suggestions for improvements

We conclude our reaction with a number of suggestions for the final standard, not yet covered in our response to the consultation questions.

1. Primary financial statements presentation

If leases are material, the relevant line-items should always be shown as separate line-items in the primary financial statements.

Even though the lease expenses 'interest expense from leases' and 'consumption expense from leases' are very similar to interest expense on debt and depreciation/amortisation of fixed assets/intangible assets, there is a key difference: reporting entities can scale back on capital expenditures and still have access to the assets owned, whereas reporting entities cannot scale back on lease expense without losing the assets controlled. Lease expenses imply lease payments, whereas depreciation expense may not require immediate capital expenditures. This difference is for

financial analysis so fundamental that it justifies requiring separate line items for lease expenses by the standard. Proper application of the concept of materiality, outside the scope of this standard, will help prevent possible disclosure overload in this respect.

We do see room for a more simple presentation of leases in the primary financial statements: from an investor point of view, lease expenses only break up in two categories: 'consumption expense from leases' (i.e. a sort of 'cash depreciation') and interest expense from leases. We regard Type B lease expense (for property) as an integral part of the overall interest expense from leases. Therefore the lease expenses for type B leases should not be a separate (third) expense, but should be part of a single line-item 'interest expense from leases' (type A and type B combined).

We also see room for a more simple presentation of leases in the cash flow statement: We prefer to present all line items relating to leases as operating cash flows. This best facilitates financial analysis by the investor community. Conceptually, it is also very difficult to distinguish whether a lease payment contains anything like a principle or capital expenditures component that would justify it for categorising it as a financing cash flow, or an investing cash flow. To illustrate this: let's assume a reporting entity has a lease expense of € 200 a year, and then it cancels halve of its contracts to end up with € 100 a year. If one would want to identify a lease cash flow from investing, it should be negative (as less assets are leased), and if one were to expect a lease cash flow from financing, it should be positive (since the liability becomes lower). We expect in these cases that the ED results in amounts in financing cash flows that have counterintuitive signs.

2. Discount rate

We disagree with how the ED describes the discount rate to be used for lease obligations of lessees. The discount rate for the lessee should not be referred to in terms of 'incremental' borrowing rate of the lessee. A lease contract can be regarded as a loan secured by the asset leased. If a lessee can no longer pay any lease due, the lessor does not run the risk of losing the asset. In many cases, the lessor can repossess the asset (comparable with a full return of principal) and still claim damages and fines for breach of contract. Some breaches of lease contracts actually prove to be very profitable for lessors. Managing a repossessed asset generally is much more core business to a lessor, than it is to a bank that provides a secure loan. These dynamics justify a discount rate no higher than the rate on a very well collaterised loan to the lessee with generally very little credit exposure to the principal.

Referring to 'the' incremental borrowing rate implies that there is a single incremental borrowing rate, which is not true. This definition may result in a discount rate that is too high, and therefore understate liabilities. It may be interpreted as the implied yield on a borrowing that is more junior than the described collaterised loan (or even the current yield on the most junior loan), or may have a different duration than the duration of the lease. For example, an explicit reference to the 'lowest possible' incremental borrowing rate for a loan of a size that matches no more than the interest components of the lease payments is likely to be more accurate.

3. Impairment and revaluation

The proposal allows lessees to value a right of use asset at market value, and to allow the impairment of a right of use asset. We disagree with both. We consider these options as creating significant complexity for users, instead of enhancing insight. Besides, both impairment and revaluation create temporary differences only, since at the end of the lease contract the underlying asset will be returned to the lessor and there cannot be any value remaining. Right of use assets are hardly ever traded and we therefore think that estimating a market value for any right of use asset will be extremely judgmental. This is a key difference with assets owned. Since a right of use asset is very difficult to trade, and often quite unique, it is quite easy to argue that the asset needs to be impaired even on the day the lease contract is signed. Investors are not interested in seeing temporary differences running through the financial statements. We are also fearful that this option creates significant room for earnings management. If management thinks there is a significant different value in selling an existing lease contract to a new lessee (and the contract actually allows for such sale), it should only be recognized on an actual transaction with a third party that takes over the contract. Besides, management remains free to renegotiate a lease contract. Investors would benefit if reporting entities were to explain in narrative that after termination of certain contracts in x years, investors should expect to pay a higher (or lower) rent for certain leased assets.