VMEBF
Bilanzierung in Familienunternehmen

Project Manager
International Accounting Standards Board (IASB)
30 Cannon Street

London EC4M 6XH
United Kingdom

Weinheim, 13/09/13

Dear Sir or Madam,

ED/2013/6 – LEASES

We appreciate the opportunity to comment on ED/2013/6 "Leases".

The Association for Participation in the Development of Accounting Regulations for Family-owned Entities (VMEBF) was founded in 2006 and consists of German companies with a strong family shareholder background. Beyond its members, the association represents a large part of family-owned large and medium-sized entities in Germany, often legally organised in the form of partnerships. The aim of the VMEBF association is to make the role of German family businesses as stakeholders in the development of international accounting more visible and to act as a constructive partner for the standard setters. We work closely together with the German standard setter ASCG and the German Institute of Chartered Auditors (IDW) as well as other political institutions.

We understand the background of the project on leases and the objective set by the boards, especially to improve the comparability of financial statements and to reduce the possibilities to account for leased assets off-balance. However, we also recognise the increased room for discretionary decisions and the need to resort to estimation in some places. Those findings along with further concerns regarding the decision-usefulness of the information to be provided by the proposed standard leads us to disagree with the approach proposed by the boards. Therefore, before responding to the specific questions as stated in the re-ED we would like to express our continuing concerns regarding the conceptual basis of the proposed standard and add some general remarks.

Vereinigung zur Mitwirkung an der Entwicklung des Bilanzrechts für Familiengesellschaften e.V.
VMEBF e.V., c/o Freudenberg & Co. Kommanditgesellschaft, 69465 Weinheim, Germany

Managing board: Frank Reuther (Chairm.) · Phone: +49 (6201) 805817 · E-Mail: frank.reuther@fhp-ww.com
Prof. Dr Dieter Truxius (Vice Chairm.) · Phone: +49 (831) 5916-7000 · E-Mail: dieter.truxius@dachser.com
Peter Notz · Phone: +49 (40) 44188335 · E-Mail: peter.notz@ganske.de
Prof. Dr Norbert Winkeljohann · Phone: +49 (541) 3304517 · E-Mail: norbert.winkeljohann@de.pwc.com

Banking account: Deutsche Bank AG, Mannheim · account no. 040158800 · BLZ 670 700 10

It is common understanding that only an approach to lease accounting that is capable of depicting the economic substance of the underlying business transaction will be able to result in decision-useful information and thereby justify severe changes to the concept of lease accounting and subsequently to an entity's internal processes and routines. We still believe that the transition of the risks and rewards of a leased asset best reflects the economic substance of the underlying contract. This leads to differences in the economic substance of finance and operating lease transactions. We therefore principally agree with the boards differentiating between two types of leases. However, the boards should – in line with the economic substance of the transactions – as well implement different treatment for those types of leases in the statement of financial position. As a result, Type B leases should not be recognised in the statement of financial position of the lessee. This would also be more consistent with the straight-line recognition of lease expense in profit and loss as it better reflects the economic substance of the transaction in terms of granting access to the leased asset (in contrast to the "consumption" of the asset in a Type A lease).

We would therefore recommend the boards to retain the current approach on lease accounting in the first place. To focus on the economic substance of leased items, the existing standard (IAS 17) could be amended with regard to selected notes disclosures increasing transparency according to user´s needs. If the boards should adhere to an approach to lease accounting recognising all lease contracts on the statement of financial position, the boards should consider a „one-line"-presentation of leased assets in the statement of financial position (similar to IFRS 5).

Please refer to the appendix to this letter for our detailed answers to the questions asked in ED/2013/6.

Kind regards,

Vereinigung zur Mitwirkung an der Entwicklung des
Bilanzrechts für Familiengesellschaften e.V. (VMEBF)

Frank Reuther Prof. Dr Dieter Truxius Peter Notz Prof. Dr Norbert Winkeljohann

Appendix:
VMEBF comments on the boards´ additional questions

<u>Question 1: identifying a lease</u>

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?

We believe that recognition of an asset on an entity´s statement of financial position has to comply with the economic substance of the underlying transaction. Therefore, an approach to lease accounting recognising all lease contracts on the statement of financial position has to ensure that the criteria identifying a lease are unmistakable and unambiguous.

In reference to the criteria defining a lease, we are afraid that those criteria might not be applicable unambiguously in practice. Let us (for example) assume that an entity leases an asset with the objective of leasing that asset to another party on *<u>identical</u>* conditions (strategic sublease agreements). From our point of view, such an arrangement would not meet the criteria of par. 18 of ED/2013/6 as the lessor within the sublease agreement (i.e. the lessee within the original lease agreement) is not able to derive benefits from the use of the asset (i.e. primary output and by-products or other economic benefits realised from a commercial transaction with a third party). The same applies to the lease of a car if the car is ceded to an employee for business *and* private use. As the employee can decide on the use of the car while using it privately, it is doubtful whether the entity is able to “obtain substantially all of the potential economic benefits from use of the asset throughout the term of the contract” (par. 18). Those examples reveal the wide scope of discretion/judgement associated with the definition proposed. Such a wide scope of discretion might also lead to different interpretations of the very same transaction by lessee and lessor (e.g. when assessing whether a right to substitute an asset is substantive). Furthermore, the boards should consider that the definitions of assets and liabilities as used in the final standard on leasing comply with the definitions of the Framework. At the moment, the definitions of lease assets and liabilities do not meet the definition criteria of the Framework.

There are several unclear issues applying the definition of a lease according to ED/2013/6. Thus, we are still concerned about the consistency of the concept as proposed. If the boards decide to pursue the approach as set out in ED/2013/6, further guidance and more definite criteria would be helpful.

Additional remark on separating components of a contract: We principally agree with the need for separate accounting treatment for lease and other components of a contract. However, we think that the guidance on separation when there are no observable stand-alone selling prices for all/some of the components is not reasonable and does not depict the economic substance of the different components of the contract. Hence, further guidance on differentiating lease and other components would be required (as well as a distinct definition of services).

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?

When commenting on the boards´ former ED/2010/9, we were cautiously supportive of the right-of-use approach for lessees (with several proposals for conceptual modifications). This was due to the fact that the boards proposed one single approach to accounting for lease contracts. However, **we do not agree with the approach proposed im ED/2013/6**. The former objective of the joint project was to simplify lease accounting, especially by reducing the number of accounting models. Now the result is two very complex models. If the boards should adhere to the approach recognising all lease contracts on the statement of financial position, we would rather prefer the front loading effect of one single approach to lease accounting (as proposed in ED/2010/9) than the distinction between Type A and Type B leases as proposed in ED/2013/6.

On a conceptual level, we doubt that the amortisation pattern of the right of use asset of a Type B lease reflects the economic substance of the issue. The amortisation amount is calculated as the difference between the periodic lease cost (straight line) and the periodic unwinding of the discount on the lease liability (decreasing). This leads to increasing amortisation amounts over time. This is not consistent with IAS 16 or IAS 38. Both standards state that the amortisation method "shall reflect the pattern in which the asset´s future economic benefits are expected to be consumed". In practice, increasing amortisation amounts usually do not reflect the pattern of consumption of economic benefits. Moreover, according to ED/2013/6 a lessee shall recognise a single lease cost for the unwinding of the discount on lease liability and the amortization of the right-of-use asset. However, it is not determined in which profit or loss position such single lease cost should be recognised. This will result in decreased comparability of financial statements. Furthermore, no financial expense would be recognised in profit or loss measuring Type B lease liabilities subsequently. This is also not in line with the economic substance of the transaction.

Besides those conceptual issues, we are concerned about the complexity and cost of implementing reliable processes and IT systems that are able to cope with the integration of classification and measurement issues. For example, standardised routines calculating amortisation amounts for Type B leases would require dynamic linkages between several ledgers in SAP systems (e.g. PP&E and liabilities). Some of our member companies have several thousand lease agreements. In general, the current approach requires those entities to test the classification criteria for each individual contract (lease term test, present value test) and

– depending on the classification – to measure and present liability/asset, expense and cash flow. The resulting one time and ongoing needs regarding accounting, reporting and documentation will significantly increase. This will require the implementation of new databases and much more capable IT systems than currently which will be very costly. Much will depend on the possibilities to record and measure lease contracts in a standardised way. The subjectivity and needs for remeasurement will in our opinion set limits to a far reaching standardisation and at the end cost will outweigh the benefits targeted at.

In summary, the boards should refrain from recognising lease assets and liabilities for Type B leases and should instead return to former accounting for leases according to IAS 17. However, if the boards should adhere to the classification proposed in ED/2013/6 the boards should return to former accounting for operate leases for Type B leases.

Additional remarks on short term leases: The definition of a short-term lease does not reflect the economic substance of such transactions. Although we appreciate the simplification, we propose that instead leases of non-core assets should be excluded from the scope of the proposal. The costs for the preparer of the financial statements will rise significantly, in particular as a result of the lessee having to account for minor assets which are not material for the financial position of an entity, e.g. photocopying machines. Measuring those assets will be particularly difficult in cases of options and in terms of separation of non-lease components of a contract. Additional costs triggered by the proposed changes will by far outweigh the benefits.

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?

In accordance with our answer to question 2, we disagree with the proposed model. Especially, we see severe problems in measuring the residual asset. On the one hand, this is due to the need for inclusion of the present value of expected variable payments when calculating the residual asset. On the other hand, that kind of calculation is likely to trigger notes disclosures according to IFRS 7 and IFRS 13. The boards should reconsider the use of different accounting models in lessor accounting.

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?

We see severe problems in practice when applying the criteria underlying the classification as Type A or Type B leases as set out in ED/2013/6. As a general rule, the classification has to be made by assessing the nature of the underlying asset (property or not property). However, the boards define additional criteria preventing an entity from classifying a lease merely by the nature of the underlying asset. This means that an entity has to assess the additional criteria for every single contract to decide on the type of lease. Moreover, the additional criteria are too vague as they do not specify what is meant by “major part”, “substantially all” or “insignificant part”. Hence, the classification of leases will provide structuring opportunities which the IASB with its ED set out to eliminate. We therefore propose a classification in accordance with the economic substance of the transaction (rent-like agreements or in-substance purchases), regardless of the nature of the asset.

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?

We do not agree with the boards considering under certain circumstances extension or termination options for determining the lease term. The lease term should be limited to the non-cancellable period as otherwise the assets and liabilities will be determined based on subjective considerations by one of the two parties involved, which could be subject to further changes over the lease term. Amounts due under extension options conflict with the requirements of the Conceptual Framework and IAS 37 as there is no present obligation arising from a past event. Instead, the existence of the obligation depends of an uncertain future event. Moreover, these amounts do not provide relevant information to users of financial statements (consider a 20-year lease would probably be accounted for in the same way as a 10-year lease with a 10-year extension period despite the reduced risk involved). Additionally, options are regularly considered when pricing lease payments. With this in mind, we would propose verbal notes disclosures describing relevant extension or termination options and significant economic incentives to exercise or not exercise those options. The current proposal seems to grant a wide scope of discretion/ judgement as e.g. significant economic incentives are not defined sufficiently. Finally, we are not sure how to apply the criteria for a lease contract (principally for an unlimited period) that can be terminated by each party within a period of 12 months or less. The lessee is usually not able to assess whether the lessor has a significant economic incentive to terminate the contract.

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?

We acknowledge the boards´ decision not to include variable lease payments that are based on usage/performance in the measurement of lease liabilities and receivables. However, we are concerned about the requirements leading to reassessment of the lease liability or receivable. Particularly, we question the need of reassessment of lease liability and the right-of-use asset upon a change of an index. The adjusted book value of lease liability and of the right-of-use asset will result in higher interest/amortization in future years. In comparison, accounting for a change of index as an expense in the period in which it is incurred will have nearly the same effect on the profit and loss statement. Hence, a reassessment has no additional benefit but results in a considerable administrative burden and increases the cost of producing financial statements. We believe that the informational benefits of a reassessment do not outweigh the costs and administrative burden arising from implementing and applying the processes and routines necessary to reassess the lease payments.

Additionally, we miss a clear definition of in-substance fixed payments. The current proposal seems to grant a wide scope of discretion/judgement (e.g. when being applied to an obligation to take over certain maintenance costs), which in turn substantially increases the cost for identification/measurement/IT/audit and finally outweighs the benefits resulting from such treatment in our opinion.

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?

We doubt that the modified retrospective approach (compared to the full one) would effectively reduce the measurement complexity of lease contracts. Furthermore, that approach does not enhance comparability. We recommend the application of the retrospective approach only in order to avoid deferrals between the different levels in the statement of profit and loss (e.g. EBIT, profit/loss) in the year of transition and to enhance comparability of financial statements in that year.

Question 8: disclosures

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

We are surprised that the proposals for a better and more consistent standard on lease accounting (as assumed) requires such an amount of additional disclosures explaining the recorded assets and liabilities. It appears to us that the significant extent of additional explanation is rather resulting from the complexity of ED/2013/6 and as such contributing substantially to a negative cost/benefit relation. For example: what is the benefit of disclosing a reconciliation of opening and closing balances of right-of-use assets by class of underlying asset separately for Type A leases, Type B leases and right-of-use assets measured at revalued amounts? From a practical point of view, a big part of the amount of disclosures currently proposed by the ED will not be readily available. For instance, the accounting departments of entities with a great variety of lease contracts will not have information about significant assumptions and judgements which were made on each single contract.

The extent and detail of disclosures is not only too far reaching in our opinion, it is also intentionally subjective. Par. 59 states: ”A lessee shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee shall aggregate or disaggregate disclosures so that useful information is not obscured". Such subjective determinations will substantially increase audit time and cost of it.

Therefore, we disagree with the proposals and instead propose retaining IAS 17, if necessary supplemented by selected additional information. However, in reference to the discussion on a disclosure framework the boards should think about whether such a huge amount of additional information (as required by IAS 17 as well as by ED/2013/6) is really helpful for users.

Questions 9, 10 and 11

We refrain from answering questions 9, 10 and 11 as they are for FASB only.

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?

We expect that an extension of the application of IAS 40 to certain lease contracts would add further complexity to the process of accounting for and measuring lease assets. IAS 40 includes options as well as determinations based on judgements which would need to be integrated in the accounting and IT procedures for leases under a new standard. Again, this will further contribute to a negative cost/benefit relation in our opinion. We therefore disagree with the proposed amendments to IAS 40.