



14 December 2010

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
UNITED KINGDOM

Dear Sir David

### **AOSSG comments on Exposure Draft *Leases***

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on Exposure Draft *Leases* (ED/2010/9) issued jointly by the International Accounting Standards Board (the IASB) and the US Financial Accounting Standards Board (collectively the Boards) in August 2010.

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Thailand, and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Individual member standard setters may also choose to make separate submissions that are consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold. We attach the separate comments on certain Islamic finance impacts of the proposals in the ED from the Islamic Finance Working Group of AOSSG.

This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG Leases Working Group. The AOSSG has not received any substantive contrary views from our constituents.

The AOSSG is broadly supportive of the Boards' efforts to develop a single lease accounting framework to ensure that all assets and liabilities arising from lease contracts are recognised. The AOSSG believes that the proposals would address the main criticisms of the existing lease accounting model under IAS 17 *Leases*, which relate to the off-balance sheet treatment of long-term leasing arrangements involving core operating assets by lessees.

However, the AOSSG has several concerns over certain areas. Specifically, the AOSSG is of the view that a single model should be adopted for lessor accounting to ensure consistency in

application and to avoid replicating the artificial line between operating and finance leases which the Boards are seeking to remove in the first place.

In addition, the AOSSG is concerned that the ED proposals would not necessarily provide more decision-useful information on the expected future cash flows of lessees and lessors due to the significant subjectivity and judgement involved in applying the proposals.

Furthermore, the major overhaul in the leases accounting requirements would impose significant costs and operational burden on preparers, and these cannot be ignored by the Boards. At a macro level, the costs of implementing the ED proposals 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. The proposals could also impact financial ratios and debt covenants compliance, which could possibly increase the cost of capital for some entities. The AOSSG therefore urges 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 truly justify the costs imposed on the preparers. The AOSSG strongly believes that the quality of the final standard should not be compromised to meet the Boards' June 2011 timeline.

The AOSSG believes that ample transition time should be provided for preparers to implement the proposed changes so as to ensure a smooth transition.

The AOSSG's views are expressed in detail under the following key areas which are identified through the AOSSG Leases Working Group:

#### **QUESTION 1: 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).*

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?

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?

1. Most AOSSG members prefer a single approach rather than a hybrid approach 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. These AOSSG members are concerned that a hybrid approach for lessor accounting retains this

artificial line and the consequential potential arbitrariness in lease accounting, which the Boards are seeking to remove.

2. The hybrid approach receives very limited support from AOSSG members. One AOSSG member believes that day one profit should not be recognised for certain types of leases, such as leases currently classified as operating leases, because the lessor retains significant risks and benefits associated with the underlying assets. Therefore, this AOSSG member thinks that applying the performance obligation approach to such leases would be appropriate.
3. Most AOSSG members who support a single lessor accounting approach prefer the *partial* derecognition approach over the performance obligation approach. Under the partial 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 total useful life, then the fact that the right of use for 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.
4. These AOSSG members are of the view that the performance obligation approach does not reflect accurately the economic substance of a lease because lessors will continue to recognise the underlying asset and a “new” asset (i.e. the rights to receive rental payments), thereby artificially inflating the balance sheet of 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. A liability is recorded in relation to the leased asset, when in reality there is no additional obligation assumed by the lessor. Furthermore, the recognition of the underlying asset is inconsistent with the definition of an “asset” in the *Framework*; where an asset is recognised in the balance sheet 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 underlying asset should not be recorded as an asset because the inflow of economic benefits is already being recognised in the form of the lease receivable.
5. Some AOSSG members prefer a single performance obligation lessor accounting approach as they think that this approach is consistent with the proposed revenue recognition approach on performance obligations. One AOSSG member believes that it is not appropriate to derecognise the underlying asset and permit the recognition of a day one profit because doing so implicitly assumes the lessor has transferred all rights and obligations of a portion of the underlying asset, though this may not necessarily be the case (e.g. when the lease contract includes an option for cancellation).

6. One AOSSG member supports a single *full* derecognition lessor accounting approach on the basis that partial derecognition does not provide intuitive outcomes when the fair value of the residual asset is greater than its carrying amount, as a profit may be recognised at the end of the lease contract if the residual asset is subsequently revalued.
7. Should the Boards retain the 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 judgment is to be made. This would result in inconsistencies in application and reduced comparability across entities.
8. The Boards would also need to address the concerns with the performance obligation approach, which is a rather convoluted way of requiring the gross presentation of an additional asset (i.e. the right to lease payments) and corresponding performance obligation, thereby overstating assets and liabilities, and then requiring a net presentation to offset the effect again.
9. A few AOSSG members have a particular concern that with the hybrid model, the Boards would also need to address the lease accounting for land and building to ensure consistency in application. For example, in the case of a lease of land with a useful life of 999 years with a building on it with a 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 should 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.
10. Thus, most AOSSG members urge the Boards to consider a single partial derecognition approach which would avoid the complexities arising from a hybrid approach and the performance obligation approach.

## **QUESTION 2: CONTRACTS THAT REPRESENT PURCHASES OR SALES OF THE UNDERLYING ASSET**

*The exposure draft proposes that an entity shall not apply the proposed IFRS to a contract which represent a purchase or sale of an underlying asset, where the contract results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity. The criteria for distinguishing a lease from a contract that represents a purchase or sale are set out in paragraphs 8, B9, B10 and BC59–BC62).*

Do you agree with the proposed accounting for a contract that represent a purchase or sale of an underlying asset and do you agree with the criteria in paragraphs B9 and B10 of the ED 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?

*Accounting for contracts that represent purchases or sales of an underlying asset (in-substance purchases or sales)*

11. There are mixed views from AOSSG members. AOSSG members who disagree with the proposal do not think that the proposed accounting for contracts that represent purchases or sales of the underlying asset (in-substance purchases or sales) is necessary.
12. Under the ED proposals, lessors would account for their existing finance leases under the “derecognition approach” or as “in-substance sales” depending on the extent to which risks and benefits are transferred to the lessee and whether control is transferred. Several AOSSG members are concerned as to how one would distinguish between “all but trivial amount of the risks and benefits” and “significant risks or benefits”. This would introduce yet another potentially artificial line between the “derecognition approach” and “in-substance sales”, in addition to the other artificial line between the performance obligation approach and the derecognition approach, which contradicts with the Boards’ objective to remove the complexity in distinguishing between operating leases and finance leases. Thus, these AOSSG members are of the view that it is not necessary to have separate requirements for in-substance purchases or sales as the complexity of distinguishing leases from in-substance sales or purchases outweighs the benefits. In other words, it suffices that lessors and lessees account for all contracts that meet the definition of a lease under lease accounting.

*Criteria for distinguishing a lease from a contract that represent a purchase or sale of the underlying asset*

13. Should the Boards retain the proposal relating to in-substance purchases or sales, some AOSSG members consider that the criteria set out in paragraphs B9 and B10 of the ED for distinguishing such contracts from leases are inadequate. The criteria are rather rules-based and can result in artificial distinctions, for example, the inclusion of a bargain purchase option results in a contract becoming an “in-substance purchase or sale” while inclusion of other bargain clauses, such as bargain renewal clauses in perpetuity would not have the same result.
14. To strengthen the criteria for distinguishing in-substance purchases or sales, these AOSSG members propose that the criteria relating to purchase options should be worded more broadly such that it includes other bargain clauses and other circumstances where an entity is likely to exercise the purchase option. There is also 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. The ED proposes that purchase options (in general) are only accounted for when they are exercised, unlike bargain purchase options which would affect the assessment of whether the contract is an

in-substance purchase or sale. Additional criteria for in-substance sales or purchases should be considered, such as other legal criteria under specific lease agreements.

*“Control” and “all but trivial amount of risks and benefits” criteria*

15. Some AOSSG members have highlighted the importance of unifying the principles in the leases, revenue recognition and consolidation standards. The ED proposes to assess whether “control” and “all but trivial amount of risks and benefits” are transferred so as to determine whether a contract is an in-substance purchase or sale. This suggests that risks and benefits/rewards cannot be decoupled from control. Risks and benefits/rewards will generally derive from control, and thus provide a strong indicator of where that control lies. This is consistent with the tentative decisions reached by the Boards in the joint consolidation project with regards to the interaction between risks and rewards and control. Thus, the Boards should ensure that the interaction between “control” and “risks and benefits/rewards” is reflected consistently in the principles in the final standards for leases, revenue recognition and consolidation.
16. Should the Boards retain the proposal relating to in-substance purchases or sales, some AOSSG members suggest the final standard should 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 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 control. Further illustrations would be useful to distinguish a contract accounted for as an in-substance sale as compared to that accounted for under the derecognition approach for lessor accounting.

*Long-term leases of land*

17. Paragraph BC38 in the Basis for Conclusions on the ED states that long-term leases of land should be within the scope of the proposed IFRS. Most AOSSG members agree with this conclusion as scope exclusions should be based on the nature of the leases rather than arbitrary definitions of lease tenures while a few AOSSG members think that long-term leases of land (in particular, those granted by the state) should be allowed to be treated as in-substance purchases or sales. In certain jurisdictions, the lessee has acquired the right to do a variety of things with the leasehold interests of the long-term land leases just as if these leasehold interests were outright purchases like freehold land. Such leases may be renewed at very nominal amounts and can be extended indefinitely with minimum requirements, provided that the lessee uses the land according to the agreement with the land owner (government). In applying the proposed requirements, the lessee would have to amortise the right of use asset over the lease term with an indefinite extension option. Thus, these AOSSG members would like the Boards to consider expanding the criteria for in-substance purchases or sales to include the indicators discussed above so that certain long-term leases of land (in particular, those leased from the state) may qualify as in-substance purchases or sales. Otherwise, the Boards would need to provide further guidance on the amortisation requirements for such leases.

### **QUESTION 3a: MEASUREMENT OF 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?

18. Majority of the AOSSG members are supportive of the proposal that options to extend or terminate the lease should be taken into account in the measurement of lease assets and liabilities. However, there are mixed views on how the lease term should be determined. Some AOSSG members agree with the ED proposal whilst others support either the most likely approach or the expected outcome approach or an approach that uses a higher probability threshold than the threshold of more likely than not.
19. The rest of the AOSSG members do not agree with the ED proposal and consider that the future liability to pay rentals does not exist unless and until the option is exercised by the lessee. One of these AOSSG members believes that the option, however, meets the definition of an asset and the premium for the option would have been included in the rentals for the initial period. Should the Boards decide to proceed with the proposal to include options to extend or terminate the lease in the measurement of lease assets and liabilities, these AOSSG members propose that optional lease periods be included only when it is reasonably certain that the lessee would exercise the option, e.g. renewal options for which there is no commercial likelihood of non-renewal, and early-termination options that have no commercial effect in practice (additional guidance on the assessment of genuine options would be required in this regard). Alternatively, these AOSSG members suggest that the most likely approach be used to determine the lease term as it 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.

### **QUESTION 3b: MEASUREMENT OF 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).*

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?

20. Most AOSSG members agree that contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of lease assets and lease liabilities (lease payments). However, many AOSSG members express objection to the ED proposal to use an expected outcome technique to measure lease payments. Rather than mandating the use of the “probability-weighted” approach for the measurement of lease payments in all cases, these AOSSG members believe that the Boards should permit the use of the “most likely” approach (particularly in single item or small portfolio situations) if this approach results in more relevant and decision-useful financial information.
21. In a probability-weighted model, 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 statistical method based on possible outcomes and probabilities typically works well for large homogeneous populations, the AOSSG members do not believe that it is generally appropriate for single items or small portfolios as there is often no or insufficient historical data. In many circumstances, the expected outcome approach would not be an appropriate basis for measuring the amount of lease payments and hence would be no more accurate than a most likely rental payment estimate. Therefore, the AOSSG members urge the Boards to permit the use of the “most likely” approach for the measurement of lease payments in order to result in more relevant and decision-useful financial information. It is also important to ensure that the measurement basis that is eventually chosen and applied in the measurement of lease payments is consistent with other uncertain positions across all standards, including IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
22. Although some AOSSG members are agreeable to the use of the expected outcome technique for measuring lease payments, these AOSSG members also question why the approach is not consistent with the proposed “more likely than not” approach to measuring lease renewal options.

#### **QUESTION 4: 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?



23. Most AOSSG members 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 as this essentially represents the termination of the right of use of the asset and the lessee is being granted access to the underlying asset instead.
24. These AOSSG members view such purchase options as fundamentally different from renewal options. A renewal option provides an additional period of a right to use while a purchase option gives access to the underlying asset and terminates the right of use of the asset. These are different in substance and require different accounting. 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.
25. However, some AOSSG members consider that a lessee or a lessor should not account for purchase options only when they are exercised. Providing a purchase option is essentially similar to providing renewals that extend over the entire economic life of the lease; hence the accounting should be similar. The main concern is that the ED proposal might place undue emphasis on legal form instead of substance. To address this concern, these AOSSG members recommend that the final IFRS clarifies that it is the underlying characteristics of the lease (purchase or renewal) option, rather than the terminology used for the lease option, that should be assessed in determining the accounting for the lease option. A lease renewal option that allows renewal of the lease for the entire economic life of the asset would be no different in substance to a lease purchase option.

#### **QUESTION 5: CONTRACTS WITH 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?

26. The majority of the AOSSG members are supportive of the ED proposal that a contract with distinct service and lease components should be split.
27. In a contract where the service component is not distinct from the lease component, most AOSSG members believe that a lessee or lessor should not be required to bifurcate the lease and service components. If the services are truly non-distinct, it is difficult to see how one might be able to bifurcate the service from the lease component. This is in any case inconsistent with the ED *Revenue from Contracts with Customers*, which envisages different non-distinct services being accounted for as a single 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, which uses the same principles as those in the proposed revenue recognition requirements, rather than requiring a lessor that applies the derecognition approach to bifurcate the service and lease components.
28. As currently drafted, the ED presumes that where the service component is not distinct from the lease component, the entire contract has the underlying substance of a lease. Most AOSSG members believe that the lessee or lessor should apply the lease 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.
29. Some AOSSG members note that the ED does not address situations in which a lessor applying the derecognition approach is unable to allocate payments to the distinct services, and have requested that the Boards provide more guidance in this area.
30. Some AOSSG members are concerned that the ED does not go far enough to help entities distinguish between a service contract and a lease. Although some of the guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease* has been included in the ED, these AOSSG members are concerned that the guidance is not sufficiently robust to deal with the variety of service/lease situations that would now be scrutinised due to the removal of the operating lease classification.

#### **QUESTION 6: INVESTMENT PROPERTIES**

*The exposure draft proposes that an entity shall apply the proposed IFRS to investment property that it holds under a lease. However:*

*(a) after initial recognition, a lessee may measure a right-of-use asset in accordance with the fair value model in IAS 40 Investment Property. The lessee shall recognise in profit or loss changes in the liability to make lease payments arising after initial recognition in accordance with IAS 40.*

*(b) a lessor shall apply IAS 40 and not the proposed IFRS to leases of investment properties that are measured at fair value in accordance with IAS 40.*

Do you support the proposed approach? Why or why not?

31. Most AOSSG members are supportive of the proposal that a lessor should apply IAS 40 *Investment Property* rather than the proposed leases standard to leases of investment properties that are measured at fair value in accordance with IAS 40, as this would result in more decision-useful information for the users of the financial statements. However, the ED requires a lessor to apply the proposed leases standard to leases of investment properties that are measured at cost in accordance with IAS 40. These AOSSG members are concerned that the difference in treatment of leases of investment properties would result in the financial statements of entities engaging in the same leasing business becoming incomparable if the entities adopt different cost bases for their properties. Whether the investment property is carried at cost or fair value should not have any bearing on the leasing activity.
32. Accordingly, the majority of the AOSSG members propose to scope out all investment properties (whether accounted for at fair value and at cost) from the proposed lease requirements and to address all issues relating to investment properties under IAS 40. This can be justified on the basis that there is an economic difference between leasing out a long-lived appreciating asset (such as land and buildings) and leasing out a short-lived depreciating asset (such as most plant and equipment). Granting a lessee a right-of-use over short-lived depreciating assets has a significant impact on their residual value, thus it is more reasonable to unbundle the leased asset into the lease receivable and the residual asset, as compared to long-lived appreciating assets.

#### **QUESTION 7: SHORT-TERM LEASES**

*The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined 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?

33. Majority of the AOSSG members express concerns over the extent of relief offered by the narrow definition of short-term leases proposed in the ED. These AOSSG members appreciate that there are many short-term leases of non-core assets with lease term of more than 12 months in practice. Some AOSSG members note that such arrangements are particularly prevalent in leases of long-lived investment properties in their jurisdictions, as these are frequently viewed as “pay as you go” arrangements akin to service contracts. Hence, these AOSSG members urge the Boards to expand the narrow definition of short-term leases proposed in the ED. In this regard, one AOSSG member recommends that the simplified requirements be extended to all leases of non-core assets (i.e. assets that are not a fundamental part of an entity’s business) with lease term of not more than 3 years.
34. The same AOSSG members also express concerns over the extent of relief offered to lessees as lessees would still be required to recognise lease assets and liabilities in their balance sheets at inception of the lease. These AOSSG members are of the view that lessees should be allowed not to recognise assets and liabilities arising from short-term leases on the balance sheet.
35. The above AOSSG members believe that the key criticisms of the existing leases accounting model 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. Accordingly, these AOSSG members think that the pragmatic approaches suggested above should be adopted by the Boards in the final IFRS in order to achieve the Boards’ objective of a cost-benefit balance.
36. Some AOSSG members think that the disclosures requirements for short-term leases for both lessees and lessors should be reduced.

The AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the IASB finds our comments helpful.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely,



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Chairman of the AOSSG



Euleen Goh  
Leader of the AOSSG Leases Working Group



14 December 2010

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UNITED KINGDOM

Dear Sir David,

**AOSSG Islamic Finance Working Group comments on  
IASB Exposure Draft ED/2010/9 *Leases***

The Asian-Oceanian Standard-Setters Group (“AOSSG”) is pleased to provide comments from its Islamic Finance Working Group to IASB ED/2010/9 *Leases*.

***Introduction***

The AOSSG’s Islamic Finance Working Group (“AOSSG IF WG”) was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, Dubai, Indonesia, Korea, Malaysia, Pakistan, and Saudi Arabia.

The working group had mainly discussed ED/2010/9 in the context of transactions and events based on Ijarah.

The comments are additional to the AOSSG Leases Working Group’s comments on IASB ED/2010/9 dated 15 December 2010, and focus only on issues that are specific to Islamic finance. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and has not received any substantial contrary views from AOSSG members.

The working group’s comments are accompanied by a brief overview of Ijarah for the reader to better appreciate its many uses, its similarities and differences with leases, and the related accounting issues.

## ***What is Ijarah?***

- 1 Ijarah can be described as a contract of exchange in which a party transfers the usufruct<sup>1 2</sup> of an item to another party in return for a consideration. Ijarah is sometimes referred to as ‘Islamic leasing’, but this appellation may be somewhat misleading because there are many possible uses for Ijarah, as described below.

### ***Lease***

- 2 Some Ijarah contracts would be straightforwardly and unambiguously leases as it would be understood in conventional finance, for example the conveyance of the right to use of a tangible item such as property, plant or equipment. However, there are Shariah rules that apply to Ijarah that may not necessarily be required of a conventional lease. For example:

- (a) *The underlying Ijarah asset and the usufruct transferred must be specified.*

In Ijarah, the asset must be specified. An arrangement where the asset is not specified at inception would not be considered a valid Ijarah contract. The lessee’s manner of use and purpose of use must also be specified. In addition the asset and the use of it must not be contrary to Shariah. We note that the guidance given in paragraphs B2-B3 for a specified asset would be congruent with Shariah rules.

- (b) *The lessee’s use or enjoyment of the usufruct must not alter or diminish the essence of the item.*

The usufruct of an item does not include consumption of the item because it is necessary for a valid contract of Ijarah that the corpus of the leased asset remains in the ownership of the lessor during the lease itself. For example, conventionally, a lessee’s lease of a fruit orchard may include the right to consume the fruit therein, but some believe that in Ijarah, the lessee’s right to access the orchard may not include a right to consume the fruit, and a sale of fruit from the orchard owner to the lessee would be required. We note the scope exclusion in paragraph 5(b) for leases to use minerals, oil, natural gas and similar non-regenerative resources would be congruent with Shariah rules.

- (c) *The lessor has an obligation to maintain the asset for the lessee’s use.*

Under the classical rules of Shariah, the lessor must bear the risks associated with permanent impairment (for example, a house under Ijarah being destroyed in an

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<sup>1</sup> **usufruct** [yoo-zoo-fruhkt, -soo-, yooz-yoo-, yoos-] –*noun Roman and Civil Law*. The right of enjoying all the advantages derivable from the use of something that belongs to another, as far as is compatible with the substance of the thing not being destroyed or injured. *Origin*: 1620–30; < LL *ūsūfructus*, equiv. to L *ūsū*, abl. of *ūsus* (use (n.)) + *fructus* (fruit)  
(Source: “usufruct”, *Dictionary.com Unabridged*, Random House, Inc. Available on <http://dictionary.reference.com/browse/usufruct>, accessed 2 December 2010.)

<sup>2</sup> For the purposes of this letter, the words “usufruct” and “right-to-use” are used interchangeably.

earthquake); and, in the case of such impairment, the lessor must either offer the client a similar asset to use for the remainder of the contract or refund part of the lease rental. The lessor must also bear major repair costs. There are differing views as to whether these responsibilities can be transferred in whole or in part to the lessee.

### ***Service***

- 3 Ijarah can be used to engage for services such as maintenance, consultancy, etc. as well as services ancillary to a lease of an item.

### ***Employment***

- 4 Linguistically, payment of wages to a person for their employment could also be deemed Ijarah.

### ***Intangible rights***

- 5 The underlying asset need not necessarily be something that is tangible. Ijarah can also be used to convey the right to a patent, copyright, trademark or other rights over a period in return for consideration.

### ***Ijarah Muntahia Bittamleek (Ijarah ending with ownership)***

- 6 Ijarah Muntahia Bittamleek (sometimes referred to as Ijarah Wa Iqtina) is Ijarah accompanied by an arrangement to convey ownership of the asset to the lessee by, or at, the end of the lease. In some jurisdictions, the arrangement may be similar to a hire purchase transaction where title passes to the lessee at the end of the hire with only some minimal formality. However, not all Shariah scholars agree with this method of conveying ownership because of a Shariah prohibition that two agreements, e.g. hire and purchase, cannot take place within one contract. The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) in its Financial Accounting Standard 8 (FAS 8) *Ijarah and Ijarah Muntahia Bittamleek* recommends the following four ways to transfer ownership of an asset in Ijarah Muntahia Bittamleek:
  - (a) Transfer through gift
  - (b) Transfer through sale for a token consideration or other amount as specified in the lease
  - (c) Transfer through sale prior to the end of the lease term for a price equivalent to the remaining Ijarah instalments
  - (d) Transfer through gradual sale of the leased asset

It may be noted that at the inception of the Ijarah, the arrangement to transfer ownership is not contractual, but usually takes a form of *wa'd*, or a unilateral promise – either the lessor would promise to sell the underlying asset to the lessee, or the lessee would promise to buy the underlying asset from the lessor. Although some question whether *wa'd* creates a legal obligation in the way conventional options do, the majority view is that it does in circumstances where the promisee would suffer loss as a result of failure to fulfil the promise. At the very least, it could be said that there would be a constructive obligation on the part of the promisor.

- 7 Ijarah Muntahia Bittamleek may be used to approximate what in the conventional world would be financing transactions. For example, in a car financing or a mortgage, the bank may buy the asset and lease it to the customer, with an option for the customer to buy it in one of the ways set out above.
- 8 In jurisdictions that follow an AAOIFI financial reporting framework, the Ijarah and the transfer of ownership are accounted for as separate transactions, and are not deemed as linked transactions. Thus, Ijarah Muntahia Bittamleek may not be deemed to be an in-substance sale or purchase of the underlying asset. [See paragraph 46, 'AAOIFI requirements' for further explanation.] Moreover, the current drafting of the ED may also result in some Ijarah Muntahia Bittamleek not being recognised as a sale or purchase, despite the fact that it is an arrangement to transfer ownership by or at the end of the lease. [See paragraphs 24-29 for further explanation.]

### ***Sukuk Ijarah***

- 9 Sukuk is the plural of sakk, which is Arabic for a legal document, cheque, or deed. In current usage, sukuk commonly refers to a financial instrument that purportedly represents a proportional ownership in an asset or business venture along with the cash flows and risks associated with that ownership. Sukuk is often likened to bonds or securitisation, and can either be asset-backed or 'asset-based', i.e. the cash flows are referenced to an underlying asset but the sukukholder does not have recourse to the underlying asset.
- 10 In accordance with Shariah requirements, sukuk must be based on permissible contracts. AAOIFI describes 14 types of sukuk structures, one of which is Sukuk Ijarah. There are variations among individual structures, but the basic mechanism of Sukuk Ijarah involves an entity selling an asset through a special purpose entity ("SPE"), which in turn would collect the sale proceeds from investors, and issue sukuk to represent the investors' proportional ownership in the asset. The asset is then Ijarah to the originating entity, and the investors, called 'sukukholders', would receive periodic Ijarah rentals. Note that in some cases the asset transferred may itself be a usufruct, and it may be possible for Sukuk Ijarah to take the form of a long lease and a shorter leaseback. For example, an originator may grant a 50-year lease to the SPE, and then take a 5-year lease from the SPE. At the end of the sale and leaseback



(or lease and leaseback), the originating entity would repurchase the asset from the sukukholders.

- 11 In a typical Sukuk Ijarah structure, the basic Ijarah contract is supplemented by several other contracts which enable the economic substance to approximate more closely to a conventional bond. A recent manual on sukuk structuring indicates 5 additional agreements that would normally be present, in addition to those required to establish a trust structure for the SPE.

### *Accounting issues relating to Ijarah*

- 12 This ED is an important one from the standpoint of Islamic finance, because of the frequent use within Islamic finance of the Ijarah contract. As explained in earlier paragraphs, the concept of Ijarah is wider than that of leasing and can, for example, be applied to contracts for service and employment. The ED therefore appears to apply only to a subset of Ijarah contracts.
- 13 However, due the current drafting of the ED, there are some Ijarah transactions – in particular, Ijarah Muntahia Bittamleek - for which clarification is needed as to how they would be treated under the ED. In answering the questions posed in the ED, the working group had focused primarily on issues specific to Islamic finance, and our answers comprise explanations of those issues.

### *Q1: Lessees*

- 14 The ED's requirement for a lessee to recognise a right-of-use asset and a liability to make lease payments would more appropriately reflect the rights and obligations of a lessee in Ijarah.
- 15 The current IAS 17's 'bright line' distinction between operating and finance leases has caused much consternation among preparers, users and standard-setters involved in Islamic finance. The finance lease classification was largely thought to be inappropriate for Ijarah because it would ignore the lessor's ownership of the underlying asset and the obligations related to that ownership, as well as being presented similar to interest-based borrowings. Thus some in the industry had preferred to classify Ijarah as operating leases to give cognisance to the lessor's retention of ownership. However, the operating lease classification had the unwanted effect of ignoring the lessee's right-of-use, which under Shariah would be an asset in itself; as well as obscuring the lessee's obligation for making lease payments. In addition, the presence of side agreements to a base Ijarah contract meant that many transactions, when considered as a whole, hover close to the boundary between operating and finance leases, forcing judgement calls as to their treatment. The ED is thus helpful in removing the distinction between a finance lease and an operating

lease, which has been a source of difficulty in Islamic finance, and introducing a single lease accounting model.

- 16 The working group has no objection to the lessee amortising the right-to-use asset. However, there may be some resistance by some to the recognition of ‘interest’ on the liability to make lease payments. We believe that some may prefer to present an item of ‘pure rental’ without reference to any interest rate. Others have suggested the use of more congenial terminology in describing references to rates of return.

***Q2: Lessors***

- 17 Under the classical rules of Ijarah, the lessor would have a duty to maintain the usufruct of the asset for the benefit of the lessee. This would include responsibility for major maintenance, and for replacing the asset if it could not provide the usufruct contracted to the lessee. These obligations could be regarded as evidence of the lessor retaining "exposure to significant risks and benefits associated with the underlying asset".
- 18 In some jurisdictions it may be possible to vary the classical terms of an Ijarah contract such that costs related to responsibilities usually held by the lessor are instead paid for by the lessee. For example, the Shariah Advisory Council of Bank Negara Malaysia (“BNM SAC”) allows this arrangement on the basis that:
- (a) a lessee may pay for such costs on behalf of the lessor, and subsequently these costs would be deducted from the selling price when the underlying asset is sold to the lessee at the end of the Ijarah (i.e. in an Ijarah Muntahia Bittamleek contract); and
  - (b) it is permissible for a contracting party to waive the other’s obligations towards the first party, where there is mutual agreement.

Moreover, from a consumer viewpoint, this results in cheaper pricing. In these circumstances, one could clearly conclude that the lessor has transferred all significant risks or benefits associated with the underlying asset to the lessee. Most Middle Eastern jurisdictions, however, would not permit the classical terms to be varied in this way, and they may be adjudged to retain significant exposure in the terms of B22-B27 of the ED.

- 19 However, some lessor entities may take on the responsibility for maintenance of the underlying asset but factor in the expected costs into the rental rates or, in the case of Ijarah Muntahia Bittamleek, into the sale price at the end of the Ijarah. Staff of the Malaysian Accounting Standards Board (“MASB”) believe that passing on the costs to the lessee may be an indirect transfer of risks and rewards from the lessor to the lessee. Staff of the Dubai Financial Services Authority (DFSA”), however, do not believe that charging higher rental or a higher purchase price represents a transfer of

risks and rewards - rather it is compensation for retaining them - unless the higher price is explicitly linked to the costs actually incurred.

- 20 It seems that while the ED has succeeded in a more appropriate treatment for Ijarah lessees from a Shariah perspective, the proposed treatment for lessors has received a mixed reception. Some industry practitioners have lauded the IASB's proposed two approaches for lessor accounting. We note that their reasoning is somewhat similar to paragraphs BC25 and BC27 of the ED's Basis for Conclusions.
- 21 Working group members believe that there is merit in applying a single approach to lessor rather than introduce a new area of subjective judgement about how far risks and rewards have actually been transferred. Not only has the ED has not removed the 'bright line' distinction of whether a lessor's risks and rewards have been transferred, it has also substituted the examples and indicators in paragraphs 10-11 of IAS 17 for making that distinction with new factors in paragraphs B22-B27 that may result in markedly different conclusions as to whether a lessor has retained significant risks and rewards.
- 22 Moreover, for many of the Ijarah contracts where the lessor transfers risks and rewards, they are likely to be classified as sales. This means that there will be relatively few contracts to which the derecognition approach would apply. Thus, there is some debate within the industry as to whether the derecognition approach is worth retaining. Some, as described in paragraph 20, believe there is a sufficient difference in economic substance to justify maintaining two different lessor accounting treatments. Others believe that there is merit in applying a single approach to lessor accounting rather than introduce a new area of subjective judgement about how far risks and rewards have actually been transferred. On balance, working group members prefer the second position, which will allow a greater degree of comparability.

***Q3: Short-term leases***

- 23 [The working group has not identified any issues specific to Islamic finance to date.]

***Q4: Definition of a lease***

- 24 The definition of a lease given in the ED accords with the usual description of Ijarah. However, paragraph 8 and the Application Guidance would mean that some types of Ijarah would fall within the scope of the ED, and others, such as Ijarah for employment, would not. There are also some Ijarah contracts for which the case requires further clarification – in particular, Ijarah Muntahia Bittamleek.
- 25 Ijarah Muntahia Bittamleek is Ijarah accompanied by an arrangement to transfer ownership of the underlying asset by or at the end of the lease. If such a transaction is

to be construed as a contract that represents, in substance, a purchase or sale of an underlying asset, instead of a lease, then the current wordings of paragraph 8 and paragraphs B9-B10 may not effectively convey that point.

26 Paragraphs 8 and B9 characterises a contract that represents a purchase or sale as one where “all but a trivial amount of the risks and benefits” are transferred to another entity. In many Ijarah Muntahia Bittamleek transactions, the lessor would bear much of the maintenance costs, insurance etc related to the underlying asset throughout the Ijarah period, thus the risk and rewards remaining with the lessor are far from ‘trivial’.

27 We note that paragraph B10 requires an entity to consider all relevant facts and circumstances when determining whether control of an underlying asset is transferred. However, paragraph B10 also states that control is transferred when the contract:

(a) automatically transfers title to the underlying asset at the end of the contract term; or

(b) includes a bargain purchase option

In Ijarah Muntahia Bittamleek, there are five ways to convey ownership in the underlying asset – none of which is ‘automatic’ but would require formally entering into a sale and purchase contract, or at the very least some formalities related to transfer of title. Additionally, in at least two of the five methods of transfer, the sale is not transacted at a ‘bargain’ price, but the cash flows from the Ijarah and sales transactions as a whole amounts to substantially all of the fair value of the leased asset. Thus, paragraph B10, as currently worded may allow some Ijarah Muntahia Bittamleek contracts to be within the scope of this ED, instead of another more appropriate standard e.g. as a sale under IAS 18 or financing under IAS 39 / IFRS 9.

28 In this instance, the wording of the current paragraphs 10(a) and 10(d) of IAS 17 for a finance lease may be better than the wordings of paragraph B10 to describe a transaction which is, in substance, a sale and purchase, i.e.

- “the lease transfers ownership of the asset to the lessee by the end of the lease term”; and
- “at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset”.

29 We thus consider that many transactions based on Ijarah, but used to finance a purchase, ought under the ED to be treated as contracts of sale. However, the main point in the present context is that this is likely to give rise to many difficult judgement calls on the extent to which risks have been transferred. We should, at minimum, like to see much more guidance on how such calls should be made. Additionally, however, their treatment under the revenue standard is likely to pose a number of questions for that standard. As with other Islamic contracts, decomposition into a sale and a financing component will be unacceptable to some, and there will be

issues about the timing of revenue recognition. We hope to offer further comments on this in due course.

***Q5: Scope exclusions***

30 As mentioned in paragraph 2(b) above, the exclusion of leases to use minerals, oil, natural gas and similar non-regenerative resources in paragraph 5(b) would be congruent with Shariah rules on Ijarah.

***Q6: Contracts that contain service components and lease components***

31 [The working group has not identified any issues specific to Islamic finance to date.]

***Q7: Purchase options***

32 The ED proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase when the purchase option is exercised. This may be problematic for Ijarah Muntahia Bittamleek arrangements where there is a ‘gradual sale and purchase’ of the underlying asset. Should the contract be further stratified into individual sub-contracts of leases and sales and purchases?

33 An additional, though secondary, issue is how to account for the options for early termination within such a contract. This will be most significant where the contract is used to approximate a conventional mortgage, because it is quite likely that over the period the client will opt to move house, and therefore exercise the option. However, to assess the period over which the contract is more likely than not to run implies taking a view on residential (or commercial) mobility over, say, a 20-year period. The practicality of this is arguable.

***Q8: Lease term***

34 [The working group has not identified any issues specific to Islamic finance to date.]

***Q9: Lease payments***

35 [The working group has not identified any issues specific to Islamic finance to date.]

***Q10: Reassessment***

36 [The working group has not identified any issues specific to Islamic finance to date.]

***Q11: Sale and leaseback***

- 37 Sukuk Ijarah commonly takes the form of a sale and leaseback and would therefore be treated in accordance with paragraphs 66-69 of the ED. They are often accompanied by a repurchase agreement. Most such transfers will not meet the conditions for being treated as a sale. (See in particular paragraph B31 of the ED.) The transferor must therefore account for the contract as a financing and may not derecognise the asset. This is entirely justifiable in terms of the economic substance of the transaction, and in such an example, involving multiple contracts, it would be very difficult to argue for a "form over substance" approach in which each of these contracts is treated separately.
- 38 As mentioned in paragraph 10, some sukuk transactions take the form of a (long) lease and (shorter) leaseback. The ED should be extended to deal with such transactions. In principle, there is no reason why these too should not be treated as financings, and it would be anomalous if that were not the case.

***Q12: Statement of financial position***

- 39 Some would prefer presenting a lessee's right-of-use asset as an item of intangible asset. Although not accounting in nature, classical *fiqh* texts do discuss the differences between ownership of usufruct and ownership of tangible items.

***Q13: Statement of comprehensive income***

- 40 [The working group has not identified any issues specific to Islamic finance to date.]

***Q14: Statement of cash flows***

- 41 The requirement in paragraph 27 of the ED for a lessee to classify cash payments for leases as financing activities may be inappropriate as it would mean that payments for office equipment which are clearly to support the day-to-day operations of an entity would be confused with financing payments for e.g. business expansion, etc. It may be better if the lease payments are classified according to what the item is used for, therefore not eliminating the possibility of classifying the lease as an operating activity.

***Q15: Disclosure***

- 42 [The working group has not identified any issues specific to Islamic finance to date.]

***Q16: Transition***

- 43 [The working group has not identified any issues specific to Islamic finance to date.]

***Q17: Benefits and costs***

44 [The working group has not identified any issues specific to Islamic finance to date.]

***Q18: Other comments***

*Terminology*

45 The language applied to the ED uses terms like ‘effective interest’ which will be problematic in Islamic finance. We note the much more inclusive language of ED/2010/8 *Insurance Contracts*, in which that ED’s paragraph 31 refers to a discount rate which shall reflect "the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk."

*AAOIFI requirements*

46 We would like to highlight to the IASB that the ED’s proposals are significantly different from the requirements of AAOIFI accounting standards in which all Ijarah are treated as operating leases. Moreover, AAOIFI requires Ijarah Muntahia Bittamleek to be accounted for as separate transactions of an operating lease followed by a disposal, the accounting treatment of which would depend on the mechanism of transferring ownership, as follows:

<i>Transfer through gift</i>	“Leased assets shall be depreciated according to the lessor’s normal depreciation policy for similar asset. However, no residual valued of leased assets shall be subtracted in determining the depreciable cost of these assets since they are to be transferred to the lessee as a gift.” [AAOIFI FAS 8, paragraph 27]
<i>Transfer through sale for a token consideration or other amount as specified in the lease</i>	“...The consideration for the transfer of title in a leased asset at the conclusion of a lease (i.e., the asset’s residual value to the lessor) shall be subtracted in determining the depreciable cost of these assets. “[AAOIFI FAS 8, paragraph 34]
<i>Transfer through sale prior to the end of the lease term for a price</i>	“Legal title shall pass to the lessee when he buys the leased assets prior to the end of the lease term for a price that is equivalent to the remaining Ijarah instalments and the lessor shall recognize any gain or loss resulting from the difference between the selling price and the net book value. [AAOIFI

<i>equivalent to the remaining Ijarah instalments</i>	FAS 8, paragraph 44]
<i>Transfer through gradual sale of the leased asset</i>	<p>“The book value of the sold portion of the asset shall be removed from the leased assets account and the lessor shall recognise in its income statement any gain or loss resulting from the difference between the selling price and the net book value.” [AAOIFI FAS 8, paragraph 49]</p> <p>“Upon the full payment of both the Ijarah instalments and the price of the purchased portion of the leased assets, all Ijarah related accounts shall be closed.” [AAOIFI FAS 8, paragraph 52]</p>

*Treatment for Ijarah Muntahia Bittamleek*

- 47 In an ideal world, we would propose a treatment of Ijarah Muntahia Bittamleek and similar transactions which would go back to first principles and analyse the cash flows and the uncertainties associated with them, and propose a treatment which does not depend on decomposition into conventional contracts. This would also deal with the issues on the revenue standard. We should be prepared to assist the IASB in producing such a treatment if it so wished.

*Guidance in SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

- 48 We note the ED proposes to supersede SIC-27 once the lease standard is issued. However, much of the guidance in SIC-27 may be useful in deriving at the appropriate accounting treatment for Ijarah Muntahia Bittamleek and Sukuk Ijarah - in particular, its consensus in paragraph 3 that:

*“A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence.”*

The guidance would assist in determining whether an Ijarah transaction, or an arrangement which includes an Ijarah transaction, would meet the definition of a lease and fall within the scope of a standard on leases, or otherwise, e.g. a sale within IAS 18, or a financial instrument within IAS39/IFRS 9. As such we would like the IASB to consider retaining SIC-27, or transfer its guidance into the eventual lease standard.



### *Regulatory requirements*

- 49 Many Ijarah lessors are financial institutions, which are subject to capital adequacy requirements. If the financial institution is deemed to have retained significant risks and rewards, the ED proposes applying the performance obligation approach, and it may not be able to derecognise the assets in question. This may have highly adverse effects on their capital adequacy treatment. However, many of the leases in question would probably, under the ED, be treated as sales. The issues which this raises are dealt with under Q4.

### ***Conclusion***

- 50 We hope the IASB would give due consideration to all the points raised in this comment letter. However, in summary, the two main issues where we would like to see substantial improvements on are as follows:

#### *Distinguishing between a lease and a purchase or sale*

- 51 Given the specificities of Ijarah Muntahia Bittamleek, we urge the IASB to reconsider the guidance given in paragraphs B9-B10 for distinguishing between a lease and a sale or purchase of the underlying asset, because as currently drafted, some Ijarah Muntahia Bittamleek transactions may not be classified as a sale or purchase, even though the economic effect of the transaction is to eventually transfer ownership to the lessee.
- 52 We also urge the IASB to reconsider the parallel guidance in paragraph B31 on when a transaction should be dealt with as a purchase or sale, rather than a lease.

#### *Lessor accounting*

- 53 With regards to lessor accounting, we would like the IASB to reconsider whether it is necessary to have two lessor accounting approaches which would depend on the transfer of risk and rewards, because retaining the 'bright line' distinction would require subjective judgement which would not improve comparability, and is not congruent with the objective of a single lease accounting model. Moreover, given that many Ijarah that transfer risks and rewards to the lessee may be in substance sales, maintaining the derecognition approach may be superfluous.
- 54 However, if the IASB decides to maintain two lessor accounting approaches, we would like the IASB to consider whether the indicators and examples currently given in paragraphs 10-11 of IAS 17 may be more appropriate than the guidance given in paragraphs B22-B27 of the ED in determining whether a lessor has transferred significant risks and rewards.

55 Additionally, since there was not much discussion of lessor accounting in IASB's earlier documents on leases, and it is only in this ED that the specificities are detailed to readers for the first time, we would like to propose that further discussions be held with constituents on the matter before the IASB arrives at a conclusion.

We thank you for this opportunity to express our concerns, and hope that you would give due consideration to our comments. The Working Group would be pleased to assist the IASB in considering these matters, and if you have any queries regarding this submission, please feel free to contact us.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'M. Azmi', with a stylized flourish at the end.

Mohammad Faiz Azmi  
Leader of the AOSSG Islamic Finance Working Group