4 October 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Hans

AOSSG comments on Exposure Draft ED/2013/6 *Leases*

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on the Exposure Draft ED/2013/6 *Leases* (the ED). In formulating its views, the AOSSG sought the views of its constituents within each jurisdiction.

The AOSSG currently has 26 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, Syria, Thailand, Uzbekistan and Vietnam.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Each member standard-setter 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. 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 continues to firmly support the IASB's efforts to develop a new lease accounting model that would require the recognition of assets and liabilities arising from lease contracts by lessees, rather than retaining the existing requirements in IAS 17 *Leases* and supplemented by additional disclosures. In particular, the AOSSG strongly supports a right-of-use model that requires lessees to recognise lease assets and liabilities for most leases, including current operating leases under IAS 17. Most AOSSG members also broadly support a dual lease accounting model that is based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset (the 'more than insignificant' consumption classification principle). Furthermore, the AOSSG appreciates the significant efforts made by the IASB to address constituents' concerns over the complexity and subjectivity of the previous lease accounting model that was proposed in the Exposure Draft ED/2010/9 issued in August 2010.

Notwithstanding the above, the AOSSG has significant concerns about certain aspects of the dual lease accounting model that is proposed in the ED, which are perceived as lacking conceptual merits and not providing decision-useful information about the rights and obligations arising from the lease arrangements. A number of AOSSG members are also concerned with the overall complexity of the proposals, including the use of significant judgement in lease classification, the number of different accounting models for both lessees and lessors, and the proposed lessee accounting for Type B leases and lessor accounting for Type A leases.

Whilst most AOSSG members support the 'more than insignificant' consumption classification principle, they have diverse views on how this classification principle is proposed to be applied. Some AOSSG members support the proposed classification criteria that are based on the nature of the underlying asset, but most others are concerned that the different criteria are rule-based and conflicting, and could result in outcomes that are inconsistent with the classification principle. There are a few other AOSSG members that support either a single lease accounting model or a lease classification that is based on the extent of the volatility of the value of the residual asset retained by the lessor.

Furthermore, AOSSG members have diverse views on the dual lease accounting model that is proposed in the ED. On lessee accounting, most AOSSG members support the proposed right-of-use model for Type A leases but many members have significant concerns about the proposed accounting for Type B leases. These members can accept either an approach similar to the operating lease accounting under IAS 17 for Type B leases, provided that the proposed classification criteria are refined, or a single measurement model that is based on the proposed Type A accounting for all leases. On lessor accounting, most AOSSG members generally support the proposed accounting for Type B leases, but some members either disagree with the recognition of day-one gain on the lease or the accretion of the residual asset for Type A leases as proposed in the ED, or support a variant of the proposed Type A lessor accounting that includes expected variable lease payments in the measurement of lease receivables and to permit residual assets to be measured at, or accreted to, fair value.

The AOSSG is also concerned with the excessive disclosures proposed in the ED, some of which could be unduly costly without significantly improving the usefulness of financial information.

Our views in relation to the proposals in ED/2013/6 are explained in more detail in Appendix A. The views of the AOSSG Islamic Finance Working Group on issues specific to Islamic finance are outlined in Appendix B.

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

Yours sincerely,

Kevin M. Stevenson
AOSSG Chair

Michael Lim
AOSSG Leases Working Group Leader

Appendix A
AOSSG detailed comments on ED/2013/6 Leases

Question 1: Identifying a lease
This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether: (a) fulfilment of the contract depends on the use of an identified asset; and (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

1 AOSSG members generally agree with the proposed definition of a lease and the proposed requirements to determine whether a contract contains a lease. Most AOSSG members believe that the proposals would enable a lease to be distinguished from a service or a sale transaction, to which different accounting would apply. In particular, one AOSSG member believes that the importance of the distinction between leases and other contracts should not be underestimated, and that the definition of a lease should be suitably robust to ensure that the perceived differentiation is the end result when the final Leases IFRS is operationalised and adequate guidance should be provided to appropriately draw this distinction.

2 AOSSG members also support the consistent use of the 'control' principle across different IFRSs, including the proposed new Revenue IFRS and IFRS 10 *Consolidated Financial Statements*. However, some AOSSG members suggest that it would be useful if the IASB could develop additional guidance on the 'control' principle in areas such as the practical substitutability of assets (e.g. applying the criterion to remote assets such as assets associated with some mining operations, as there is concern that an entity could fall outside the scope of the ED by permitting substitution of assets with no intention or practical ability to do so), the specified capacity of an asset (e.g. specified time slots to use a rail line), take or pay arrangements (e.g. when operating protocols are established upfront and decisions are pre-determined), and the principal/agent guidance in IFRS 10.

3 Some AOSSG members disagree that a capacity portion of an asset that is less than substantially all of the asset's capacity cannot be an identified asset, and therefore a lease of a capacity portion of an asset would be outside the scope of the ED. These

members disagree with paragraph BC105(c) of the Basis for Conclusions, and understand that in some arrangements (e.g. capacity portion of a fibre-optic cable), the customer has the right to control the use of that capacity (i.e. has the ability to direct the use and obtain the benefits from its use, including restricting the access of others to those benefits), even if it is less than substantially all of the capacity of the asset. In such situations, a lease of a capacity portion of an asset does not appear to be economically different from a lease of a physically distinct portion of an asset (e.g. a specific unit in a building). Accordingly, these members recommend that the IASB reconsider and develop guidance on whether and when a capacity portion can be an identified asset.

Allocating consideration to components of a contract

4 Some AOSSG members raise concerns about the proposal for *lessees* to account for the entire contract as a single lease component when there are no observable stand-alone prices for any components of the contract. These members observe that the proposal appears to presume that all such contracts are in-substance lease contracts, which may not always be true. Hence, these members suggest that the IASB require the lessee to account for such contracts based on the nature of the primary component in the contract (i.e. when the non-lease component is regarded as the primary component, the entire contract would be accounted for as a service contract and vice-versa).

Scope for transactions that are in-substance purchase or sale of underlying assets

5 Some AOSSG members believe that it is unclear whether an in-substance purchase or sale of assets would be within the scope of the ED, and that there is a lack of guidance on how to distinguish such transactions from lease transactions. These members consider the distinction to be important due to the different presentation, disclosure and impairment requirements. Specifically, one member suggests preserving the guidance in IAS 17 *Leases* on 'finance leases' (including 'bargain purchase options') as the basis for distinguishing in-substance purchase/sale of assets and to provide guidance on the accounting treatment for these transactions.

Scope for transactions that are in-substance collateralised borrowings

6 One AOSSG member asks for clarification of the scope for transactions that are in-substance collateralised borrowings, such as hire purchase transactions. In typical hire purchase transactions, the hirer hires the underlying asset with an option to purchase from the owner (the financier, which is normally a bank) by paying scheduled instalments to the owner, and the ownership of the underlying asset would be transferred to the hirer after all instalments have been paid. This member considers that these transactions are not leases and should not be accounted for as such, and suggests that the IASB provide guidance on distinguishing lease contracts from a collateralised borrowing transaction.

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?

Overview

7 Most AOSSG members agree that there are fundamentally two different types of leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, and hence, *in principle* support a dual lessee accounting model to reflect the differing economic substance of these different types of leases.

8 However, these AOSSG members have diverse views on the dual lessee accounting model proposed in the ED. An overview of the broad views of these members is set out below:

- View 1: Most of these AOSSG members support the proposed right-of-use (ROU) model for Type A leases, but have significant concerns about the proposed accounting for Type B leases, although they appreciate that a single straight-line lease expense provides better information for some Type B leases. In particular, these members are concerned with the proposed amortisation method for ROU assets that is linked to the finance cost of lease liabilities and results in an increasing amortisation charge over the lease term that does not reflect the pattern in which the economic benefits embedded in the ROU asset are consumed. These members have the following differing views on how their concerns could be overcome or mitigated:

  - View 1A: Most members can accept an approach similar to operating lease accounting under IAS 17 for Type B leases, provided that the lease classification criteria proposed in the ED are refined.

  - View 1B: Others can accept a single measurement model that is based on the proposed Type A lessee accounting for all leases.

- View 2: One of these AOSSG members agrees with the dual lessee accounting model proposed in the ED, whilst another can accept the proposed model, but has concerns with the application of a form of ROU model to *all* leases (other than short-term leases). In particular, this member observes that it is common for contracts that contain a lease to also include service components. In cases where it is operationally difficult to discern service from lease components, applying the ROU model could result in the recognition of an asset and a liability for the service components. Furthermore, the proposals would require the lessee to capture the transfer of the right to control the use of the underlying asset, even if the lease term is relatively short as compared to the economic life of the underlying asset. This member thinks that it is unclear whether the benefits to users would outweigh the costs of applying the ROU model, and suggests that consideration be given to refining the scope of lease transactions to which the ROU model should be applied.

9 A few AOSSG members however strongly support a single lessee accounting model that is based on the proposed accounting for Type A leases. One of these members believes that the fundamental economics of a lease – obtain a ROU asset in exchange for an obligation to make lease payments – do not vary depending on whether a lessee consumes more than an insignificant portion of the underlying asset. This member considers that all leases include a financing element and the expected extent of consumption of the underlying asset by the lessee merely affects the risk borne by the lessor, which is most appropriately reflected in the finance charge included in the lease payments. This member is also concerned that a dual approach to lessee accounting is unnecessarily complex and at odds with an important objective of the Leases project, which is to create a single accounting model for all leases, and has the potential to reduce comparability and transparency of information about lease arrangements. Another member believes that a single ROU model, which is based on the proposed accounting for Type A leases, would result in a more workable model that would reflect the economic substance of a variety of lease arrangements that arise in practice, without being overly complex or costly to apply and providing significant structuring opportunities. In particular, this member has significant concerns with the complexity of the proposals, including the use of significant judgements in lease classification, and the introduction of a new measurement method for Type B leases that is not applied in other IFRSs and appears to lack clear conceptual rationale.

Type A leases

10 AOSSG members generally agree with the proposed lessee accounting for Type A leases. We believe that the accounting would faithfully represent the ROU asset that the lessee has acquired and the related financing, and result in comparable outcomes with other asset acquisition and financing arrangements.

Type B leases

11 Most AOSSG members are deeply concerned about the accounting outcome that results from the proposed lessee accounting for Type B leases that is widely perceived to be a compromised solution in order to bring all lease assets and liabilities onto the balance sheet of lessees. These AOSSG members believe that the recognition of a single straight-line lease expense is fundamentally at odds with the principles underlying a ROU model. Although the proposed measurement of ROU assets is the only possible outcome to achieve a straight-line lease expense whilst measuring the lease liability at amortised cost, it is highly doubtful that such an accounting would produce understandable and decision-useful information.

12 The concerns of these AOSSG members are further elaborated below:

- The proposed amortisation of the ROU asset in a way that is dependent on the financing costs incurred on the lease liability, and effectively results in increasing amortisation over the lease term, does not faithfully capture the depletion of economic benefits embodied in the ROU asset and is inconsistent with the requirements of the *Conceptual Framework* and existing IFRSs.

- The arbitrarily amortised ROU asset balance does not reflect the economic benefits embedded in the asset and is therefore inconsistent with the definition of an asset in the *Conceptual Framework*.

- There is a lack of clarity as to how the arbitrarily amortised ROU asset balance would interact with other requirements in the ED, including applying the revaluation or fair value approach to ROU assets and the impairment testing requirements. For example,

  - The resulting revaluation gains or impairment losses are not always represented by actual increase in, or loss of, economic benefits embedded in the ROU asset.

  - It is unclear whether the ROU asset is potentially exposed to impairment in earlier periods due to the relatively lower level of amortisation in earlier periods.

  - For ROU assets that are measured using the fair value model, it is unclear how the proposal to recognise a single straight-line lease expense can be achieved, or how the accretion of the lease liability ought to be reflected in profit or loss, since technically the ROU asset is no longer subject to amortisation.

- The proposed accounting introduces a new class of 'amortised cost' financial liability, the accretion of which does not give rise to interest cost.

- The proposed accounting would result in both the lessee and the lessor recognising the same asset which is inappropriate.

13 Accordingly, majority of these AOSSG members suggest the following alternative lessee accounting for Type B leases:

(a) An approach similar to the current operating lease accounting

(b) A measurement model is that based on the proposed accounting for Type A leases

14 Amongst those AOSSG members mentioned in paragraph 13 above, most can accept an approach similar to current operating lease accounting, provided that the proposed lease classification criteria are refined, such as applying the 'more than insignificant' consumption classification principle consistently to both property and non-property leases (see comments under question 4 for further details).

15 Most of these members can accept the off-balance sheet treatment for some leases on cost-benefit considerations since the impact is likely to be contained – for depreciable assets, only shorter-term leases would be affected; for land, it is uncommon for economic reasons to structure such leases for relatively short periods without renewal options (e.g. the significant costs and long useful life of building(s) that would be constructed on the leased land would discourage entities from leasing the land for a relatively short period). Together with the enhanced disclosures as proposed in the ED, this accounting model would not impair the decision-usefulness of financial statements. Furthermore, this approach is symmetrical to the proposed lessor accounting for Type B leases. In particular, if the lessor continues to recognise the underlying asset, it would

be counter-intuitive for the lessee to recognise a ROU asset because both parties would claim to have some form of control over the same asset, given that control is the key criterion in the definition of an asset and a prerequisite for the existence of a ROU asset.

16 Another member views the proposed dual measurement model as an indication that the ROU model may not fit all lease arrangements. Specifically, this member believes that an approach similar to the current operating lease accounting reflects the lessor's business model for Type B leases – generate cash flows from the underlying asset by managing the asset over a period typically longer than one lease term rather than to provide financing to the lessee – and the same accounting treatment should be applied by the lessee. Accordingly, this member suggests excluding Type B leases from the scope of the final Leases IFRS.

17 Other AOSSG members mentioned in paragraph 13 above can accept a measurement model that is based on the proposed accounting for Type A leases. These members view the recognition of lease asset and liability for all leases by lessees as the most important accounting outcome, and taking into consideration the conceptual issues and complexities of the proposed Type B lessee accounting, are prepared to accept a single measurement model for all leases, notwithstanding the differing economics of the two different types of leases.

Measurement of ROU assets

18 For ROU assets that meet the definition of, and are classified as, inventories (e.g. leasehold land that is used to develop properties for sale in the ordinary course of business), some AOSSG members note that it is unclear how the proposal to measure the ROU asset at cost less accumulated amortisation and impairment would interact with IAS 2 *Inventories*, which requires inventories to be measured at the lower of cost and net realisable value. One could interpret that (i) IAS 2 would be the applicable standard once the ROU asset meets the definition of inventories, i.e. the ROU asset is capitalised as inventories once development commences, or (ii) the ROU asset is merely a resource necessary to bring the inventories to their present location/condition and is capitalised as cost of inventories as and when it is amortised in accordance with the ED. To avoid potential diversity in practice, these members suggest that the IASB make it clear in the final Leases IFRS that ROU assets should be accounted for in accordance with IAS 2 once they meet the definition of inventories.

19 For ROU assets arising from leased assets that meet the definition of property, plant and equipment (PPE) and investment property (IP), one AOSSG member notes that the ED permits revaluation for the former, but requires fair value accounting for the latter, when the lessee measures assets under that class of PPE and IP using the revaluation and fair value model, respectively. This AOSSG member considers that ROU assets and the underlying assets that the lessee owns are of different nature and create different rights, and hence, should not be subject to the same measurement basis. Accordingly, this AOSSG member believes that the lessee should be permitted, but not required, to measure ROU assets at revalued amount or fair value if it applies the revaluation or fair value model to the underlying assets that it owns, and suggest

aligning the remeasurement proposal for ROU assets arising from leased property that meets the definition of an IP to the proposal for ROU assets relating to PPE.

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?

Overview

20 Consistent with the comments under question 2 above, most AOSSG members believe that there are fundamentally two different types of leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. These AOSSG members, including those who are prepared to accept a single measurement model for lessees, therefore support a dual lessor accounting model to reflect the differing economic substance of these different types of leases.

21 These AOSSG members further agree with the proposed lessor accounting for Type B leases, subject to comments on the proposed classification criteria under question 4 below, but have differing views on the proposed lessor accounting for Type A leases. An overview of the broad views of these AOSSG members is set out below:

- View 1: Most members can accept the proposed Type A lessor accounting.
- View 2: A few members either disagree with the recognition of a day-one gain on the lease or can accept such an accounting on the condition that there is some degree of certainty that the gain would not be reversed after lease commencement.
- View 3: A few other members disagree with the accretion of residual assets and prefer to subsequently measure the residual asset at allocated cost.

22 A few AOSSG members however strongly support a single lessor accounting model. One member can accept a variant of the proposed Type A lessor accounting to be applied to all leases, as this member believes that there is no conceptual basis to draw a bright-line distinction between leases depending on the expected extent of consumption of the underlying asset by the lessee, and considers that for all leases where a lessee recognises a liability for its obligation to make lease payments, a lessor should recognise a corresponding asset for the right to receive payments. Another member supports a derecognition approach that prohibits the accretion of residual assets and requires residual assets to be measured at either cost less accumulated impairment or fair value.

Type A leases

23 Most AOSSG members can accept the proposed lessor accounting for Type A leases on the basis that it reflects the economic substance of the lease arrangement, i.e. a sale of a portion of the asset that the lessee is expected to consume and a right to recover the underlying asset at the end of the lease term, and would also be consistent with the proposed lessee accounting for Type A leases.

24 However, some AOSSG members express concerns over various aspects of the proposed Type A lessor accounting as further elaborated below.

Recognition of day-one gain

25 Most AOSSG members agree that the lessor should recognise a day-one gain on the fair value uplift relating to the right of use transferred to the lessee on the lease commencement date, as the lessor would have satisfied its performance obligation by making the underlying asset available for use by the lessee.

26 A few AOSSG members however believe that, in order to recognise a day-one gain on the lease commencement date, it would be necessary to have some degree of certainty that the gain would not be reversed after lease commencement. These members consider that even in cases where the lessee is expected to consume more than an insignificant portion of the underlying asset, the lessor might not be able to reliably estimate, at the lease commencement date, the value that it expects to derive from the underlying asset following the end of the lease term, especially in the absence of an active market. When the value of the residual asset is highly volatile, any day-one gain recognised by the lessor could be subsequently reversed.

27 For the aforesaid reasons, one AOSSG member disagrees with the recognition of a day-one gain on the lease. Another AOSSG member suggests that the *lessor* should distinguish the two different types of leases based on the extent of the volatility of the value of the residual asset retained by the lessor. Under this notion, the lessor would apply Type A lessor accounting when (i) the lease transfers substantially all risks and rewards associated with the underlying asset to the lessee (as volatility is expected to be relatively small for such leases), or (ii) the value of the residual asset is not highly volatile.

Measurement of residual assets

28 Most AOSSG members are prepared to accept the proposed accretion of residual assets, to depict the economic benefits that the lessor derives from the underlying asset (including the residual asset) during the lease term and which the lessor prices into the lease contract. Although some of these members observe that the proposal introduces a new class of non-financial assets that are measured on a basis similar to amortised cost using the effective interest method, they can appreciate the IASB's rationale that the nature of the residual asset, and its measurement, is somewhat different from other non-financial assets as articulated in paragraph BC249 of the Basis for Conclusions.

29 Some AOSSG members however disagree with the proposed accretion of residual assets as they question the conceptual merits of recognising interest on non-financial assets and consider that the proposal would create significant complexity. Most of these members suggest measuring residual assets at allocated cost throughout the lease term, whilst one member suggests permitting residual assets to be subsequently measured at fair value.

30 Furthermore, one AOSSG member disagrees with the proposed calculation of residual assets, as an aggregate of the discounted gross residual asset and the present value of expected variable lease payments, less any unrealised profit (see comments under Question 6 below). This member suggests a variant of the proposed Type A lessor accounting that includes expected variable lease payments in the measurement of lease receivables, and an option to measure residual assets at fair value, or at least permit the accretion of residual assets to fair value.

Type B leases

31 Subject to comments on the proposed classification criteria under question 4 below, most AOSSG members agree with the proposed lessor accounting for Type B leases, which are mostly property leases, for the reasons set out in paragraph BC73 of the Basis for Conclusions.

32 However, some AOSSG members are concerned with the asymmetrical accounting between lessees and lessors of Type B leases. Given that control is the key criterion in the definition of an asset and a prerequisite for the existence of a ROU asset, these members believe that it is inappropriate for both the lessor and the lessee to be recognising the same asset. The impact of the asymmetrical accounting would be particularly pronounced for entities with back-to-back leases, i.e. the entity would recognise both ROU asset and lease liability for its head-lease, but not the corresponding lease receivable for its sub-lease, and the outcome of which would not reflect the economics of such transactions. Some members believe that their suggestion to apply the current operating lease accounting to Type B leases by lessees would address this issue.

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?

Overview

33 Most AOSSG members support a classification principle that is based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. However, these AOSSG members have

different views on how this classification principle is proposed to be applied. An overview of the broad views of these members is set out below:

- View 1: Most members are concerned that the classification principle is applied inconsistently to leases of property and non-property using different criteria, which are seen as rule-based and conflicting. In particular, one member suggests aligning the classification criteria for property leases to those for non-property leases, whilst another member suggests aligning the classification criteria for property to those for non-property only for *lessees*, and to introduce a *variant* of the proposed classification criteria for property lessors.

- View 2: Others agree with the proposed classification criteria for both property and non-property leases on the basis of the different attributes between property and non-property.

34 Amongst the above AOSSG members, a few members further suggest that the final Leases IFRS should prescribe 'consume more than an insignificant portion of economic benefits' as the overriding classification principle, whilst paragraphs 29 – 34 of the ED should be rewritten as application guidance instead.

35 One AOSSG member however disagrees with the proposed lease classification for *lessors* and suggests that leases should be distinguished based on the extent of the volatility of the value of the residual asset retained by the lessor. In particular, a lease is accounted for as a Type A lease by the lessor when (i) it transfers substantially all risks and rewards associated with the underlying asset to the lessee, or (ii) the value of the residual asset is not highly volatile.

36 Furthermore, a few other AOSSG members support a single lessee and lessor accounting model. One of these members believes that the expected extent of consumption of the underlying asset by the lessee should not result in a different accounting approach, but rather, is most appropriately reflected in the finance charge included in the lease payments. Another member considers that the distinction between Type A and Type B leases lacks conceptual rationale, and is concerned that the high degree of judgement required in determining 'more than insignificant' consumption is difficult to operationalise and could create structuring opportunities around margins.

<u>Classification criteria based on nature of underlying asset</u>

37 Most AOSSG members are concerned that the underlying consumption-based principle is applied inconsistently to leases of property and non-property using different criteria. In particular, some members consider that such an approach lacks conceptual basis and that the explanation in paragraph BC51 of the Basis for Conclusions does not offer sufficiently robust rationale for the different criteria. Furthermore, the implication that the criteria 'would not always result in conclusions that are consistent with the principle' has not been adequately addressed and could result in inconsistent accounting for transactions that are economically similar. Contrary to the IASB's view, another AOSSG member considers that the classification proposals, based on the nature of the underlying asset as well as different thresholds, are overly complex.

38 Notwithstanding the above, one of the above AOSSG members is prepared to accept a variant of the proposed classification criteria for property lessors. This member is not convinced that the outcome of applying the proposed Type A lessor accounting to most property leases, specifically the accounting for each and every physically distinct portion of a property as a residual asset, would provide better information as compared to an approach similar to the current operating lease accounting as proposed in the ED, where rental income and the fair value of the entire underlying property are reported in the financial statements of lessors. This member can also appreciate the operational challenges of applying the proposed Type A lessor accounting to most leases of multi-unit, multi-storey buildings (for instance, the lessor would have to determine the fair value and cost of each unit in a multi-unit, multi-storey building that is subject to a lease, at different points in time and for numerous times over the economic life of the building, for purposes of establishing the carrying amount of the residual asset). As such, this member suggests that property lessors would apply the 'major part of *total* economic life' or 'substantially all of fair value' threshold instead (i.e. as opposed to 'major part of *remaining* economic life' for the former as proposed in the ED). Another member suggests scoping out property lessors of investment property measured at fair value under IAS 40 *Investment Property* and requiring all investment property to be recognised in the lessor's financial statements, to satisfy user needs for information about investment property and revenue streams and to allow for consistency across the investment property industry.

39 Some other AOSSG members however welcome the proposed criteria that are based on the nature of the underlying asset as this approach would pragmatically reflect, for most property leases, that the consumption of the property as a whole would be insignificant due to the land element. Notwithstanding so, one of these members acknowledges that it is not always appropriate to assume that the land element accounts for a significant portion of property as a whole, as explained in paragraph BC51 of the Basis for Conclusions, because the significance of the land element to the property as a whole could differ considerably depending on the geographical area. Another of these members further recommends requiring both proposed criteria to be satisfied in order to account for a non-property lease as a Type B lease or a property lease as a Type A lease.

Classification criteria for property leases

40 A few AOSSG members are concerned with how the '*economic life*' classification criterion is applied differently based on the *remaining* economic life for *property* and the *total* economic life for *non-property.* These members see no conceptual basis for the proposed difference in the classification criterion. Furthermore, one of these members observes that applying this criterion based on the remaining economic life of building could result in more Type A leases as the building ages and questions whether it is appropriate to classify economically similar transactions differently depending on the age of the underlying assets. This member supports a classification criterion based on the *total* economic life of the asset and sees no reason why the rationale for using total economic life in the case of non-property leases, as explained in paragraph BC125(a) of the Basis for Conclusions, should not apply to property leases. However, another AOSSG member considers that the classification criteria for both property and non-property leases should be based on the *remaining* economic life of the asset, but

has concerns about how this proposed requirement would be applied in the context of purchased assets.

41 One AOSSG member observes that the IASB rationalises the different criteria for property leases in paragraph BC55 of the Basis for Conclusions on the premise that the underlying asset is the property as a whole (including land) and the land element represents a large proportion of the fair value of the property in some instances.

42 Firstly, this AOSSG member is not convinced that the underlying asset must necessarily be the property as a whole (including the land), and hence, disagrees that applying the proposed criteria would in most cases result in outcomes that are consistent with the classification principle. Specifically, this member observes that the economic benefits embedded in the land, which has an indefinite life, would be consumed together with an indefinite number of buildings to be constructed in the future. By assessing the classification principle based on the property as a whole, the presumption is that it is possible to consume future economic benefits embedded in the land that would be derived together with all other buildings that would be constructed in the future, which this member believes is conceptually problematic. It stands to reason that the classification criteria, which are premised on such a presumption, would also be conceptually challenged. For example, applying the 'major part of economic life of building' or 'substantially all of fair value of property as a whole' criterion to a physically distinct portion of a multi-storey building could result in a Type B lease classification, even though a considerable portion of the building's economic benefits is expected to be consumed and recovered through lease payments. Notwithstanding that the land element may have retained substantially all its service potential over the lease term and the lessee is not expected to consume more than an insignificant portion of the property as a whole (including the land), accounting for the above example as a Type B lease would not be consistent with other economically similar non-property leases.

43 Besides, this member considers that the proposal to assess the lease term relative to the *remaining economic life of building* appears counter-intuitive to the proposal's underlying presumption that *land element accounts for a significant portion of the property*. Moreover, in cases whereby land is the primary asset of the lease (e.g. a plot of farmland with some small barns erected on it), assessing lease classification with reference to the economic life of building could have outcomes that are neither consistent with similar land leases nor reflective of the economics of lease transactions (i.e. such a lease would be classified as a Type A lease even though the lessee is not expected to consume more than an insignificant portion of the land).

44 Accordingly, this member considers that an approach based on the 'more than insignificant' threshold and the *total* economic life of the *primary asset*, which could be the building or the land for which the lessee has contracted the right of use, would result in outcomes that are more consistent with the consumption principle.

45 One AOSSG member further notes that the proposed classification criteria would create practical implementation challenges for land leases in jurisdictions that do not sell freehold interest in land (e.g. the use of land is only granted via land-use rights for a substantial period of say 70 years). In such situations, assessing consumption based on the economic life of the land would always result in a Type B lease classification, and

yet both the lessee and the lessor would have no practical ability to assess consumption based on the fair value of the land in the absence of market transactions on the sale and purchase of freehold land.

Primary assets

46 One AOSSG member recommends that a lease component that contains the right to use more than one asset should be classified by assessing each asset on an individual basis. Furthermore, if the requirements in paragraph 32 of the ED are retained in the final Leases IFRS, this member recommends adding an example in which the primary asset is the land on which the building is located.

47 Another AOSSG member notes that for a single lease component that contains more than one 'non-distinct' asset, it is not always clear how the primary asset should be determined for lease classification purposes. This member suggests defining 'primary asset' and providing further guidance on how the primary asset should be determined in such situations, in addition to IE5 of the Illustrative Examples.

Reassessment

48 Some AOSSG members disagree with the proposed requirement not to reassess the lease classification after lease commencement, unless there is a substantive change to the contract. These members consider it to be inconsistent with the proposal to reassess lease term in paragraph 27 of the ED, and that reassessment of lease classification would have little added costs over those already incurred on the reassessment of lease term and lease liability/receivable. These members suggest requiring lease classification to be reassessed for changed circumstances to prevent structuring opportunities.

Others

49 Some AOSSG members request the IASB to clarify what is meant by '*insignificant portion', 'major part'* and *'substantially all'* so as to reduce subjectivity and prevent the inconsistent application of the lease classification criteria. Furthermore, one AOSSG member notes that IE7 of the Illustrative Examples suggests that 16.6% of the economic life or 27.8% of the fair value is not 'insignificant'. To prevent any misinterpretation of the benchmark at an artificially high level, this member suggests developing other than clear-cut examples to illustrate how the criteria are intended to be applied.

50 Given that the distinction of property is important for lease classification purposes, some AOSSG members suggest that the IASB clarify the definition of 'property', and in particular, whether it would include structures that are situated on land, and share similar attributes of property but lack features usually associated with a building. One AOSSG member suggests refining the definition of 'property' to include all long-lived structures that are permanently affixed to land.

51 One AOSSG member requests the IASB to clarify how the '*substantially all of fair value*' criterion should be assessed for lease components that contain (i) the right to use

more than one asset and (ii) both land and building. Paragraphs BC55 and BC56 of the Basis for Conclusions appear to suggest that this criterion would be applied relative to the fair value of the underlying asset as a whole, which should be included as part of the classification requirements if this indeed reflects the IASB's intention.

52 One AOSSG member is concerned about the proposal to classify sub-leases with reference to the underlying asset, rather than the ROU asset. This member believes that lessees and lessors should account for the sub-lease with reference to the ROU asset, and suggests requiring so in the final Leases IFRS and defaulting to the underlying asset only when information about the ROU asset is not available.

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?

53 AOSSG members generally agree with the proposals on lease term. We can appreciate that incorporating the 'significant economic incentive' concept to reflect an entity's reasonable expectation of the lease term would result in an outcome that better reflects the economics of lease arrangements and is comparable to economically similar transactions.

54 Some AOSSG members question how the '*significant economic incentive*' concept differs from the '*reasonably certain*' concept in IAS 17. In particular, these members note that the IASB expects the 'significant economic incentive' concept to provide a threshold that is similar to the 'reasonably certain' concept in IAS 17, as explained in paragraph BC140 of the Basis for Conclusions. These members suggest replacing the 'significant economic incentive' concept with the 'reasonably certain' concept, since the latter has worked well in practice, and retaining the application guidance in paragraph B5 of the ED.

55 One AOSSG member is concerned that the assessment of 'significant economic incentive' is a matter of judgement and may differ between lessees and lessors or between lessees of identical leases.

<u>Reassessment</u>

56 A few AOSSG members raise the concern that the way in which the proposals are currently expressed would lead entities to reassess their estimations every reporting period. These members suggest that the approach taken to reassessment should be similar to that in IAS 36 *Impairment of Assets*, and that reassessment should be required only when there has been a 'trigger' event.

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?

57 Most AOSSG members can agree with the proposal to include in lease payments only variable lease payments (VLPs) that depend on an index or a rate and those that are in-substance fixed payments.

58 Some other AOSSG members think that conceptually, all forms of VLPs should be included in the measurement of lease assets and liabilities because they meet the definition of an asset for the lessor and a liability for the lessee – the lessee has no unconditional right to avoid payment, it is only the amount to be paid that is uncertain. Besides, excluding VLPs that are performance or usage-based from the measurement of lease assets and liabilities would not reflect the economics of lease arrangements and may present structuring opportunities. The proposed approach is also not consistent with how contingent consideration is accounted for in other IFRSs or projects. For example, the proposed new Revenue IFRS would require variable consideration to be included in the transaction price and estimated based on the expected or most likely amount, whilst IFRS 3 *Business Combinations* requires the acquisition date fair value of contingent consideration to be included in the measurement of consideration transferred.

59 Furthermore, from the lessor's point of view, including VLPs in the measurement of the residual asset, rather than the lease receivable, is not representative of the nature of the asset. Besides, the residual asset in such cases would include various elements that represent different concepts with dissimilar cash flows, and obscure the asset and credit risks to which the lessor is exposed. This accounting approach would also have consequences on the subsequent measurement of the residual asset, including (i) the derecognition of a portion of the residual asset and the recognition of this portion as an expense for VLPs that are expected to be earned in the period, which is unnecessarily complex and appears inconsistent with the definition of an expense in the *Conceptual Framework*, given that it represents a payment that is expected to be received rather than 'a decrease in the economic benefits' embedded in the residual asset, and (ii) the interaction of various elements with the impairment proposals in the ED, in particular, whether expected VLPs that are included in the residual asset should be tested for impairment under IAS 39 *Financial Instruments: Recognition and Measurement* or IAS 36.

60 Due to the reasons in the aforementioned paragraphs, one of these other AOSSG members disagrees with the proposals on VLPs, and suggests including all VLPs in the measurement of lease payments for both lessees and lessors, on a basis consistent with the approach adopted in the proposed new Revenue IFRS.

61 On the other hand, notwithstanding the concerns expressed in the aforementioned paragraphs, another of these other AOSSG members can appreciate that including all

forms of VLPs in the measurement of lease assets and liabilities is not only operationally challenging, but highly judgemental and subjective, especially for longer-term leases. There are also concerns that such subjectivity and uncertainty could significantly reduce the reliability of financial statements. Accordingly, subject to the comments under the 'in-substance fixed payments' section below, this member can accept the pragmatic approach that the IASB has taken in the ED on cost-benefit considerations.

62 Another AOSSG member notes that the IASB's Discussion Paper on *Conceptual Framework*, which addresses the types of variable consideration that would meet the definition of a liability, could affect the accounting for VLPs and suggests that consideration be given to the discussions on this project.

In-substance fixed payments

63 Some AOSSG members are concerned that the concept of 'in-substance fixed payments' has not been clearly articulated in the ED. These members do not consider that the scenarios in Example 17 of the Illustrative Examples are sufficient to aid in the application of this concept. Furthermore, these examples could be interpreted that the intended scope of 'in-substance fixed payments' is limited to price floor, which may present structuring opportunities. For example, entities may structure lease payments entirely in the form of performance or usage-based VLPs, together with protective clauses that restrict the lessee's ability to avoid using the underlying asset, to get around recognising lease assets and liabilities. One of these AOSSG members further suggests that the IASB enhance the robustness of this concept to capture various forms of VLPs that are in-substance fixed for measurement purposes.

Reassessment

64 Some AOSSG members are concerned that the way in which the proposals are currently expressed would require entities to reassess their estimations of VLPs every reporting period. One member thinks that the approach taken to reassessment should be similar to that in IAS 36, and that reassessment should be required only when there has been a 'trigger' event. Another member suggests that reassessment should be required when there has been a substantial change in the reference rate/index, or a change in that rate/index has resulted in a reassessment of (i) the lease term or (ii) whether the lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

Question 7: Transition
Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

65 AOSSG members generally support the proposed transition requirements. Whilst a full retrospective approach would provide better information, we believe that allowing the option of using a modified retrospective approach would provide significant operational relief especially for entities with numerous lease arrangements.

66 One AOSSG member suggests that the IASB consider providing transition relief for contracts that are currently accounted for as leases under IAS 17 but would no longer meet the definition of leases under the ED.

67 Some AOSSG members understand from their constituents that the proposals would have significant impact on systems, processes as well as lease arrangements, which would necessitate significant amount of time for transition. These members request that sufficient lead time of at least two to three years should be provided to implement the new Leases IFRS.

Question 8: Disclosure
Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

68 AOSSG members observe that the disclosure requirements would increase significantly under the ED as compared to the existing requirements under IAS 17, and are concerned that the costs imposed on the preparers are likely to outweigh the benefits of enhanced disclosures to the users of financial statements. Some members consider that the proposed reconciliations are unnecessarily detailed, whilst others raise concerns about the usefulness of the narrative information on the nature of the lease arrangements, particularly so for entities with significant number of leases with differing nature. AOSSG members therefore urge the IASB to reconsider the necessity of all the proposed disclosures as certain proposals could be unduly costly without significantly improving the usefulness of financial information.

69 Specific suggestions are provided below:

- Require disclosure of reconciliations of opening and closing balances of lease liabilities on an aggregated basis, instead of separately for Type A and Type B leases, since the same measurement basis applies to all lease liabilities.

- Remove the detailed list of examples of items to be included in the reconciliations of opening and closing balances of lease assets and liabilities, to avoid being interpreted as mandatory reconciling items.

- Align the maturity analysis requirements for lease liabilities and lease receivables to those in IFRS 7 *Financial Instruments: Disclosures*, which require an entity to use its judgement to determine an appropriate number of time bands for the maturity analysis.

70 One AOSSG member notes that many of the proposed disclosures would appear to be irrelevant to short-term leases (since most of these proposals focus on disclosures about lease assets and liabilities arising from Type A and Type B leases) and that it is unclear what disclosures would be required for such leases. This member is concerned that even less information would be provided on short-term leases than is currently provided on operating leases, which would obscure information about the rights and obligations arising from short-term lease arrangements. This member suggests requiring disclosures of total future lease payments and a breakdown of lease expense/income recognised for the period into components such as lease payments, VLPs not included in the straight-line lease expense/income calculation, and sub-lease payments.

71 Another AOSSG member observes that the ED explicitly requires a lessor to disclose qualitative and quantitative information relating to risks arising from leases required by IFRS 7, but is silent on whether a lessee is required to make similar disclosures. This member suggests that the IASB clarify the applicability of IFRS 7 disclosure requirements on the lease liabilities of lessees to avoid potential diversity in interpretation.

Question 12 (IASB-only): Consequential amendments 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?

72 Most AOSSG members agree with the proposed amendments to IAS 40.

73 One AOSSG member however disagrees with the proposal. This member considers that a ROU asset is of a different nature and creates different rights from an investment property that is owned by the lessee, and should not be subject to the same measurement basis. The measurement of ROU assets would be best dealt with in the new Leases IFRS. Consistent with the proposals for ROU assets that relate to property, plant and equipment, this member believes that the lessee should be permitted, but not required, to measure the ROU asset at fair value if the conditions in paragraph 52 of the ED are met.

Other issues

Scope: Leases of intangible assets

74 One AOSSG member considers it inappropriate to not require lessees to apply the proposals to leases of intangible assets. The exclusion for lessees effectively creates a gap in the requirements for lessees, and has the potential to reduce consistency and comparability of accounting for leases of intangible assets by lessees. This member does not consider that the provisions in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would sufficiently address this gap. Given that the expected timing and outcome of a separate and comprehensive review of the accounting for intangible assets is uncertain, this member is of the view that a more appropriate approach would be to require lessees to apply the lease accounting requirements to leases of intangible assets, and to subsequently determine whether the outcome of any review of the accounting for intangible assets requires the scope of the lease accounting requirements to be amended.

Short-term leases

75 One AOSSG member has concerns about the proposed exception from the recognition, measurement and presentation requirements for short-term leases. This member considers that the exception has no conceptual basis, is a departure from existing requirements for short-term rights and obligations to payments under other IFRSs, and could present structuring opportunities. This member is of the view that removing the exception would result in little additional cost to preparers, but would yield significant benefits to users by simplifying the lease model (by effectively removing a third approach to the proposed lease accounting model) and increasing the transparency of such leases, particularly where the rights and obligations arising from such leases are material. If the proposed exception for short-term leases is retained, this member suggests that additional guidance should be provided on the accounting for VLPs that are excluded from the definition of 'lease payments' and the disclosure requirements for such leases (see comments under question 8 above). This member also suggests that the IASB provide further guidance on the presentation requirements for short-term leases, and rectify the exclusion of paragraph 57, which includes a requirement to present short-term lease payments within operating activities in the statement of cash flows, as proposed in paragraph 118 of the ED.

76 Another AOSSG member thinks that the inclusion of all extension options in the assessment of short-term leases, regardless of the likelihood that the option would be exercised, could result in different accounting for economically similar transactions. For example, a lease with a non-cancellable term of 12 months would be exempted from recognition on lease commencement date, but a 12-month lease with an option to extend for another 12 months would be accounted for using the proposed lease accounting based on a lease term of 12 months, even when it is remote that the lessee would exercise the option. This member proposes that the IASB align the criteria for short-term leases to the proposal for lease term, by taking into account periods covered by an extension option only if the lessee has a significant economic incentive to exercise the option.

Sale and leaseback transactions

77 One AOSSG member observes that the use of the 'major part of remaining economic life' or 'substantially all of fair value' criterion to determine whether the transferor-lessee obtains substantially all of the remaining benefits from the asset appear to run contrary to, and raises further question on, the IASB's rationale for applying the same criterion to property leases to determine whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

78 Moreover, in cases where land is the primary asset, applying the 'major part of remaining economic life' criterion with reference to the building could result in outcomes that are not reflective of the economics of sale and leaseback transactions. For example, an entity enters into a contract to (i) sell a property, comprising a freehold land and a building with remaining economic life of 10 years, and (ii) lease back the property for 8 years. Applying the 'control' principle in the proposed new Revenue IFRS to the entire sale and leaseback transaction should theoretically lead to a conclusion that the transfer is a sale since the transferee-lessor has obtained control of the property as a whole. However, it would be concluded under the ED that the transfer is not a sale because the lease term is for the major part of the remaining economic life of the building.

79 Consistent with the comments under question 4 above, this member considers that assessing lease classification with reference to the *primary asset* would address this issue. In the above example, the primary asset for the purpose of assessing the transfer and the lease would be different – the land in the case of the transfer (i.e. predominant asset promised in the sale and leaseback contract with the transferee-lessor) and the building in the case of the lease (i.e. predominant asset for which the transferor-lessee has contracted the right to use). Accordingly, the transfer would be recognised as a sale whilst the lease would be accounted for as a Type A lease. This member believes that such an accounting outcome would better reflect the economics of the entire sale and leaseback transaction, which is to enable the transferor-lessee to unlock the value in the land.

Foreign exchange risk exposure

80 One AOSSG member is concerned with the potential profit or loss volatility arising from foreign exchange risk exposures and suggests including effects of changes in foreign exchange rates in the definition of VLPs. This member considers that the ROU asset and lease liability in a leasing arrangement are intricately linked, and accordingly, any changes in the estimated future lease payments, whether due to changes in the reference index or rate used to determine VLPs or foreign exchange rates, should result in a change in the estimated cost of the ROU asset.

Lease incentives

81 With the proposed withdrawal of SIC-15 *Operating Leases – Incentives*, one AOSSG member recommends that the final Leases IFRS should provide guidance on the recognition of lease incentives.

Appendix B

Comment letter from the AOSSG Islamic Finance Working Group

4 October 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Hans,

AOSSG Islamic Finance Working Group: Comments on IASB ED/2013/6 *Leases*

The Islamic Finance Working Group of the Asian-Oceanian Standard Setters Group (AOSSG) is pleased to provide its comments on IASB ED/2013/6 *Leases*.

These comments are additional to those in the letter developed by the AOSSG Leases Working Group dated 4 October 2013, and focus only on issues specific to Islamic finance. The Working Group had sought comment and feedback from other AOSSG members before finalising this letter, and none of those members have expressed significant disagreement.

Commendation from Shariah scholars

A member of the Working Group consulted with prominent Shariah scholars in its jurisdiction about the lease accounting proposals. The Shariah scholars commend the IASB for the proposed lessee accounting treatment, which they believe better reflects both the substance and form of a lease contract, particularly the lessee's recognition of a right-of-use asset instead of the underlying asset itself.

The Shariah scholars further believe that Type A lease classification is acceptable as long as the lease contract is not cancellable. The acceptability is based on the fact that the contract is enforceable. They also note that some Type A leases conclude with the transfer of the underlying asset to the lessee, which makes these leases an alternative to sale.

Need for guidance to distinguish between a lease and a sale

Contrary to the conclusions in paragraphs BC117 and BC118, some Islamic finance stakeholders want <u>more</u> clarification to the 2010 guidance on distinguishing a lease from a sale/purchase, not its elimination.

Such guidance is particularly important for *ijarah muntahia bittamleek* (literally, 'a lease that ends with ownership') which is a lease contract followed by a legally separate contract to transfer ownership of the underlying asset. The guidance in the 2010 exposure draft would have clearly resulted in many (if not most) *ijarah muntahia bittamleek* being treated as a sale and the resultant receivables as financial assets at amortised cost under IAS 39. The elimination of that guidance and the following statement in BC118 may lead to confusion:

> "The proposals apply to any contract that conveys the right to use an underlying asset for a period of time. They do not apply to transactions for which control of the underlying asset is transferred to the lessee…"

The statement could be misunderstood to mean that the proposals apply during the lease period, and the revenue standard then applies upon legal transfer of the underlying asset. This would disregard the linkage between the two transactions.

The lack of clarity may result in disparate reporting of *ijarah muntahia bittamleek* that are economically similar, e.g.:

(i) Asset recognition – An entity reporting as a lessee will recognise a right-of-use asset, while an entity reporting as a purchaser will recognise the 'whole' asset

(ii) Revenue presentation – An entity reporting as a lessor will present revenue as lease income followed by sales revenue upon transfer, while an entity that considers itself to have sold the asset for profit with deferred payment will present finance income; and

(iii) Impairment – An entity that considers the amount due from the lessee to be a lease receivable may elect to apply the simplified approach proposed in ED/2013/3 *Financial Instruments: Expected Credit Losses*, while an entity that treats the amount due from the lessee as a financial asset at amortised cost would not be able to do so.

The stakeholders who raised this concern would like the IASB to re-instate guidance to distinguish between a lease and a sale in the final standard.

Need for guidance to distinguish between a lease and collaterised borrowing

We are concerned that the ED proposes to supersede SIC 27 *Evaluating the Substance of Transactions Involving the Legal From of a Lease*. SIC 27 is extensively referred to in accounting for *sukuk ijarah*.

In *sukuk ijarah*, an entity transfers an asset to a special purpose entity which will 'sell' proportionate ownership of the asset to investors/financiers. The investors/financiers then lease the asset to the original transferor entity. At the end of the lease period, the original transferor will purchase the asset from the investors/financiers.

The principles in SIC 27 are currently crucial in assessing whether a *sukuk ijarah* should be accounted as a financial instrument under IAS 39/IFRS 9 or as a sale and leaseback under IAS 17. The loss of SIC 27 may have negative repercussions, especially since *sukuk ijarah* structures form a substantial portion of the Islamic capital market in many jurisdictions.

If SIC 27 is to be superseded, we recommend that the IASB incorporate guidance in distinguishing between a lease and collaterised borrowing that is in the legal form a lease.

Other issues

The following are implementation issues that may not necessarily require amendments to the exposure draft. Nevertheless, we have included them to inform the IASB of concerns regarding the ED among Islamic finance stakeholders.

Lessee accounting: It may be difficult to ascertain 'minimum lease payments' for ijarah in some jurisdictions

In some jurisdictions, it may be difficult for a lessee to measure the lease liability because "the rate the lessor charges the lessee" is not clearly stated in the *ijarah* contract. Moreover, it is unclear whether a lessor needs to include late payment penalties in its measurement of lease payments because there may be a requirement to give away such penalties to charity.

Lessor accounting: Items described as receivables may incur additional zakat for a lessor.

Zakat is a wealth tax imposed on eligible assets of an entity by a jurisdiction's *zakat* authority. In some jurisdictions, receivables are subject to *zakat*. Some items that a lessor currently describes PPE or investment property under current accounting requirements may be recognised as receivables if the proposals are adopted. This change in recognition may result in the lessor incurring additional *zakat*.

In one Working Group member's jurisdiction, a lease receivable is characterized as "unstable receivable" since its realization is contingent on the continuous functionality of the underlying assets (future benefits derived from the assets). This leads to different views regarding whether it is subject to *zakat* in its entirety or on the current portion. The separate disclosure required for lease receivable besides the maturity analysis required in paragraph 106, however, are sufficient to satisfy the different opinions.

Conclusion

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,

Mohammad Faiz Azmi
AOSSG Islamic Finance Working Group Leader