List of Submissions to ED 242 *Leases*

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14 August 2013

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Vic 8007

COMMENTS ON ED 242 "LEASES"

1. FinPro – Local Government Finance Professionals

Thank you for the opportunity to comment on ED 242 "Leases". FinPro is the professional association representing finance professionals working in Local Government entities in Victoria, Australia. Our members are chief financial officers, financial and management accountants and Council officers working in the finance field.

The predominant users of financial reports prepared by Councils are ratepayers and other community members, many of whom are not experienced in reading financial statements and rely on the expertise of the financial professionals to present the information in an easy-to-understand format.

The comments provided in this submission represent the views of our members.

2. Response to Specific Issues Requested by AASB and IASB

The AASB has requested a response highlighting any regulatory issues in the implementation of the proposals.

The following implementation issues have been identified for local government entities in Victoria.

2.1 Implementation issues - recognition of current operating leases as borrowings on the balance sheet (AASB Question 2)

The recognition of the proposals in relation to leases currently classified as "operating leases" would most likely result in a materially neutral net effect on a Council's balance sheet as both an asset and a liability is also recognized. However, these leases would be classified as borrowings by a Council.

The Local Government Act (Vic) 1989 currently refers specifically to finance leases as being included in borrowings, but *only* refers to finance leases, as distinguished from operating leases.

Section 144 Local Government Act (Vic) 1989

(1) Subject to the principles of sound financial management, a Council may borrow money to enable the Council to perform the functions and exercise the powers conferred on Council under this Act or any other Act.

(2) This section also applies to borrowing in the form of finance leases.

Section 3 Local Government Act (Vic) 1989

Finance lease means a finance lease within the meaning of the Australian Accounting Standards issued by the Australian Accounting Research Foundation. (sic)

The Local Government Act (Vic) 1989 would therefore require amendment to realign the definition of leases as borrowings, and provide direction as to the inclusion of leases under section 144.

All borrowings by Council must be approved in the Council's annual budget *(Local Government Regulations (Vic) 2004, Regulation 8(a))*. At the point of transition to ED 202R, leases currently classified as operating leases would be recognised as borrowings but *would not* have been approved in a previous budget.

Borrowings by Council are also subject to approval by the Australian Loan Council. Previous incarnations of the Australian Loan Council set prudential requirements for borrowings which compared the debt commitment to Council's rate revenue, as an indicator of the Council's ability to service the debt. Council's level of assets was not taken into account. Therefore, the recognition of operating leases "on balance sheet", as proposed by ED 242, would have resulted in increased debt levels; a constant level of rate income; and a perceived reduced ability to service the debt even though no new commitments are introduced and the pattern of cash flows does not change.

The assessment criteria currently applied by the Australian Loan Council for approval of Council borrowings are not as transparent or widely known as previous oversight regimes, but debt levels would need to be revised if operating lease commitments are not currently included in the consideration of borrowing commitments and debt serviceability.

2.2 The cost to Council of the proposed method of accounting will be high (AASB Questions 3 & 5)

The proposals contained in ED 242 focus on the quality of balance sheet reporting through the recognition of all assets and liabilities relating to lease contracts.

The impact of the proposed methodology on the Statement of Comprehensive Income will be minimal, as the replacement of operating lease payments with amortisation of the right-to-use asset plus any interest expense is likely to materially the same. Similarly, the impact on the Statement of Cash Flows will be neutral.

For Councils as lessee, many of whom have extensive lease portfolios covering buildings, vehicle fleets, and computer equipment, new systems will need to be developed to measure the assets and liabilities; assess the expected term of the lease at commencement, and reassess the term of each lease if conditions change.

Councils act as lessor in numerous arrangements, as it is a common occurrence that the Council provides assets to meet community service objectives, not financial or investment objectives.

The full, diverse variety of arrangements that Council's enter as lessor includes:

- Appointment as Committee of Management, with a range of degrees of delegation of rights and responsibilities.
- Long term (for example, 20 – 99 years) occupation of sites by community groups, often with an unspecified term and for a nominal or “peppercorn” rental.
- Assignment of responsibility for Crown Land, recognized as an asset by Councils on the basis of control, not ownership. Therefore, unable to be de-recognised even when rights and responsibilities are predominantly re-assigned under a lease.

Council would need to assess each arrangement as to what extent the rights and obligations associated with the asset are retained, in order to determine whether to apply the performance obligation or de-recognition approach.

FinPro therefore welcomes the dual approach for lease expenses and the simplified lessor accounting for Type B leases, however believes the proposed lessee accounting is very complicated and confusing. These are explained further under section 2.3.

FinPro do not agree that the benefits for local government entities of adopting the proposed changes outweight the costs of implementation and ongoing application, given the profile of the readers of our financial reports.

The annual reporting process by Councils is aimed at providing information about Council’s performance to members of the local community, many of whom do not have a financial reporting background. The current distinction between finance and operating leases can be explained in plain English as finance of a purchase versus rental, and can be understood. The majority of these users will not understand the concept of intangible rights to use assets and offsetting liabilities for future payments recognised on the Statement of Financial Position.

2.3 The complexity of the lessee accounting and the mismatch of lessee and lessor accounting treatment for Type B assets (IASB Questions 2, 3 & 4)

FinPro supports the classification of leases as a Type A lease or a Type B lease and welcomes this sensible approach of distinguishing assets according to asset consumption (*ED 242 paragraph 29*).

The lessee accounting proposed by the ED 242 is however too complicated and confusing. According to ED 242, both Type A and Type B leases must be recognised on the statement of financial position and the statement of profit & loss. The accounting treatment for Type A leases and Type B leases are both very complicated however very different from one another (*ED 242 paragraphs 54 to 57*). This will cause unnecessary confusion for accounting practitioners and report users.

On the other hand, the lessor accounting for Type B leases proposed in ED 242 is much simpler, with no requirements to recognise the lease receivable in the Statement of Financial Position (*ED 242 paragraphs 93 to 97*).

FinPro supports the much simplified lessor accounting treatment for Type B leases and would like to see similar approach applies to lessee accounting. If lessee accounting for Type B leases can also be given the relieve of not having to be recognised in the statement of financial position, it will not only make lessee accounting much simpler, but also resolve the mismatch between lessee and lessor accounting for Type B leases.

The reports users can gain similar insight into Type B leases through disclosure notes. This is also similar to the treatment of liabilities arisen from service contracts.

3. Contact details:

Please contact the FinPro Technical Committee for further information.

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Defence Housing AUSTRALIA

14 August 2013

The Chairman
Australian Accounting Standards Board
Level 7, 600 Bourke Street
MELBOURNE VIC 3000

Dear Sir

Submission – Exposure Draft 242 Leases

This submission provides general concerns and comments to the Australian Accounting Standards Board on the proposals outlined in exposure draft 242 – Leases.

Background

Defence Housing Australia (DHA) was formed under the *Defence Housing Australia Act 1987* with the main function of DHA being to provide housing and related services to members of the Defence Force and their families. DHA is the preferred supplier of housing for married members of the ADF and competes with private rental markets in the provision of off-base housing for Defence singles (apartments).

DHA is a Government Business Enterprise (GBE) which operates under the provisions of the *Commonwealth Authorities and Companies Act 1997*. In addition to meeting Defence requirements it must maintain a strong balance sheet and meet shareholder return obligations.

DHA is active in the Australian property market as a developer, creating sustainable communities of mixed Defence and private owners and tenants. Its current portfolio includes projects with a total value in excess of $1 billion in Darwin, Townsville, Brisbane, Sydney, Canberra and Adelaide. DHA also constructs, purchases and leases houses and apartments.

DHA leases over 16,000 residential properties to members of the Defence Force via a Services Agreement with the Department of Defence. The agreement to provide these 16,000 properties has an estimate net present value of $2.8 billion to DHA. More than 12,500 of these residential properties are owned privately by investors and are leased to DHA through a long term sale and leaseback or direct lease arrangement. Typically, DHA will lease a property from a private investor for 12 years with options to extend by up to 3 years. This term represents a relatively low proportion of a houses expected useful life. Principal risks and rewards related to financial returns relate to rental and capital growth and these lie with the private investor, not DHA. The lease obligations for these properties are estimated to have a net present value of approximately $2.3 billion and are on-leased to Defence.

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Although fully Government owned, DHA is not funded from the Federal Budget. Its main source of funding is revenues from Defence for the provision of housing, the sale of properties on its sale and leaseback program and the disposal of land and residential property excess to requirements. In the 2013-14 financial year DHA will have total revenues in excess of $1 billion of which $375 million will be from the sale and leaseback of residential property.

Under current accounting standards all the residential property leases with private investors are accounted for as operating leases with disclosures within the financial statements of future lease payments as commitments.

DHA also holds a fleet of motor vehicles and occupies commercial properties which are currently recognised as operating leases.

General Concerns with the Proposed Approach

When reviewing the changes proposed in exposure draft 242 and applying them to DHA a number of significant issues were identified. These issues are practical in nature and reveal concerning impacts to financial information provided to users.

Type A and Type B Lease Accounting Classifications

The difference in definition and treatment of Type A and Type B leases is based on the premise of whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

DHA has considered these lease type classifications in respect of leased residential property. The useful life of a property is generally well in excess of the DHA lease term and the property may increase in capital and rental value (due to land value and location). Therefore generally the economic benefits of the underlying asset are not consumed and are consequently treated as Type B leases.

The proposed leasing classifications do not take into consideration the circumstances of the lessee in classifying the lease type but the circumstances of the owner of the property. Property may increase in value but no longer meet changing community or, more importantly for DHA, Defence standards in regards to what a residential property should comprise. Such a property is a regular issue for DHA as older leased properties are required to be exited from the portfolio as they are of no further use for meeting Defence housing requirements and therefore lose their economic benefit to DHA. However, that property will retain its economic benefit in the broader residential property market.

Furthermore, the classification of leases does not seem to be consistent with the objective of recognising forms of financing on the Balance Sheet. The type A leases are treated as a form of financing through the profit and loss statement but are not classified using financing principles, rather concentrating on the concept of consumption of economic benefits. Type B leases are required to be recognised on the Balance Sheet but not treated as a source of finance.

The classification and subsequent treatment of the leases does not seem to be connected to the actual objective or purpose of undertaking the lease. This is especially the case when the leasing of assets is a business in itself (as is the case of DHA) as opposed to a form of financing.

Measurement of Variable Lease Payments

DHA understands after the initial recognition of the lease that reassessment of variable lease payments will only occur if there is a change in an index or rate used to determine lease payments. Subsequent to the initial recognition, a change in market rent on a property would not change the value of the Right of Use Asset or Lease Liability. The rental for DHA properties are independently valued each year, and consequently, DHA's future lease obligation or benefit would not be accurately recognised on the Balance Sheet. This would make the Balance Sheet information for users redundant after the 1st year of a long term lease as market rent on DHA's portfolio is updated each financial year. DHA has experienced significant movements in rental values (up to 20%) in some locations within a financial year.

Recognition of Make good

DHA currently recognises a make good obligation as an expense in the profit and loss statement on the inception of a lease with a private investor. The proposed leasing standard is unclear on whether the make good cost is required to be capitalised as part of the right of use asset or whether DHA will be able to continue to recognise the cost as an expense.

Inventory v Investment Property

DHA holds approximately $1.1 billion worth of property planned to be sold via a sale of leaseback arrangement. These properties are recognised on DHA's Balance Sheet as Inventory properties. The properties are already leased to members of the Defence Force and will continue to be leased after the sale and leaseback transaction to members of the Defence Force. The proposal to recognise the right of use asset as an Investment Property will move the underlying asset from an inventory classification to an investment classification after it is sold. Notwithstanding the anomaly of such a re-classification it also puts into question whether property planned to be sold on a sale and leaseback basis should be recognised as Inventory stock. Further consideration may be required to the Inventory standard.

Cyclical or Seasonal Lease Commencements

The recognition of amortisation and interest expense in the Profit and Loss Statement for Type A leases will result in higher expenditure or revenue in the early years of a lease. Although DHA does not hold a significant number of Type A leases, there is a concern about the impacts on profitability when lease commencements are cyclical or seasonal in nature. An entity with a large number of Type A leases may show unusual profit and loss patterns providing misleading information to users. Over the life of the lease, total expenses or revenues on the lease are the same but a timing disparity is created which could result in higher or lower profits depending on the age of the leased portfolio. This would increase the risk of users of financial statements forming views based on a misunderstanding of an entity's true underlying financial position and performance.

Resourcing

As at 30 June 2013, DHA held approximately 12,500 lease transactions as lessee and undertakes each year approximately 600 new sale and leaseback transactions, re-leases 300 existing leases on a further term, exercises 900 lease options, enters into 150 new direct leases and manages over 1,500 lease ends. The systems and resourcing required to facilitate and manage the requirements of the proposed leasing standard is anticipated to be substantial.

Key Performance Indicators

The significant change in DHA's Assets and Liabilities impacts a number of DHA's Financial Key Performance Indicators. General calculations used to indicate performance or highlight risk factors of an entity such as Current Ratio, Interest Times Cover Ratio, Gearing Ratio and Debt to Equity Ratio are heavily impacted if performed under the proposed accounting standard. Users of the financial statements may consider these ratios difficult to interpret as a result of the classification of different lease types, artificial (right of use) assets being recognised as Investment properties and lease obligations being unable to be adjusted to reflect current market lease payments. This would increase the risk of users of DHA financial statements forming views about DHA based on a misunderstanding of DHA's true underlying financial position and performance.

Balance Sheet Impacts

The lessee proposals as presented would result in a significant increase in the size of DHA'S Balance Sheet. The magnitude of DHA's lease commitments means the Balance Sheet will be dominated by leasing obligations and impact or confuse other disclosed Balance Sheet items, in particular Investment Properties held.

Forecasting

The number of variables involved in calculating the present value of lease payments makes it extremely difficult to reliably forecast results. This would be more difficult with the inability to vary obligations as rental markets move. Financial Statements look at a single point of time however users need reliable information when making informed decisions. DHA does not believe the information supplied would be reliable for users.

Recommended Approach

DHA believes that the current proposal would create unnecessary complexities for preparers and has the potential to provide misleading information to financial report users. The use of artificial assets and liabilities will provide complications for businesses and will surpass any benefits obtained by users from including operating lease obligations on the Balance Sheet. The proposal seems to have progressed away from the original scope of recognising financing arrangements on the Balance Sheet and incorporates treatments inconsistent with financing principles.

The use of an operating lease (or similar definition) disclosure note for receivable and payable commitments will provide the same information to users without creating the

balance sheet and profit and loss statement issues identified. This option deserves consideration.

DHA also believes further consideration should be given to the scope to when an entity should be required to apply the standard. An entity whose primary business is leasing (as opposed to the traditional leasing of an asset under a financial arrangement) should be given flexibility to elect not to apply the standard. Government agencies may also be considered to be out scope of the standard taking into consideration the current requirement to disclose future commitments.

Should you wish to discuss DHA's submission further, please do not hesitate to contact me.

Yours faithfully

Jon Brocklehurst
Chief Financial Officer

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Mr Kevin Stevenson
Chairman
Australian Accounting Standard Board
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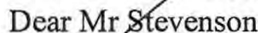
Dear Mr Stevenson Kevin



ED 242 Leases

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to the Australian Accounting Standards Board's Exposure Draft (ED) 242 *Leases*.

HoTARAC acknowledges that the existing lease accounting model is problematic and therefore supports the objectives of this project. HoTARAC supports:

- adopting a standard that applies to both lessees and lessors;
- recognising assets and liabilities arising from non-cancellable lease contracts;
- the dual approach to lease accounting depending on the degree to which the lessee consumes the economic benefits embedded in the underlying asset;
- the lease term being determined as the non-cancellable period of the lease; and
- adopting simplified requirements for short-term leases.

HoTARAC considers that the 2013 ED improves on the Board's 2009 Discussion Paper and 2010 Exposure Draft and notes that it addresses many of the issues raised by HoTARAC in response to those proposals. However, HoTARAC has some additional concerns with the 2013 ED. These are set out in the Attachments and primarily relate to:

- relief given to lessors in short-term leases [Question 3];
- inconsistent terminology in relation to lease classification [Question 4];
- lease classification where a lessee measures its right-of-use asset based on fair value [Question 4];
- guidance on determining the lease term [Question 5];

State Government Victoria

- recognising, measuring and presenting variable lease payments [Question 6];
- revaluation of a lessor's residual asset [Question 6];
- excessive disclosures [Question 8]; and
- GAAP/GFS harmonisation issues [AASB specific Question 1].

HoTARAC recommends that the Board allows a **substantial** period for implementation in view of the likely impact of the proposal on accounting systems and processes.

Please contact David Laidley on 02 9228 4759 from New South Wales Treasury if you would like to discuss any of the matters raised by HoTARAC.

Yours sincerely

Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

14th August 2013

ATTACHMENT 1

DETAILED COMMENTS ON EXPOSURE DRAFT ED 242 LEASES

HoTARAC offers the following comments and suggestions in response to the questions in the exposure draft (ED) and related matters.

Scope

Question 1 Identifying a lease

> The 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 the 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.

HoTARAC agrees with the definition of lease and the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease.

HoTARAC considers the proposal to be an improvement on IFRIC and AASB Interpretation 4 *Determining whether an Arrangement contains a Lease* and particularly the guidance on the right to control the use of the asset in paragraph 9(c) of that Interpretation.

HoTARAC would welcome additional guidance on interpreting and applying the definition of a lease, particularly in relation to barriers to substituting alternative assets [paragraph 9(b)] and ability to derive benefits from use [paragraphs 12(b), 18 and 19].

The accounting model

Question 2 Lessee accounting

> Do you agree that the recognition, measurement and presentation of expenses and cash flows 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?

HoTARAC agrees that a lessee's accounting should vary, depending on the degree to which the lessee consumes the economic benefits embedded in the underlying asset.

While this approach does not always result in symmetrical accounting by lessees and lessors (especially in Type B leases), it appears to be a reasonable and principles-based approach that recognises the variable nature of the underlying economics of leases. It also acknowledges that leases are not always financing arrangements.

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?

HoTARAC agrees that a lessor's accounting should vary, depending on the degree to which the lessee consumes the economic benefits embedded in the underlying asset.

While this approach does not always result in symmetrical accounting by lessees and lessors (especially in Type B leases), it appears to be a reasonable and principles-based approach that recognises the variable nature of the underlying economics of leases. It also acknowledges that leases are not always financing arrangements.

HoTARAC notes that, in a Type B lease, the lessor continues to recognise the leased asset while the lessee recognises a right-of-use asset in relation to the same asset. The recognition of an asset by both parties, conceptually, is not ideal.

Optional relief for lessors in short-term leases

HoTARAC notes that while lessors in short-term leases are given optional relief from the measurement requirements that would otherwise apply, they are not given relief from the recognition requirements.

Paragraph 119 gives a lessor, in a short-term lease, optional relief from the requirements of paragraphs 69-97. Those paragraphs relate to measurement. The optional relief does not extend to the recognition requirements in paragraph 68. This does not appear to be the intention of the proposals as set out in the *What are the main proposals?* section on page 7 of the ED which states that the simplified requirements (for short-term leases) would be similar to operating lease accounting.

HoTARAC recommends that a lessor in a short-term lease also be given optional relief from the recognition requirements in paragraph 68.

HoTARAC also recommends that the proposed relief be mandated for all short term leases. This will enhance comparability between entities, as similar transactions will be accounted for consistently.

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 an underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

HoTARAC agrees that lease accounting should vary depending on the degree to which the lessee is expected to consume the economic benefits embedded in the underlying asset. HoTARAC also agrees that in many leases this principle can be conveniently operationalised by distinguishing equipment leases from property leases, subject to the appropriate exception criteria in paragraphs 29 and 30, and accounting for them differently.

HoTARAC notes the inconsistent terminology used in the exception criteria for distinguishing Type A leases from Type B leases. Type A exceptions are based on ***insignificant*** economic life and fair value of the underlying asset whereas Type B exceptions are based on the ***major part*** of the economic life and ***substantially all*** of the fair value of the underlying asset. HoTARAC recommends using more consistent terminology, defining what is meant by ***insignificant***, and either replacing ***major part*** and ***substantially all*** with ***significant*** or defining those terms.

Lease classification where the lessee measures the right-of-use asset based on fair value

HoTARAC notes that where a lessee measures the right-of-use asset at, or based on, fair value, as permitted by paragraphs 52 or 53 of the proposal, paragraph 35 prohibits the lease from being classified as a Type A lease or a Type B lease. While paragraph 35 requires such a lease to be treated as a Type A lease for presentation and disclosure purposes, it is unclear how it should be classified and therefore recognised in this situation. Public sector entities in Australia would be likely to measure their right-of-use assets based on fair value, as they presently do with property plant and equipment.

HoTARAC therefore recommends that the proposal clarify how a lease should be classified and recognised if the lessee chooses to measure the right-of-use asset based on its fair value.

Asymmetry in Type B leases

HoTARAC notes that lessee and lessor accounting is symmetrical in a Type A (equipment) lease but asymmetrical in a Type B (property) lease. In the latter, the lessee recognises a lease liability but the lessor does not appear to be required to recognise a corresponding lease receivable. This appears to be inconsistent with the core principle of the proposal: that an entity shall recognise assets and liabilities arising from a lease [paragraph 1]. Is this the boards' intention? Where the lessee and lessor are both entities within the same group, as is often the case in the public sector, this asymmetry will have to be adjusted in the consolidated whole-of-government financial statements.

Peppercorn leases

HoTARAC notes that where a lease has peppercorn lease payments, the usual lease classification may be reversed. An equipment lease would be classified as a Type B lease ***because*** "the present value of the lease payments would be insignificant relative to the fair value of the underlying asset at the commencement date". A property lease for the major part of the remaining economic life of a building would be classified as a Type A lease, ***despite*** "the present value of the lease payments being insignificant relative to the fair value of the underlying asset at the commencement date". This is not necessarily an issue but entities with peppercorn leases would need to be careful of how they classify them.

HoTARAC recommends that the AASB provide extra guidance on this for not-for-profit entities.

Measurement

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?

HoTARAC agrees with the proposals and considers them to be much more workable than those in the 2010 exposure draft.

HoTARAC notes that the lease term includes periods covered by an option to extend (or early-terminate) the lease where the lessee has a significant economic incentive to exercise (or refrain from exercising) the option. Despite the guidance given in paragraph B5, HoTARAC considers the meaning of ***significant economic incentive*** to be open to interpretation and requests further guidance of the meaning of ***significant*** in this context.

HoTARAC also requests further guidance on when a change to the lease term or variable payments would be recognisable. For example, would in-principle agreement between the parties be sufficient or would a formal change of the contract be necessary?

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?

HoTARAC disagrees with several aspects of the proposals on the measurement of variable lease payments.

In HoTARAC's view, the requirements in paragraphs 39(c) and 70(c) for a lessee's lease liability and a lessor's lease receivable, respectively, to include 'variable lease

payments that are in substance fixed payments' is too subjective and would be open to manipulation. If the Boards proceed with including such payments in the lessee's lease liability and the lessor's lease receivable, HoTARAC strongly recommends that further guidance be included.

HoTARAC also recommends that variable lease payments dependent on an index or rate initially measured at the rate at the commencement of the lease term only be reassessed where there is a significant change in lease terms.

HoTARAC suggests that variable lease payments in very long-term leases be measured in the same way as other long term assets or liabilities, for example using a superannuation liability approach.

HoTARAC disagrees with the proposal, in paragraph 72, for certain variable lease payments receivable by a lessor to be included in the initial measurement of the residual asset. HoTARAC considers that such payments should instead be accounted for as part of the lessor's lease receivable.

HoTARAC also finds paragraph 72 to be unclear and requests the Boards to provide some clarification in the final standard.

HoTARAC notes that there is no guidance on how a lessee (or lessor) should present variable lease payments ***not*** included in the lease liability (or the lease receivable). Should they be presented separately or included in the lessee's interest expense (or lessor's interest income)? HoTARAC recommends that such payments be presented separately and suggests that this be clarified in the final standard.

Revaluation of the residual asset

As explained in paragraph BC261, a lessor in a type A lease is not permitted to revalue the residual asset.

HoTARAC is concerned that the restriction on the revaluation of residual assets will cause inconsistencies for entities, such as Australian public sector entities, that adopt the revaluation model for similar property, plant and equipment.

HoTARAC therefore requests the Board to reconsider its reasoning and recommends that a lessor be permitted to apply the revaluation model to a residual asset if it applies that model to similar items of property plant and equipment.

Transition

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?

HoTARAC agrees with the proposal to permit two approaches to transition.

HoTARAC considers that the full retrospective approach is conceptually superior to the modified retrospective approach. Given the long-term nature of some leases, differences between the full and modified approaches could produce long-term comparability issues between entities. However, the full retrospective approach would add to the complexity of initial implementation, probably with little real benefit for users of financial statements.

Therefore, HoTARAC acknowledges the practicality of the modified retrospective approach and considers that allowing a choice of approaches is a reasonable and pragmatic solution.

HoTARAC expects the proposals to be challenging and costly to implement, regardless of whether the full or modified retrospective approach is adopted. HoTARAC therefore recommends that the Boards allow entities a ***substantial*** period to adopt the proposals.

Disclosure

Question 8 Disclosure

> Paragraphs 58-67 and 98-109 set out the disclosure requirements for a lessee and 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?

HoTARAC strongly supports the disclosure objectives set out in paragraphs 59 and 98 but disagrees with the voluminous mandatory disclosures listed subsequently. These requirements are too prescriptive and rules-based.

HoTARAC notes that the proposed disclosures are more extensive than those of the existing standard and considers that they would be excessive for some entities and would potentially confuse users.

Therefore, HoTARAC urges the Boards to review the need for so many disclosures. HoTARAC suggests that most of the disclosure paragraphs could be framed as examples of information that would meet the disclosure objective, subject to relevance and materiality considerations.

In particular—

- Paragraphs 54, 89 and 90 give preparers discretion as to whether to present lease disclosures on the face of the financial statements or in the notes. HoTARAC recommends removing such choice as it may result in inconsistent reporting and could facilitate financial statement manipulation. It is also likely to impair comparability between entities and potentially between years.

- Paragraphs 58 and 98 require disclosure of qualitative and quantitative information about ***all*** leases. HoTARAC suggests that the proposal should be clarified regarding the level of detail to be disclosed. For example, would these paragraphs require an entity to disclose the vehicle registration number for each leased vehicle?

- Paragraphs 61, 64, 103 and 104 require lessees and lessors to disclose reconciliations of amounts recognised in the statement of financial position. HoTARAC recommends removing these requirements. This information is likely to be confirmed during the audit.

Questions 9, 10 and 11

HoTARAC has no comments on Questions 9, 10 and 11 as those questions relate only to the proposed FASB standard and therefore would not apply in Australia.

<u>Other comments</u>

Consequential amendments to the framework

Appendix D to the exposure draft sets out amendments to other standards.

HoTARAC notes that the AASB's Framework for the Preparation and Presentation of Financial Statements will also need to be amended. It refers to finance leases at paragraph 51 and leases at paragraph 57.

Editorial suggestions

Appendix A contains a definition for *investment property* which paraphrases the full definition set out in IAS 40 *Investment Property*. HoTARAC considers that it would be more appropriate to refer readers to the original standard rather than paraphrasing the definition.

HoTARAC suggests the following editorial improvements to remove potential ambiguity.

- In paragraph 41(b), replace *unless paragraph 52 or paragraph 53 applies* with *subject to paragraphs 52 and 53*; and
- In paragraph 54(c), clarify whether it is two or three types of right-of-use assets that are to be presented separately.

ATTACHMENT 2

ADDITIONAL COMMENTS ON AASB SPECIFIC MATTERS

Question 1 GAAP/GFS harmonisation

In relation to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*:

(a) are you aware of any implications for GAAP/GFS harmonisation of the proposed changes?

(b) how do you think the implications for GAAP/GFS harmonisation of the proposed changes should be dealt with in the context of the principles in AASB 1049?

HoTARAC notes that GFS currently distinguishes operating leases from finance leases. The proposals will fundamentally change the basis for lease classification and change the recognition and measurement requirements for lessees and some lessors. These changes are likely to increase GAAP/GFS divergence.

HoTARAC notes that the proposals introduce asymmetry between lessor and lessee accounting in Type B leases. Conceptually this will be incompatible with GFS and will create a GAAP/GFS harmonisation issue.

The implications of using different lease classification schemes for GAAP and GFS are unclear. However, HoTARAC considers that several possible issues are likely to arise—

- New GAAP/GFS convergence differences would arise in relation to other economic flows (as defined in AASB 1049) as lessees would recognise reassessments of right-of-use assets and lease liabilities and revaluations of right-of-use assets under GAAP but not under GFS.

- The value of various key fiscal aggregates (as defined in AASB 1049) would change, for example net lending/(borrowing) would increase due to more leases being recognised on balance sheet.

- Net debt and net financial liabilities would increase due to the more extensive recognition of lease liabilities under the proposals. This could adversely affect a government's credit ratings.

HoTARAC also observes that GFS uses the term ***amortisation*** in relation to non-produced assets (eg land, subsoil assets and certain intangible assets) whereas the ED uses it in relation to right-of-use assets (paragraphs 41 and 42). It is unclear whether a right-of-use asset would ever be recognised under GFS and, if it was, whether it would be regarded as non-produced and therefore subject to amortisation under GFS.

Question 2 Regulatory issues

> Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
>
> (a) not-for-profit entities; and
>
> (b) public sector entities?

HoTARAC is not aware of any regulatory issues that may affect implementation of the proposals.

Question 3 Usefulness to users

> Overall, would the proposals result in financial statements that would be useful to users?

HoTARAC considers that the proposals would result in financial statements that are more useful to users, principally because of the recognition of lessees' right-of-use assets and lease liabilities.

Question 4 The Australian economy

> Are the proposals in the best interests of the Australian economy?

HoTARAC makes no comment on whether the proposals are in the best interests of the Australian economy.

Question 5 Costs and benefits

> Do you have any comments on the costs and benefits of the proposals relative to current requirements, whether quantitative (financial or non-financial) or qualitative?

HoTARAC notes the comprehensive effects analysis in paragraphs BC329 to BC439 and has nothing further to add.

Mr Kevin Stevenson
Chairman
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16 August 2013

Dear Kevin

Exposure Draft ED 242 – Leases

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board (AASB) with its comments on ED 242 Leases (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

Grant Thornton's response reflects our position as auditors and business advisers to the Australian business community. We work with listed and privately held companies, government, industry, and not-for-profit organisations (NFPs). This submission has benefited with input from our clients, Grant Thornton International, and discussions with key constituents.

The main views in this response are consistent with those of Grant Thornton International, although the proposed Grant Thornton International submission has not yet been finalised due to the significant difference between the closing dates for submissions to the AASB and the IASB. Nevertheless, our comments in this submission are expected to be largely consistent with Grant Thornton International's submission to the IASB and FASB. We have also included some additional comments that are not necessarily consistent with the Grant Thornton International views.

General comments

We welcome the Boards' decision to re-expose their leasing proposals. We also commend the Boards for continuing to work jointly on this critical and high profile project. We continue to support the Boards efforts to improve lease accounting. However, we are not in favour of proceeding with finalisation of the ED at this time. While we appreciate the efforts that the Boards have expended in undertaking to address the issues raised with the first ED, we do not believe that the proposed revisions would constitute an improvement to financial reporting.

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In our view, the revisions to the first ED are symptomatic of broader conceptual issues with the right of use asset approach to lease accounting. The first ED allowed for practical exceptions to the right of use asset model for short term leases and investment properties recorded at fair value. During the comment process it became apparent to us that the receivable and residual approach for lessors would not be practicable for all leasing arrangements and that lead to the realisation that not all leases would fit into a single model based on a right of use asset. We became concerned that the results of applying the right of use asset model would not be representationally faithful in all cases. By focusing on the right to use tangible assets, the model creates a distinction between service activities and rights of use that would create opportunities to structure transactions to not meet the definition of a lease. We also became concerned as time went on with the relevance of the information in terms of measurement of the assets and liabilities and revenue and expense recognition and the relationship of those measures to the timing and amount of future cash flows. The process of allocation of contractual payments to lease and non-leases elements adds complexity and the result ultimately may not provide the information that users need in terms of committed cash flows of the lessee in an understandable and convenient format.

At this time, we are not convinced that accounting for a right of use asset as tangible property is always representationally faithful. While amortisation and impairment testing may be appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not, nor would revaluation under IFRS be the appropriate model. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation. If control of the asset has passed to the lessee, there is no need for a separate right of use asset: the lessee should account for the underlying asset.

We also identified other inconsistencies that could arise from application of the right of use model to transactions to acquire groups of assets. If control of the underlying assets passes to the lessee, the transaction may be a business combination. If control of the underlying assets does not pass to the lessee, the arrangement would appear to be an executory supply arrangement. The right of use model would not appear appropriate for these transactions.

The Boards' efforts to address some of those concerns introduced additional complexity into an already overly complex model. We do not believe that the end result in this ED is conceptually consistent with the accounting in the Revenue Recognition project, the Consolidations project, nor the Conceptual Framework at the IASB. At this point, the significant anomalies identified with the right of return asset model have accrued to such an extent that we believe that it is time to develop an alternative approach.

A model based on control of the underlying asset

We believe that it is possible to develop a model that would provide users with information that is more relevant and representationally faithful, more understandable, less complex, and conceptually consistent with the accounting for similar transactions with customers or acquisitions. We encourage the Boards to further develop a model for classifying leases in a manner that would curtail current abuses and provide relevant and representationally faithful information to the users of the financial statements.

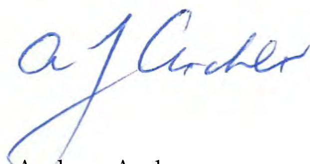
We suggest that the Boards develop a model for lessor accounting for a lease that is similar to the accounting for economically similar contracts with a customer, either a sale or an executory arrangement. Similarly, lessee accounting should be similar to the accounting for economically similar acquisitions, whether an asset purchase, a business combination, or an executory arrangement. In the long run, given the direction of Revenue Recognition, Business Combinations, and the Conceptual Framework, we believe a control based model combined with a model for accounting for executory arrangements is the only long-term solution to lease accounting.

We believe that the recognition, measurement and presentation of the assets, liabilities, expenses, and cash flows arising from a lease should differ based on whether control of the underlying asset has transferred from the lessor to the lessee. A control based model would be more consistent with the models for revenue recognition, consolidation, and the proposed change in the definition of an asset in the conceptual framework. A distinction, based on control of the underlying asset, was described in paragraph 8 of the Discussion Paper. In that document, the Boards proposed separate accounting for "a contract that 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." To that end, we would not use the term trivial in describing the risks and rewards and would also consider other indicators of control, such as the length of the lease term relative to the economic life of the asset, existence of options to renew a lease for the economic life of the underlying asset, purchase options, the ability to refinance, and perhaps other factors. We would prefer to see in this project an updated definition of control that would align with that in Revenue Recognition so that the opportunities to achieve a particular result through structuring are limited or non-existent.

A control based model should be based on control of the underlying asset not the right of use asset. We are not convinced that accounting for a leased asset as tangible property is always representationally faithful. While amortisation and impairment testing may be appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not, nor would revaluation under IFRS be an appropriate model. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation. Recognition and measurement of the rights and obligations created by the contracts for the lessor should be determined by the Revenue Recognition project. Recognition and measurement of the rights and obligations of the lessee should be part of this project and determined consistently with the intent of the Board in the Conceptual Framework project.

If you require any further information or comment, please contact Peter Kidd or myself.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED



Andrew Archer
National Head of Audit

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.

Grant Thornton Comments:

We do not agree with the current definition of a lease. Our main objections stem from concerns about whether the definition would be operational as a means of distinguishing between a lease contract and a service contract or between lease elements and non-lease elements within a contract. Specifically, we are concerned that the criteria for control of the right to use the asset and specified assets could lead to significantly different accounting outcomes for economically similar transactions, a result that is a major shortcoming of the current model. Potential ambiguity between what is a lease contract or element and what is an executory contract or element creates opportunities to structure transactions to achieve a particular accounting result. Even if structuring of transactions was not a concern, the degree of judgment required to distinguish whether an arrangement contains a lease could lead to diversity in practice.

We are concerned that the criteria for a specified asset will not result in financial statements that provide useful information. Application of these criteria would provide inconsistent information to users, create structuring opportunities, and potentially lead to diversity in application. The right to control the use of an asset appears to offer criteria in Examples 2 and 3 that would not be met by some owned asset and the determination relies heavily on whether consumables are available from third parties regardless of whether the customer has the right to use those consumables. We believe that the relevant information for users centres on the timing and amount of non-cancellable future cash flows. Whether consumables are or are not available in the marketplace would not appear to be relevant. Time spent evaluating, documenting and auditing the judgments made would therefore be a suboptimal use of scarce resources better employed elsewhere.

We are concerned that in many cases distinguishing between lease elements and non-lease elements will not provide the most useful information to the users of the financial statements. Users of the financial statements are interested in information about all the cash flows from all future commitments. The current definition of a lease will not provide that information.

We believe that a user is more interested in the committed cash flows than whether the contract conveys the right to use a particular strand or a comparable amount of capacity. The requirement to identify a specified asset also creates opportunities for structuring a transaction to obtain a particular accounting result in certain industries, including transportation and storage.

In addition, we note that, as written, there is potential for structuring between accounting for a transaction as a lease or a purchase of a group of assets. Under IFRS 3, a purchase of a group of assets that constitute a business would be accounted for as a business combination, including recognition of an unrecognised intangible assets and goodwill. However, if the transaction is structured as a lease, it would fall under the right of use asset model, a significantly different accounting result. We believe that transactions such as those described in Examples 1-3 should be evaluated under the consolidation literature first and, if not consolidated, accounted for as a supply agreement. If the group of assets does not meet the definition of a business, the acquisition should be accounted for as an asset purchase if the acquirer has control of the underlying assets as per IFRS 3 or, if the acquirer does not obtain control of the assets, as a supply agreement. We do not believe that power supply arrangements and similar contracts should be included within the right of use asset model. While we would not object to accounting for power supply arrangement as an operating lease, we believe it would be preferable to separately promulgate disclosure requirements for power supply agreements and similar non-cancellable contracts. We would include rights to use fibre optic cables, indefeasible rights of use (IRUs) in that same category.

Therefore we strongly prefer that the Boards develop a model for lessor accounting for a lease that is similar to the accounting for economically similar contracts with a customer, either a sale or an executory arrangement. Similarly, lessee accounting should be similar to the accounting for economically similar acquisitions, whether an asset purchase, a business combination, or an executory arrangement. In the long run, given the direction of revenue recognition, business combinations, and the conceptual framework, we believe a control based model combined with a model for accounting for executory arrangements is the preferable long-term solution to lease accounting.

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?

Grant Thornton Comments:

We agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases but do not agree with a model based on consumption alone. Nor do we agree with the accounting model proposed for Type B leases.

We believe that the recognition, measurement and presentation of the assets, liabilities, expenses, and cash flows arising from a lease should differ based on whether control of the underlying asset has transferred from the lessor to the lessee. Consumption may be one of the indicators of whether control of the underlying asset has been transferred to the lessee. We believe that a control based model would be more consistent with the models for revenue recognition, consolidation, and the proposed change in the definition of an asset in the conceptual framework.

There was a distinction based on control of the underlying asset, described in paragraph 8 of the Discussion Paper. In that document, the Boards proposed separate accounting for "a contract that 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." We encourage the Boards to further develop that distinction as a means of classifying leases in a manner that would curtail current abuses and provide relevant and representationally faithful information to the users of the financial statements.

We would prefer to see in this project an updated definition of control that would align with that in Revenue Recognition so that the opportunities to achieve a particular accounting result through structuring are limited or non-existent. To that end, we would not use the term trivial in describing the risks and rewards and would also consider other indicators of control, such as the existence of options to renew a lease for the economic life of the underlying asset, purchase options, and perhaps other factors.

We also do not agree with the accounting model proposed for Type B leases. At this time, we are not convinced that accounting for a right of use asset as tangible property is the correct model. While amortisation and impairment testing are appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation.

In the long run, given the direction of Revenue Recognition, Business Combinations, and the Conceptual Framework, we believe a control-based model combined with a model for accounting for executory arrangements is the best long-term solution to lease accounting. We believe that a control-based model for leases and similar transactions would be more conceptually consistent, and therefore more understandable, and more likely to provide useful information than the current right of use asset approach.

Measurement basis for right-of-use asset for Type B leases

We are concerned that the determination of a lease expense on a straight-line basis for Type B leases ignores the commercial reality that all leases have a financing element and results in a right-of-use asset that is a 'balancing number' that is not based on any clear principles.

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?

Grant Thornton Comments:
We agree that consumption is one of the factors that could be considered for classification of leases, but not the only factor. Consumption is another way of describing the extent to which the benefits of the underlying property accrue to the lessee, and is one of the current criteria in IAS 17. We believe that other factors would be relevant for determining whether control of the underlying asset has passed to the customer.

We believe that a better classification scheme would be to distinguish between those leases that are in substance a sale of the underlying asset (a Type A lease) and those that are not (in substance an executory contract that will be completed over time). Such a model, based on control of the underlying asset, was described in paragraph 8 of the Discussion Paper. In that document, the Boards proposed separate accounting for "a contract that 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." A Type B lease would be a lease that does not transfer control of the underlying asset to the lessee and therefore is not a sale but a performance obligation that will be satisfied over time.

If the Boards elect to continue with the proposed model, we believe that the classification criteria should be applied uniformly to property and non-property leases. We do not agree with classifying leases from the perspective of the lessor based on transfer of more than an insignificant portion of the economic benefits to the lessee. We note that this is not consistent with the criteria in revenue recognition for transfer of the significant risks and rewards of ownership of the asset. The proposed model therefore creates the potential for different accounting treatments for economically similar transactions. Therefore, we would prefer that the criteria for classifying property be used for all leases, in part because it is more consistent with the model in revenue recognition.

Complexity for Type A leases
Lessor accounting for Type A leases will be significantly more complex than for finance leases under the current requirements. Lessors would also need to establish processes to identify certain changes (e.g., changes in lease term, assumptions about any significant economic incentive to exercise an option to purchase the underlying asset, indexes or rates on which variable lease payments are based) that could trigger a reassessment of the lease receivable.

Type B leases – comparison to lessee accounting
Lessors would account for Type B leases by continuing to recognise the underlying asset and, at lease commencement, would not recognise a lease receivable (or residual asset) on the balance sheet or initial profit. We have some concerns that both the lessee and lessor would be recognising what is essentially the same asset. While it is acknowledged that lessee and lessor accounting does not necessarily have to be symmetrical, this does appear to be counterintuitive.

Type B leases – recognition of lease payments

The ED would require lessors to recognise lease payments from Type B leases over the lease term on either a straight-line basis or another systematic basis if that basis better represents the pattern in which income is earned from the underlying asset. Currently, when rental payments for an operating lease are not made on a straight-line basis, IAS 17 requires lessors to recognise lease income on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property (in which case that basis should be used). This requirement usually results in lessors recognising operating lease income on a straight-line basis.

It is unclear what the ED intends 'earned' to mean, as it relates to other systematic bases of lease income recognition. The basis for conclusions suggests that for stepped rent increases when those stepped rents are expected to compensate the lessor for increases in market rentals, recognising lease income as lease payments are received would better reflect the pattern in which income is earned from the underlying asset.

It is not clear whether a lessor receiving straight-line rent payments for the lease of an asset for which it expects market rentals to increase over the lease term could, by analogy, recognise lease income in a pattern reflecting higher periodic income in later periods (as it would also better reflect the pattern in which income is earned from the underlying asset).

Determining that lease payments in a Type B lease should be recognised on a basis other than straight-line would likely require significant judgement. In many cases, there will not be a clear distinction between increases in contractual lease payments that reflect the pattern in which lease income is earned (e.g., 'stepped' increases intended to compensate the lessor for changes in the market rentals) and other contractual increases that do not. Additional guidance may be needed.

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?

Grant Thornton Comments:

We agree that consumption of the underlying asset is one of the indicators of whether control of the underlying asset has transferred to the customer. We do not believe that it is the only factor that should be considered in making that determination. We would prefer that the Boards develop a model based on transfer of control of the underlying asset to distinguish between those contracts that should be accounted for as a sale and purchase and those contracts that do not and therefore are executory in nature.

Meaning of 'insignificant' – Type A leases

The revised ED does not define 'insignificant' for purposes of assessing the exception criteria for classifying leases of assets other than property, nor does it include much guidance on how this criteria should be applied. Therefore, evaluating whether a non-property lease meets either of the exception criteria would likely be subjective and require careful judgement. It is unclear whether 'insignificant' might be considered to be similar to 'minor' (i.e., 10%) in the current US lease standard or whether other criteria might be considered. We believe that guidance needs to be included in the Standard.

Meaning of 'major part' or 'substantially all' – Type B leases
Similarly, the revised ED does not define 'major part' or 'substantially all' for purposes of assessing the exception criteria for classifying leases of property assets, nor does it include much guidance on how these criteria should be applied. However, these terms are used to describe the indicators included today under IFRS to distinguish between finance and operating leases. Although these terms are used in IAS 17 today, they were introduced into IFRS by borrowing from the principles behind the bright-line 75% of the economic life and 90% of the fair value tests used for lease classification in the current US lease standard. Therefore, this could provide arguments to apply the 75% and 90% tests often used today except that there would be no bright-lines. We believe that guidance needs to be included in the Standard.

Land and buildings
The ED provides specific guidance for classifying a single lease component that contains both land and a building. In those instances, entities would refer to the remaining economic life of the building when classifying the lease (paragraph 33), which overrides the requirement to use the economic life of the primary asset (paragraph 32). This could result in a different classification than if the lease of land was assessed separately.

Land and buildings as one asset for this purpose does not make sense in many situations. For example, a lease of land and an older building, where the lease term is for the major of the remaining economic life of the building, but most of the economic use by the lessee is of the land would be classified as Type A. The substance would suggest that the lease should either be classified as Type B or split with the building lease as Type A and the land lease as Type B.

The lease classification criteria may also lead to opportunities for structuring leases into Type B when the substance is that they should be in Type A.

Definition of property
Additional guidance on the definition of property may be needed. For example, it is not clear whether certain structures that are attached to land, or buried under land, would be considered property assets or non-property assets under the ED. The distinction could affect the classification of leases for such assets.

Lease that includes the rights to use both a property asset and a non-property property asset
The determination of the primary asset in a lease that includes the rights to use both a property asset and a non-property property asset (i.e., the lease component contains the right to use more than one interrelated asset) might be difficult when the property asset and the non-property asset are dependent upon each other (i.e., the lessee cannot benefit from either asset without the other). Additional guidance may be needed to help entities apply this concept because the determination of the primary asset would affect the classification of the lease as well as the related accounting.

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?

Grant Thornton Comments:
In general, we do not agree with reassessment of the lease term absent a modification of the lease. The proposed guidance on reassessment of the lease term is an element of the right of use asset approach that has not proven its ability to provide useful information to investors. In our view, optional renewal periods would be a factor in determining whether control of the underlying asset has passed to the customer and therefore is determining whether the transaction is a completed sale or an executory contract. Reassessments of whether the transaction has transferred control to the customer should be rare unless there has been a modification of the contract.

If control has transferred to the lessee, the lessee should account for the underlying asset with a corresponding obligation to pay or return the asset. On exercise, the obligation to return would reclassify as an obligation to pay. A change in the likelihood of exercise should not change the accounting until it occurs. If control has not transferred to the lessee, the contract would be accounted for on exercise of the option.

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?

Grant Thornton Comments:
We do not agree with the proposals. We are not convinced that the proposals would provide users with relevant information. Our preference would be that the lessor use the same measurement prescribed in the Revenue Recognition project. A similar model should be developed for lessee.

Variable payments are a broad group and include many payments that are very different in economic substance. For example, assuming that control of the underlying asset has passed to the lessee, the asset should be recorded at its entry price. A subsequent change in a variable payment that that is due to a change in an inflation or interest rate index would affect the cost of financing the acquisition, but not of the cost of the asset and should be accounted for as such. Variable payments based on usage or sales may be may be an indicator as to whether control of the underlying asset has or has not transferred to the lessee. The payments may be executory in nature or may be a factor in determining the value of the residual asset of the lessor or obligation of the lessee at the end of the lease term. We believe that the accounting model should reflect those differences.

Question 7: transition
The ED proposes a modified retrospective approach to transition as an alternative to a full retrospective approach. The modified retrospective approach permits the use of certain ‘short-cut’ calculations to initially measure the lease-related assets and liabilities. In addition, entities would be able to use hindsight to determine the lease term or whether an existing arrangement contains a lease. The modified retrospective approach is intended to be lower cost and effort than the 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?

Grant Thornton Comments:
We are satisfied that the modified retrospective approach represents a reasonable alternative to the full retrospective approach.

It is unclear whether entities would classify arrangements previously classified as operating leases at transition using information as of the lease commencement date or another date (e.g., beginning of the earliest period presented in the financial statements). Exception criteria may be met when assessed as of a particular date (e.g., the commencement date) and not met when assessed as of a different date (e.g., the effective date).

For current finance leases, the ED does not address lessors' accounting for the lease receivable balance (effectively the residual asset) that remains at the end of the lease. It appears that lessors would reclassify such amounts to the appropriate category of asset (e.g., property, plant or equipment), but additional implementation guidance might be needed.

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?

Grant Thornton Comments:
Given that all leases are proposed to be 'on balance sheet', we have some concern that there appears to be a significant increase in the amount of disclosure for both lessees and lessors. While there are no specific disclosures that we consider to be unwarranted, we encourage the Boards to review the proposed disclosures and only require disclosures that are considered absolutely necessary.

Question 12: 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?

Grant Thornton Comments:
Yes. Not aware of any major issues.

AASB Specific Matters for Comment
We have no comments on the AASB specific matters.

19 August 2013

Mr Kevin Stevenson
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Dear Mr Stevenson,

IASB Exposure Draft ED/2013/6: *Leases*

Thank you for the opportunity to provide comments on the International Accounting Standards Board's (IASB or Board) Revised Exposure Draft (revised ED) *Leases*.

The Property Council is the peak body for owners and investors in Australia's $680 billion property investment sector. The Property Council represents members across all four quadrants of property investment, debt, equity, public and private.

We commend the Board for its extensive consultation and the proposed treatment for property leases.

The Property Council supports enhanced comparability of financial information between real estate companies worldwide.

It is essential that the IASB and US Financial Accounting Standards Board (FASB) issue a single agreed leasing standard because leasing is a major commercial imperative of the real estate industry.

We agree that aligning leasing standards across the globe requires recognising different approaches based on widely used commercial imperatives. We agree that the leasing standard should specifically support fair value accounting for property investment due to heavy reliance on fair value metrics by the industry.

The Property Council strongly supports the proposal that a lessor of investment property should apply IAS 40 for property leases (Type B leases).

In Australia, the fair value model is applied to most investment properties. IAS 40 is well understood and provides critical information to the real estate industry, investors and analysts.

Fair value is essential to understand Australian property performance, based on the value enhancement / destruction caused by management actions as well as changing market value for rents and valuation yields.

IAS 40 also requires reporting the total rental income in profit or loss. This is fundamental for investors to be able to assess the performance and investment quality of property companies. Removing this metric will adversely impact the information that property companies communicate to investors, financial analysts and other users of financial statements

We agree **with the Board's view** that the real estate industry is unique because:

- real estate is fundamentally different from other leased assets - it provides the right to benefit from demand to occupy the space above or below ground on a specified plot that is unlimited by time;
- an investor of a lessor views a lease as part of a constantly changing indivisible property asset, the valuation of which is highly developed and understood. In addition, the residual value is likely to be significant to the overall value;
- real estate investment requires considerable active and intensive management to create value. The level of lessor participation exceeds that typically found in equipment; and
- lessees of real estate are looking for more than financing. In many cases, a tenant is unable or unwilling to directly buy the asset. For example, a retailer seeking premises in a shopping centre and there are no individual units available for sale and the owner/manager has created an ambience of **exclusivity and attractiveness which suits the tenants' market image**.

The Property Council understands that some respondents consider the lessee model for Type B leases is inconsistent with the lessor model. The lease should be recognised on the balance sheet of the lessor because the lessor retains the value of the asset.

Irrespective of the lessee treatment for leases, accounting for Type B property leases should remain consistent with the revised ED i.e. that IAS 40 should be applied. This is because investors rely on IAS 40 to assess the investment quality and performance of real estate companies which is key to their investment decisions.

Comments on the specific questions in the revised ED are contained in the attached submission.

We are keen to discuss our recommendations with you further at your convenience. Please do not hesitate to contact Darren Davis on (02) 9033 1936 or myself to discuss the issue.

Yours sincerely

Andrew Mihno

Executive Director International & Capital Markets

Property Council of Australia

0406 454 549

IASB Exposure Draft ED/2013/6: Leases

Property Council of Australia
August 2013

Lessor accounting

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?

The Property Council strongly supports the accounting treatment for investment properties in the revised ED i.e. that a lessor of investment property would apply IAS 40 for Type B leases.

In Australia, the fair value model is commonly applied to investment properties. IAS 40 is well understood and relied on to provide critical information to the real estate industry, investors and analysts.

Fair value is important to help users understand the property's performance. The Australian market uses fair value to assess an investment through the value enhancement / destruction caused by management actions and changing market value for rents and valuation yields.

IAS 40 also requires reporting the total rental income in profit or loss. This is fundamental for investors to be able to assess the performance and investment quality of property companies. Removing this metric will adversely impact the information that property companies communicate to investors, financial analysts and other users of financial statements.

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?

The Property Council agrees that comparing the lease term to the economic life of the property and the lease payments to the fair value of the property is an appropriate basis for determining whether or not a real estate lessor should apply investment property accounting.

However, the lease term should be compared to the total economic life, rather than the remaining economic life of the building.

While this scenario is unlikely to arise frequently in the real estate context, it is not appropriate for a five year lease of property with a ten year remaining economic life to be recognised differently from a five year lease of property with a five year remaining economic life (where the total economic life of both properties was originally 50 years).

Rentals payments made by the tenant to the landlord relate partly to the floor space being occupied, but also more significantly to the location of the property. This is demonstrated through different rates per square metre being charged for properties of the same quality in different locations. The value of the location continues to exist at the end of the building's economic life and the landlord holds the residual interest in the property. This enables redevelopment should the landlord choose.

It would therefore not be appropriate to reflect a five year lease of property with a five year remaining economic life (where the total economic life was originally 50 years) as a type A lease, unless the present value test is met.

We agree with paragraph 33 that land and buildings should be assessed together for the purpose of determining the appropriate classification of a lease. However, we concerned that the revised ED requires that the economic life of the building should always be considered to be the economic life of the underlying asset for the purposes of classifying the lease.

There are circumstances in which the land element is significantly more valuable than the building, for example in industrial type assets. In these cases, it is incorrect to default to the remaining economic life of the building because the land is the more valuable underlying asset.

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

The Property Council agrees that the lease term is the non-cancellable period for which a lessee has the right to use the property. However, we recommend that the current concept of "reasonably certain" be retained because:

- the Board has acknowledged in BC 140 that the current concept works well in practice and the threshold is expected to be similar to the current concept of 'reasonably certain'; and
- the definition of 'significant economic incentive' is unclear.

We understand that the IASB is concerned that entities will structure shorter term leases with more renewals. However, there is an economic disincentive for lessees to do this as lessors will increase the cash cost of the rental payment.

In addition, it is common for new lease incentives to be negotiated when the terms of a renewal are being negotiated. Straight-lining the lease incentive across a period beyond the non-cancellable period of the lease is inappropriate.

The Property Council is concerned about the continuous reassessment of the lease term. While the revised ED only requires reassessment when a lessee has, or no longer has a significant economic incentive to renew, we question whether practically this is any different to requiring a reassessment at each reporting date.

The factors considered in the assessment of 'significant economic incentive' are very broad (contract based, asset-based, market-based and entity-based) which makes the assessment across a large portfolio of real estate very onerous.

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?

The Property Council agrees with the requirements in the revised ED for real estate lessors to recognise variable lease payments that depend on an index or rate in profit or loss in the period in which that income is earned.

We **recommend that the use of the term 'lease payments' in paragraph 93** is clarified to **only refer to "fixed payments, less any lease incentives received or receivable from the lessor"**.

Appendix A of the revised ED defines lease payments to include variable lease payments, exercise price of options to purchase and penalties for terminating. Given the "Basis for Conclusions", we do not consider that it is the intention of the Boards for these payments to be taken into account in determining the straight-line income recognised in profit or loss.

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?

As the recognition of investment properties is not expected to change, we do not anticipate significant transitional impacts.

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?

The revised ED requires disclosure about:

- **the nature of a lessor's real estate leases** (including a general description);
- the basis and terms and conditions on which variable lease payments are determined;
- the existence and terms and conditions of options to extend or terminate the leases; and
- the existence and terms and conditions of options for a lessee to purchase the underlying real estate.

The Property Council is concerned that it will not be possible to present this information in a meaningful manner because:

- the portfolio is so diverse that this disclosure will significantly extend the length of the financial statements; or

- the portfolio may be smaller and presenting this information will result in the disclosure of commercially sensitive information.

The revised ED requires disclosure of a maturity analysis of lease payments for each of the first five years and the total of the amounts for the remaining years.

Consistent with IFRS 7 Disclosures, entities should be able to determine the appropriate number of time bands so that the information provided is useful (rather than being provided merely for compliance purposes).

We support the IASB reviewing the existing disclosure requirements in IFRSs and developing a disclosure framework. This is consistent with our comments on IASB's Agenda Consultation.

Before finalising the Leases standard, the disclosures should be in line with the objective and recommendations of the IASB's Financial Reporting Disclosure Project.

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?

We 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).

The removal of the option results in greater consistency in accounting for investment properties.

Other comments

Lease incentives

Given the withdrawal of SIC-15 ***Operating Leases – Incentives,*** the final Standard should provide guidance to lessors regarding the recognition of lease incentives.

As noted in our response to question 4, the amortisation period should be consistent with the contractual period of the lease.

Lessee accounting

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?

The Property Council agrees with the Board that the nature of real estate leases is different to equipment leases. Real estate leases are not financings (which are typically for depreciating assets) and do not result in ownership of the property asset. The accounting treatment should differ based on whether a lessee is expected to consume more than an insignificant portion of the benefits of the property.

We therefore support the position in the revised ED that tenants should recognise a straight-line expense in profit or loss.

This approach reflects the economic substance of these leases and is consistent with the manner in which real estate lessors price such leases.

We commend the Board for conducting additional outreach to better understand the views of preparers and users about the economics of such leases and adapting the accounting treatment to reflect these views.

However, the adoption of the dual approach has highlighted that different leases have different economic substance and therefore that not all leases are necessarily financing in nature. Specifically, Type B real estate leases are not financing in nature.

In addition, recognising these real estate leases on balance sheet for lessees is inconsistent with the lessor treatment for Type B leases. The lease should be recognised on the balance sheet of the lessor because:

- the lessor retains the value of the asset and;
- investors rely on IAS 40 to assess the investment quality and performance of real estate companies which is key to their investment decisions.

We therefore recommend that the Board should reconsider whether it is appropriate to recognise Type B leases on balance sheet.

As a short-term solution, the Board should retain the recognition and measurement requirements of IAS 17 and include additional disclosures to provide the information required to satisfy the needs of users.

We also recommend that the Board hold public roundtables with users and preparers to understand the nature of the additional disclosures that are necessary, and then publish the results of this outreach.

Question 4: Classification of leases

Refer to response provided in question 4 above.

Question 5: Lease term

Refer to response provided question 5 above.

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?

The Property Council agrees with the option to apply a full retrospective or modified retrospective approach. If Type B leases are required to be recognised on balance sheet in the final Standard, an exception needs to be provided for leases previously classified as operating leases (if the lease term has ended before the effective date of the Standard).

We recommend that substantial lead time is required to:

- allow financial statement preparers adequate lead time for the adoption of the Standard; and
- educate shareholders and other interested stakeholders.

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?

The detail that would be required to present meaningful information for entities with large property portfolios will result this information being more difficult to understand.

We do not believe that providing reconciliations of the right-of-use asset or lease liability for Type B property leases provides useful information to users of the financial statements.

Government of **Western Australia**
Department of **Education**

Your ref :
Our ref D13/0436407
Enquiries :

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS ST WEST VIC 8007

Dear Mr Stevenson

I welcome the opportunity to provide comments to the Australian Accounting Standards Board (AASB) on ED 242 *Leases*. We acknowledge the tremendous amount of work that the AASB and IASB/FASB have invested in this project and the difficulties in meeting all stakeholders' needs.

Overall the Department of Education has concerns with the proposals, mainly from a business impact and cost versus benefit analysis. We also have some conceptual concerns as to whether the dual model best reflects the economic reality of some lease, hire etc arrangements.

- Overall we are opposed generally to the proposals.
- Costs versus benefits should be considered in any accounting proposals. In this case, there are little or no benefits to the Department but large costs, including potentially impacting front-line services.
- With large public sector agencies and especially those with decentralised environments such as the Department having approximately 800 schools in Western Australia (note that larger jurisdictions such as NSW have approximately 2,200 schools), the costs and business impact to obtain the information could be high.
- Transition to the new proposals seems to require all existing leases and potential lease contracts to be re-analysed. There would also be an ongoing need for increased monitoring of leases to comply with the reassessment requirements.
    - As both a lessee with large existing leasing portfolios as well as being a lessor of land and buildings – the system changes are likely to be significant.
- Financial accounting knowledge in these types of decentralised public sector environments is low. Also school registrars or administrative staff to do the analysis and implementation is limited in number and there could be some impact on front line services if they are to do some work.
- If the proposals proceed:
    - Prefer the application date be deferred as long as possible beyond 2017 - 18.
    - Public sector agencies will need the funding for resources to implement. In the current fiscal environment, this will not be provided by most jurisdictions' Treasury agencies. This could impact front line services, particularly if data capture is required at schools. It will cost resources; however Treasuries are highly unlikely to provide agencies with extra resources.
    - There are an extensive number of assets and different types of assets that we will need to consider and where data lies. The Department operates on a devolved or decentralised basis where schools are given

increasing flexibility and there could be arrangements that are captured by the proposals for which central office finance staff are currently unaware.

- If schools have to capture data, we would need a new system that would impact on workload which would go against the *Classrooms First Policy* in our devolved environment. If any new work is required, this has the potential to create industrial issues.
- There are unknown impacts from areas such as the need to examine all contracts for potential leases, i.e. assess whether they:
  - contain a lease agreement
  - are essentially service contracts with embedded lease components, or
  - are primarily lease contracts with attached services, such as maintenance services.
- Training will be extensively required.
- System implementation could involve significant costs.
- Collectively from the above points, applying the ED for the first time on transition would be a time consuming and costly process for which the Department could not currently resource.

Given this, the Department does not support the proposals in ED 242 *Leases*.

If you have any queries regarding the submission, please contact John Stanley on 08 9264 4162.

Yours sincerely

JOHN STANLEY
MANAGER FINANCIAL POLICY

Att.

Attachment 1

Initial Impact Assessment for WA Department of Education

The Department has a significant portfolio of leased assets including property leases currently held under operating leases across central office and 800 schools. Complying with the requirements of the new lease proposals, would place a huge administrative burden and strain on existing resources both on transition and on an on-going basis. It is thought that implementing the new lease proposals for a Government Agency such as ours, would outweigh any benefits they might provide.

The following outlines the extent of work for Department of Education relating to the new lease proposals:

1. All existing leases to be identified and re-analysed and then classified into Type A or Type B classification under the proposals

2. For both Type A and Type B leases determine the present value of the lease discounted using an appropriate discount rate. For each lease this involves:
   - Determining the lease term
   - Determining the number and amount of lease payments required during the lease term
   - Discounting the amount of the lease payments to their present value and determining their weighted average

3. Examine all contracts/agreements for potential leases, i.e. assess whether they:
   - contain a lease agreement
   - are essentially service contracts with embedded lease components or
   - are primarily lease contracts with attached services, such as maintenance services.
   - convey in the contract the 'right to control' the use of the 'identified asset'. *(Potential implications are some current leases would no longer be leases, and vice versa (e.g. consider lessor ability to substitute leased asset without requiring lessee's consent))*
   - have variable lease payments (depend on index or a rate are included, others linked to sales or use are still excluded), *(impact: increase asset & liability)*
   - have term options (included if there is a significant economic incentive to exercise them (rather than if it is reasonably certain at inception they will be exercised). *(impact: different?)*
   - have expected, rather than total, residual value guarantees (which are included) *(impact: decrease)*
   - have lease payments which are reassessed for changed circumstances, rather than only changes in contract terms *(impact: fluctuate more over lease term)*

   Look at all possible assets and arrangements including:
   - Some concern is possible arrangements outside of Common Use Arrangements (CUA's). There are no broad exemptions for Independent Public Schools (IPS) from using CUA's. Exemption must be sought from Department of Finance (as the CUA owner)
   - Photocopiers (schools, also central office)
   - Mobile phones, devices (schools, also central office) (not currently captured, but would all be under asset capitalisation threshold so no impact)
   - ICT equipment e.g. servers, Notebooks for teachers (held by ICT area centrally)
   - Agricultural equipment (held centrally)
   - Vehicles, approx 1000 (schools, also central office)
   - Buses (on central office system)

- Lessor of lands and buildings – The department is lessor for some assets and will need to look at various deeds.
- Lessor/hire of equipment such as planes, boats (not currently captured, thought that only schools hold these arrangements, possible 'lessor' implications.)

Once assessed, separate out lease components and non-lease components of a contract as under the proposals there are differences in accounting for services and leases

4. Based on all the above (1-3):
   - extract key data
   - separate the lease and non-lease components and allocate consideration
   - make new estimates and judgements
   - perform new calculations
   - consider impact on business practices and processes

5. For purposes of initial budget estimation (in the year before proposed transition):
   - make an inventory of all leases under the new proposal
   - carry out an evaluation of all leases as per points 1, 2 and 3 above
   - make an estimation of lease assets, liabilities, expenses and amortisation for initial budget estimates.

6. At transition, depending on whether modified or full retrospective approach is to be applied, gather all existing leases as per points 1, 2 and 3 above and work out:
   - Lease liability – equal to the present value of remaining lease payments, using discount rate as of date of transition
     - PV of lease payments includes expectations about various possible cash flows i.e. variable lease payments that depend on an index or rate (e.g. CPI), purchase options, RV guarantees, term option penalties as well as lease term.
   - ROU (Type A) Asset – recognise proportion to remaining lease term relative to initial lease term
   - ROU (Type B) Asset – recognise equal to the related lease liability, adjusted for uneven lease payments
   - Make necessary cumulative adjustments in opening retained earnings

7. Examine other lease issues:
   - Potential lessor of leases e.g. boats, planes
   - Multiple component leases

8. Ensure there is a systems in place or adapt current system to be able to:
   - manage and track leases under the proposals
     - note lease classification tests also need to be applied following a lease modification
   - determine present value of the lease using appropriate discount rate
   - provide note disclosures required under the proposals
   - provide any other information required by proposals
   - any other issues (arising from refer section on 'examine all contracts for potential leases')

9. Prepare impairment testing plan for ROU Assets.

Also, educate financial statement users as it may be confusing to understand how the new requirements would apply, and any impacts on the Departments business and processes.

Attachment 2

AASB Specific Matters for Comment

Issues 3 and 4, refer to comments in letter as well as comments below under 'what alternative approach would you propose and why' (context of lessee accounting).

IASB Questions for respondents

Scope

Question 1: Identifying a lease

No comment.

Lessee Accounting

Question 2:

Land and Buildings should be Type B

There appears to be a significant drafting flaw or conceptual flaw in the classification of leases that would have a significant adverse effect on the proposals in relation to land and buildings.

Para 35 in conjunction with para 52 appears to require land and buildings leases be classified as Type A whereas the policy intention must surely be that they are Type B unless there are exceptional circumstances. This would have significant illogical accounting treatment for public sector agencies where land and buildings are commonly held at fair value (as mandated by each jurisdictions' Treasury agency).

- Para 35: "a lessee shall not classify a lease as a Type A or a Type B lease if it chooses to measure the right-of-use asset in accordance with paragraph 52 or Paragraph 53. Such a lease shall be treated as a Type A lease when applying the applicable presentation and disclosure requirements."
- Para 53 allows lessee to measure right-of-use assets relating to a class of PPE assets at revalued amount.

ROU asset in a Type B lease as an asset and the straight-line expense recognition

If the proposals are to proceed, and an ROU asset is to be recognised for Type B leases notably land and buildings, we support the alternative measurement bases i.e. paragraph 53 in paragraphs 47-53.

In Australian jurisdictions, public sector agencies land and buildings are commonly mandated to be at fair value as is arguably best practise and consistent with GAAP/GFS Harmonisation. So the alternative measurement bases of fair value of the ROU asset under AASB 116 (paragraph 53) would be used. There are conceptually then two expenses to consider:

1. Lease expense – we support preserving straight-line expense recognition for most leases of property, similar to operating leases under the current AASB 117.
2. Amortisation of the ROU asset – some accounting commentator's have referred to this ROU asset subsequently being measured each period as a 'plug' or balancing figure, calculated by deducting the difference between straight-line lease expense, less interest on the lease liability each period,

from the initial ROU asset balance. This is apparent from reading paragraph 50. What is not clear is how paragraph 50 and 53 interrelate with each other particularly for leased buildings that are at fair value and revalued annually as our agency does. Our preferred accounting treatment is that these are amortised also on a straight-line basis. However, reading paragraph 50 does not seem to produce this outcome. This may be an unintended drafting error as the potential effects of revaluations should be considered by the standard setters and to avoid:
   a. Complicated accounting (straight-line amortisation is simple and arguably best reflects the consumption of economic benefits)
   b. Increased volatility in the Statement of Comprehensive Income
   c. Increased volatility in the Statement of Financial Position
3. The comments/concerns in 1 and 2 above can be ignored if the only expense recognised is a 'single lease cost' termed "Lease expense" and this is straight-line expense recognition. We support this accounting expense recognition pattern.

Lack of clarity if ROU asset is a tangible or intangible asset
It appears as though the ROU asset is an intangible asset. In the case of land and buildings owned and leased by the lessor it makes sense that under the proposals the lessor would recognise the tangible asset and the lessee would recognise the intangible asset – otherwise it would be double counting of the same tangible asset which would be physically, legally and conceptually impossible.

On the assumption the ROU asset is proposed to be an intangible asset, it is amortised in the proposals which supports it being intangible (rather than 'depreciated'). Technical confusion emerges in that the ROU intangible asset is then revalued in accordance with AASB 116 rather than AASB 138 which technically would be that fair value be determined with reference to an active market. We suggest that if the proposals proceed, the standard setters resolve this technical confusion by consequential amendments to the amended AASB 117, AASB 116 and AASB 138 by giving clarity to what the ROU asset actually is and treated by each of these standards.

- Presentation – paragraph 54 (a) broadly describes ROU assets as presented in Statement of Financial Position or disclosed in the notes as "ROU assets separately from other assets". Yet some accounting commentators are stating to "Present ROU assets within PP&E separately from other assets that the lessee owns". There could be interpretation issues from this lack of clarity.

Asymmetry for Type B lessor and lessee accounting within the consolidated entity
Adding to the comments immediately above, there are conceptual arguments against and practical issues with the apparent 'double recognition' of assets. For example, tow agencies recognise an asset in respect of land and buildings leased within government, the lessor the physical PP&E and the lessee the ROU asset. There is double counting and this will require consolidation elimination adjustments for Government's financial statements.

Even in the private sector, what seems to be the same asset will be represented on two entities balance sheets. This may present curious outcomes for a financial institution that is lending to both entities as it would seem to need to strip out an 'asset' of one of the entities Statement of Financial Position i.e. to adjust it to the correct financial position that there is only one asset.

What alternative approach would you propose and why?

The above issues we have raised and also expected to be raised by other accounting commentators in Australia, highlight concerns with the proposals both conceptually and practically. In addition, the proposals would entail a lot of costs and work for not a lot of benefits (as detailed in covering letter). Rather, the benefits to public sector agencies such as ours are not demonstrated.

For these reasons, we would prefer that the existing Standard be maintained i.e. Operating Leases (off balance sheet) and Finance Leases and the boards focus on making improvements to eliminate or minimise the concerns with existing practices. For example, consider how the accounting structuring in practice of transactions that may in substance be a financing arrangement and 'should' be on balance sheet – could be tightened. This 'off-balance sheet' financing seems to be the predominant reason for the proposals.

We note there may be similar 'accounting structuring' under the proposals too. Considering the requirements for a leasing transaction that involves multiple component arrangements, variable lease payments with non-lease (e.g. service component) and for which there may not be observable stand-alone prices. In these sorts of circumstances, off-balance sheet structuring opportunities may still exist.

Question 4: classification of leases

The ED does not provide 'bright-line' quantitative guidance on what constitutes an 'insignificant' part of the total economic life or an 'insignificant' amount of the fair value of an underlying asset. Some users may interpret this to be less than 5% (or arguably less than 10%) i.e. 'immaterial' in accordance with the analogy of materiality under accounting standards, but this is not clear.

Question 8: Disclosure

The Boards propose to implement a fundamental change in the lessee accounting model and increase the disclosure burden at the same time. As per comments in question 2, the proposals would entail a lot of costs and work for benefits that are not apparent to us. Does the failure to reduce lessee disclosures demonstrate a lack of confidence from the Boards in the recognition and measurement proposals?