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Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
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Dear Hans

IASB Exposure Draft ED/2013/6 *Leases*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft ED/2013/6 *Leases*. In formulating these comments, the AASB sought and considered the views of Australian constituents via comment letters, roundtables and targeted outreach meetings. The comment letters received are published on the AASB's website.

The AASB supports the broad direction of the proposals outlined in the ED because they are, incrementally, a step in the right direction to achieving improved accounting for leases. In particular, the AASB supports the proposals to bring assets and liabilities arising from lease arrangements onto the statement of financial position.

Despite the specific concerns noted in the Appendix to this letter in relation to the model proposed in the ED, the AASB is strongly of the view that it is important for the IASB to work towards finalising the lease accounting proposals. The AASB does not support a view expressed by some that retaining the requirements of IAS 17 *Leases*, even with additional disclosure requirements, is preferable to continuing with the approach proposed in the ED, even as an interim solution for lease accounting.

Given the extensive discussion and due process undertaken thus far, the AASB is disappointed that the IASB was unable to arrive at a single model for lease accounting. The AASB continues to support a single model for a lessee reflecting a right-of-use asset and a liability to make lease payments, rather than the dual model proposed in the ED. The AASB also continues to support a single model for a lessor. The AASB is concerned that a dual model would result in the creation of a new set of 'bright-lines' that will encourage structuring between types of leases. The AASB notes that eliminating structuring opportunities was part of the IASB's objective in undertaking the project.

Further, the AASB has concerns around the overall complexity of the proposed requirements. A consequence of the complexity of the proposed model is the need for a number of concessions and exceptions to the proposed requirements (e.g. the exception for short-term leases), which in themselves add further complexity to the requirements of an already complex model. In addition, the complexity of the model has also resulted in a significant number of additional disclosure requirements. This complexity has the potential to result in reduced transparency in financial reporting, to create structuring opportunities which diminish comparability and reliability of financial reporting, and to increase the cost burden on users and preparers of financial information.

Consistent with our general comments above, we also have a number of concerns on specific aspects of the proposals, as summarised below and expanded on in the Appendix to this letter.

Identifying a lease

The AASB agrees with the proposed definition of a lease. The AASB also agrees with the approach proposed in paragraphs 12-19 of the ED to identify whether a contract conveys the right to control the use of the identified asset. However, the AASB:

- disagrees that a capacity portion of an asset cannot be an identified asset, and recommends that paragraph 11 be amended to include the capacity portion of an asset as a valid example of an 'identified asset'; and

- recommends that additional guidance be incorporated into any final Standard to clarify circumstances in which a service is being provided in conjunction with the asset, and to assist in applying the control criterion.

Lessee accounting

The AASB generally supports the right-of-use model; however, the AASB disagrees with the dual accounting model. The AASB recommends that for all leases, the right-of-use asset should be amortised on a basis that reflects the depletion of economic benefits embodied in the assets.

Lessor accounting

The AASB disagrees with the dual accounting model proposed for lessors, and considers that there is no conceptual basis to draw a bright-line distinction between leases depending on whether the lessee is expected to consume an insignificant or a significant part of the underlying asset. The AASB also disagrees with the requirements for the calculation of the residual asset. The AASB recommends:

- the IASB consider including an option to measure the residual asset at its fair value, or at least permit accretion of the residual asset to its fair value;

- that expected variable lease payments be included in the measurement of the lease receivable, rather than in the residual asset;

- the IASB clarifies how lessors should determine the gross residual asset; and

- additional guidance be added to address how below-market leases should be accounted for by lessors under Type A leases.

Classification of leases

The AASB has significant concerns with the proposals to apply a different accounting approach to different leases, both for lessees and lessors. The AASB recommends:

- when a lease component contains the right to use more than one asset, the nature of the underlying asset be assessed on an individual asset basis, rather than primary asset basis;
- lease classification be reassessed only when there has been a 'trigger' event; and
- the IASB clarifies the terms 'insignificant portion', 'substantially all' and 'major part' to help avoid diversity arising in practice.

Lease term

The AASB generally agrees with the proposed measurement of the lease term. However, the AASB recommends:

- lease terms be reassessed only when there has been a 'trigger' event; and
- the IASB clarifies new terms such as 'significant economic incentive'.

Variable lease payments

The AASB disagrees with the proposed accounting for variable lease payments. The AASB recommends:

- including variable payments in the measurement of lease payments for both lessees and lessors, recognised and measured on a basis consistent with the approach adopted in the *Revenue from Contracts with Customers* project; and
- the IASB clarifies the meaning of 'in substance fixed payments'.

Transition

The AASB agrees with permitting a full or a partial retrospective approach to transition.

Disclosure

The AASB considers that the overall volume of disclosure proposed in the ED to be excessive. The AASB notes that much of the proposed disclosure could be reduced if a single model, rather than a dual model, were to be adopted.

Short-term leases

The AASB disagrees with the short-term lease exception. The AASB considers that the exception has no conceptual basis and is a departure from the treatment of short-term receivables and obligations under other standards (e.g. financial instruments).

If you have any queries regarding any matters in this submission, please contact Nikole Gyles (ngyles@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman and CEO

AASB's Specific Comments on the IASB Exposure Draft
ED/2013/6 *Leases*

The AASB's views on the questions in the Exposure Draft are as follows:

ED/2013/6 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:

- fulfilment of the contract depends on the use of an identified asset; and
- 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.

Definition of a lease

The AASB agrees with the proposed definition of a lease, and generally supports the proposal that the underlying principles for determining whether a contract contains a lease should be based on whether fulfilment of the contract depends on the use of an identified asset, and whether a contract conveys the right to control the use of the identified asset. The AASB considers that the clarifications provided in the ED overcome the concerns expressed by the AASB in its comment letter on ED/2010/9 *Leases* in regard to distinguishing whether a contract is for a lease or for a service.

The AASB considers that yet further guidance may be useful to clarify circumstances in which a service is being provided in conjunction with the asset. Separating these components has been identified as a potentially signficiant area of judgement and is likely to be difficult in practice. For example:

- the lease of a shop within a shopping centre, payments for all outgoings may not be specified in the lease contract. It is likely to be difficult to identify the lease payments attributable to the asset (right of use of the shop) versus payments for ancillary services provided by the lessor to run the shopping centre (such as security, electricity and cleaning).
- a wet lease of an aircraft in which the payments for services may not be specified in the lease contract. It is likely to be difficult to identify the lease payments attributable to the use of the asset (right of use of the aircraft) versus payments for services such as crew, maintenance, and insurance.

Capacity portion of an asset

The AASB disagrees with the view expressed in paragraph 11 of the ED that a capacity portion of an asset cannot be an identified asset, and that therefore a lease of a capacity portion of an asset would be outside the scope of the requirements in the ED. The AASB does not agree with the explanation in paragraph BC105(c) that “it would be unlikely that a customer would have the right to control the use of a capacity portion of a larger asset”. The AASB considers that the question of control of the use of an asset is a question of fact, and that paragraphs 12-19 of the ED provide adequate guidance to assess whether a contract conveys the right to control the use of an identified asset. The AASB considers, for example, that where an entity leases the capacity portion of a fibre-optic cable, that entity will ordinarily be able to direct the use of that capacity portion and obtain the benefits from its use, including restricting the access of others to those benefits. As such, a lease of a capacity portion of an asset does not appear to be economically different from a lease of a distinct physical portion of an asset, such as a floor of a building.

The AASB is concerned that the exclusion of leases for a capacity portion of an asset reflects a rules-based rather than principles-based approach to the scope of the standard, which may not be representative of the economics of such arrangements, and could present structuring opportunities. In addition, the exclusion of these leases appears to be contrary to the nature of the asset that underpins a lease, being a right of use of the asset, rather than the physical asset itself.

Accordingly, the AASB recommends that paragraph 11 be amended to include the capacity portion of an asset as a valid example of an ‘identified asset’.

Right to control the use of identified asset

The AASB agrees with the approach proposed in paragraphs 12-19 of the ED to identify whether a contract conveys the right to control the use of the identified asset. In particular, the AASB agrees that it is appropriate to apply a concept of ‘control’ that is consistent with the concept of control applied in other requirements and projects (i.e. the consolidation requirements in IFRS 10 *Consolidated Financial Statements* and the forthcoming revenue recognition IFRS). However, the AASB is concerned that the proposals, as currently drafted in the ED, may not be in complete alignment with IFRS 10 and the forthcoming revenue recognition IFRS. For example, paragraph 15 of the ED appears to be inconsistent with the requirements of IFRS 10 paragraph B51. Paragraph 15 indicates that in some contracts an entity that is involved in the design of an asset is deemed to be in control of the asset, whereas IFRS 10 paragraph B51 states that being involved in the design of an investee alone is not sufficient to give an investor control. The AASB would encourage the IASB to ensure the final drafting of each standard is consistent to help ensure there are no inadvertent conflicts of requirements relating to control.

The AASB agrees with the current scope of the proposals, however, as noted below, we consider additional guidance may be useful in applying the proposals.

Further, the AASB recommends that additional guidance be incorporated into any final Standard to assist in applying the control criterion, including in the following areas:

- the practical substitutability of assets. For example, applying the criterion to specialised assets such as physically remote assets (for example, assets associated with some mining operations). There is some concern that an entity could fall outside the scope of the guidance by permitting substitution of assets with no practical ability to do so;

- the application of the proposals to specified capacity of an asset. For example, specified time slots to use a rail line. There appear to be divergent views as to whether such arrangements would fall within the scope of the proposals;

- take or pay arrangements, for example, when 100 per cent of the output is taken, but operating protocols are established up front such that the entity is not operating or directing the operation of the plant; and

- incorporating the principal/agent guidance in IFRS 10.

ED/2013/6 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?

As noted in the cover letter, the AASB generally supports the right-of-use model proposed in the ED, and encourage the IASB's efforts to bring assets and liabilities arising from leases onto the statement of financial position of lessees. The AASB considers that recognising an asset representing the right-of-use asset obtained in a lease, and bringing to account a liability representing the obligation to make lease payments faithfully represents the economics of lease transactions. However, the AASB has significant concerns about the dual accounting model proposed in the ED, as discussed below.

Dual accounting model

The AASB disagrees with the dual model approach to lessee accounting (i.e. distinguishing between Type A and Type B leases), and considers that it lacks a robust conceptual basis, has the potential to introduce unnecessary complexity into accounting for lease arrangements, and is at odds with an important objective of the *Leases* project, which is to create a single accounting model for leases. In this regard, the AASB agrees with the alternative view of Prabhakar Kalavacheria and Wei-Guo Zhang, and considers that a single accounting model should be applied in accounting for all leases. However, the AASB supports the proposal that investment property held at fair value be accounted for in accordance with the requirements of IAS 40 *Investment Property* for the reasons given in the Basis for Conclusions.

The AASB agrees that many different types of lease arrangements exist, and that such arrangements may involve the lessee consuming a greater or lesser portion of the underlying asset over the term of the lease. However, the AASB considers that the fundamental economics of a lease (that a lessee obtains a right-of-use asset in exchange for an obligation to a series of payments to the lessor) do not vary depending on whether a lessee consumes a significant portion of the underlying asset. Accordingly, the AASB considers it conceptually inappropriate to regard the extent of consumption as giving rise to two distinctly different types of lease arrangements with differing expense patterns for the lessee. The AASB considers that all leases include a financing element to varying degrees, and should therefore clearly reflect a finance charge. The expected extent of consumption by the lessee of the underlying asset merely affects the risk borne by the lessor.

Further, the AASB is concerned that a dual approach to lessee accounting is unnecessarily complex and has the potential to reduce comparability of information about leasing arrangements. To understand the impact of leases on a lessee's financial position and performance, a user would need to appreciate that different leasing arrangements were accounted for differently (e.g. right-of-use assets were amortised at different rates, depending on whether they were the subject of Type A or Type B leases), and refer to different line items (interest and amortisation for Type A leases, lease expense for Type B leases, and unspecified line items for variable lease payments and short-term leases) to understand the overall impact of leases on the entity's profit or loss. This complexity has the potential to reduce transparency and impair the overall usefulness of information provided about leases, in particular when an entity has both Type A and Type B leases for the same class of asset (for example, some equipment leases may be Type A and others Type B).

Specific comments on the accounting model proposed for Type A leases

The AASB broadly agrees with the proposed lessee accounting model for Type A leases. In particular, the AASB agrees that a lessee should recognise a right-of-use asset and a liability to make lease payments. (However, please refer to the later comments on lease term and variable lease payments).

The AASB agrees that the liability is a form of financing provided to the lessee and accordingly interest should be accrued based on a rate that reflects the risk inherent in the contract, consistent with the provisions in IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments*.

The AASB agrees that the right-of-use asset should be amortised on a basis consistent with other standards such as IAS 16 and IAS 38. The AASB considers, however, that there is currently inadequate explanation in the ED of the nature of the right-of-use asset – that is, whether it is the underlying physical asset, or an intangible asset. The AASB recommends that the nature of the right-of-use asset be expressed, preferably in the Standard itself, or, as a minimum, in the Basis for Conclusions to the IFRS. This recommendation is made regardless of whether the IASB is able to provide a conceptual basis for the nature of the asset. Rather, the AASB considers that explicitly identifying the nature of the asset, even if the asset is arbitrarily 'deemed' to be either tangible or intangible, would help reduce potential confusion for preparers and users of financial statements and increase comparability.

Specific comments on the accounting model proposed for Type B leases

As noted in the cover letter, the AASB agrees that lessees should be required to recognise a lease liability and corresponding right-of-use asset for all leases, and therefore generally supports the proposals for initial recognition and measurement of Type B leases in the statement of financial position. However, the AASB is concerned about the subsequent lessee accounting model proposed for Type B leases. In particular, the AASB considers that:

- the straight-line expense pattern required under the model is not representative of the economics of lease transactions;
- the apportionment of amortisation over the life of the asset in a way that is dependent on the financing costs incurred on the lease liability and effectively results in *increasing* amortisation over the lease term, does not faithfully capture the depletion of economic benefits embodied in the right-of-use asset, and is inconsistent with both the definition of an expense in the Conceptual Framework, and with the requirements of existing IFRSs, specifically IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*. Further, the amortisation method removes comparability between leased and purchased assets. The consumption of economic benefits of a leased and purchased asset may be the same; however, the amortisation profiles would be quite different; and
- as a result, the measurement of the right-of-use asset does not reflect the economic benefits embodied in the asset and is therefore inconsistent with the Conceptual Framework.

Further, the AASB notes the recent discussion at the IFRS Interpretations Committee in relation to ED/2012/5 *Clarification of Acceptable Methods of Depreciation and Amortisation*—Proposed amendments to IAS 16 and IAS 38, during which the Committee agreed that the focus of the amendments should remain on the principle that the method used for depreciation or amortisation should reflect the expected pattern of consumption of the future economic benefits embodied in the asset (*IFRIC Update* July 2013).

As noted in the comments on the 'dual accounting model' above, the AASB considers that a financing element is inherent in every lease transaction. In particular, the right-of-use model regards the lessee as acquiring a right to use an asset, regardless of whether the lessee consumes a significant or insignificant portion of that asset. This right, rather than the underlying asset, is brought to account as a right-of-use asset by the lessee. A lessee also incurs a liability to pay for this asset. Interest is factored into lease payments, as repayments of the liability, and the benefits embodied in the right-of-use asset are consumed over the term of the lease – reflected as amortisation. Contrary to the economics described above, the straight-line single lease expense pattern obscures the interest that accrues on the liability, by using amortisation as a balancing item. Such an expense pattern is inconsistent with the fundamental concepts of both the time value of money and amortisation as depletion of economic benefits over the life of an asset.

The AASB considers that the analogy provided for the Type B accounting model in paragraph BC44, which equates a Type B lease to "paying interest on an interest-only loan", is inappropriate. By way of illustration, this rationale, applied in its entirety to a lease arrangement, would lead the lessee to recognise the entire leased asset (rather than the right-of-use portion of the asset) at the inception of a lease and record a corresponding liability, representing the lessee's obligation to return the asset at the end of the lease term. The leased asset would not be amortised over the lease term but rather derecognised in full at the end of the lease term, while lease payments would simply be regarded as paying down the interest expense accruing on the liability, resulting in a straight-line finance expense. Such an approach, however, is fundamentally at odds with the principles underlying the right-of-use model – a model the AASB continues to view as a faithful representation of the underlying economics of lease arrangements.

It is also unclear how the arbitrarily amortised asset balance would interact with other requirements in the ED, including revaluation (if adopted) of the right-of-use asset, and the impairment testing requirements:

- In Australia it is common for entities to apply the revaluation model for property, plant and equipment, including assets that do not meet the definition of investment property. For these entities, it is not clear how the Type B asset measurement requirements would interact with the accounting policy choice to revalue property, plant and equipment. In particular, it is not clear how paragraphs 50 and 53 of the ED relate to each other for Type B leases that are measured at fair value on an annual basis.

- It is unclear whether the right-of-use asset is potentially exposed to impairment in earlier periods due to the relatively lower level of amortisation in earlier periods. The AASB notes this issue is also raised by the alternative view of R Harold Schroeder (AV28) and agree that it is likely that the resulting impairment analysis will add further complexity to the proposed requirements. In particular, the AASB agrees with the alternative view of R Harold Schroeder as stated in paragraphs AV27–AV29 of the ED.

Accordingly, the AASB recommends that for all leases, the right-of-use asset should be amortised on a basis that reflects the depletion of economic benefits embodied in the asset, rather than serve as a balancing item to the interest accruing on the liability to make lease payments.

If the IASB continues with a dual approach to accounting for lessees, the AASB recommends that any final standard should acknowledge in the Basis for Conclusions that the measurement of Type B leases is a practical expedient and not based on the economics of lease transactions.

ED/2013/6 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?

Dual accounting model

As for lessees, the AASB disagrees with the dual accounting model proposed for lessors, and considers that there is no conceptual basis to draw a bright-line distinction between leases depending on whether the lessee is expected to consume an insignificant or a significant part of the underlying asset.

The AASB considers that for all leases where a lessee recognises a liability for its obligation to make lease payments, a lessor should recognise a corresponding asset for the right to receive payments.

Specific comments on the accounting model proposed for Type A leases

The AASB is concerned with the apparent 'double-counting' of assets by the lessee and lessor. Given the definition of control, and use of the control criterion to determine whether a lease within the scope of the proposals exists or not, the AASB considers it to be inconsistent that the same asset could be recognised in the statement of financial position of both a lessee and lessor. This issue is important for sub-lease accounting, in particular for subleases in which the lessee asset is a right to use asset and the asset recognised by the lessor is the underlying physical asset.

Residual asset and profit

The AASB disagrees with the requirements for the calculation of the residual asset, in particular the proposal to calculate the residual asset as an aggregate of the discounted gross residual asset, and the present value of variable lease payments, less any unrealised profit. The AASB is concerned that the aggregation of these elements, which represent significantly different concepts with dissimilar cash flow implications, has the potential to obscure the meaning of the residual asset, and hinder users' understanding of the amount, timing, and uncertainty of cash flows arising from lease arrangements.

The AASB considers the residual asset, as articulated in the ED, is inconsistent with the concept of a residual asset under IAS 16. The proposed restriction on the revaluation of residual assets will cause inconsistencies for entities that adopt the revaluation model for similar property, plant and equipment. The AASB recommends that the IASB consider including an option to measure the residual asset at its fair value, or at least permit accretion of the residual asset to its fair value.

The AASB recommends that expected variable lease payments be included in the measurement of the lease receivable, rather than in the residual asset – this is discussed in more detail below in respect of Question 6: variable lease payments.

The AASB also recommends that additional guidance be included in any final Standard to provide clarification as to how lessors should determine the gross residual asset. It is our understanding that, at the end of a lease, lessors obtain residual cash flows in a number of different ways, including the:

- sale of the asset;
- lessee continuing lease with no renegotiation (known as inertia rentals);
- ability to release the asset to the existing lessee at new agreed rates (with the exception of property these rates are usually lower than the existing lease rate);
- rewriting the existing asset into a new lease for additional equipment; or
- lease the asset to a new lessee.

In most circumstances, the lessor will seek to achieve the best economic outcome, and with a portfolio of leases, select the most favourable outcome on average across the portfolio. However, the AASB understands that there is diversity in practice in determining which measure of cash flow used to determine the gross residual value.

Implications for below-market leases

The ED currently does not appear to contain guidance that appropriately addresses how below-market leases should be accounted for by lessors under Type A leases[1]. Clarification of this issue is warranted as such lease transactions are common for for-profit equipment manufacturing transactions as well as for-profit entities leasing property or equipment to not-for-profit entities (for example, a lessor may only charge an implicit interest rate of two per cent, when a market interest rate might be ten per cent, because the entity is keen to ensure sales of its equipment).

The AASB is particularly concerned that the proposed requirements might result in either (1) a negative discount rate being applied to such lease arrangements, or (2) a negative residual asset being recognised at the inception of the arrangement. Either way, applying the model for Type A leases, we think there is no circumstance in which a lessor could initially recognise an expense relating to the derecognition of a leased asset for below market consideration.

In relation to applying a discount rate to the lease arrangement, paragraph B8 of the ED requires the rate used for the lessor to be 'the rate the lessor charges the lessee'. This rate, in turn, is defined in Appendix A as "a discount rate that takes into account the nature of the transaction and conditions of the lease. The rate … could be, for example, the rate implicit in the lease, or the property yield." The 'rate implicit in the lease' is defined as the rate that causes the sum of the present value of lease payments and the present value of the gross residual to equal the fair value of the underlying asset.

It is not clear whether the IASB intended that where lease payments are significantly below market that the rate implicit in the lease would be negative. For example, consider a 9-year lease of an asset with a fair value of $150,000, and carrying amount of $100,000 with lease payments of $10 per annum, and a gross residual asset of $10,000 at the end of year 9. Assuming such an arrangement meets the definition of a 'lease', these terms appear to result in a negative 26% discount rate being applied to the lease – being the rate that discounts the lease payments and gross residual to $150,000. As a result, at the inception of the lease, the lease receivable and residual asset recognised are both higher than the actual amounts that will be received, and the unwinding of the discount on the lease receivable and residual asset appears to result in a 'finance charge' being incurred year-on-year by the lessor.

As an alternative approach, albeit one that does not appear to be explicitly contemplated in the ED, the lessor might apply a market-based rate to the lease. However, in this case, applying the requirements in paragraphs 73-75 of the ED in relation to realised and unrealised profit would appear to result in an excessively high unrealised profit figure, and give rise to a negative residual asset under paragraph 71 of the ED (because element C is greater than A+ B).

[1] This issue assumes that such leases would be within the scope of the proposals.

The AASB is concerned that neither outcome truly reflects the economics of a below-market lease arrangement, which the AASB would generally consider to constitute a non-reciprocal contribution from the lessor to the lessee that, economically, should be recognised as an expense by the lessor on the date the arrangement is entered into. In addition, the AASB is concerned that this outcome is not consistent with the requirements of the forthcoming revenue from contracts with customers IFRS in regard to separation of performance obligations. For example, a motor vehicle sold by a manufacturer under a lease that is heavily subsidised would be expected to recognise the finance loss embedded in the lease at inception of the contract.

An alternative view is that if a lessor enters into a lease for amounts that indicate that the carrying amount of the asset being leased is higher than the lease payments, this event would trigger an impairment test and possibly result in an impairment loss immediately before accounting for the lease transaction. The lessor accounting proposals would then be applied to the revised written-down asset amount.

Clarification of this issue in the final IFRS would help avoid diversity in practice arising in relation to below market leases.

Specific comments on the accounting model proposed for Type B leases

As for lessees, the AASB does not agree with the proposed accounting for Type B leases. As noted in the cover letter, the AASB considers that for all leases where a lessee recognises a liability for its obligation to make lease payments, a lessor should recognise a corresponding asset for the right to receive payments.

ED/2013/6 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?

As noted in the responses to Question 2 and Question 3 above, the AASB has significant concerns with the proposals to apply a different accounting approach to different leases, both for lessees and lessors. However, if the IASB concludes that there are two different types of leases, the AASB could accept, for practical reasons, that they should be distinguished based on "whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset"[2].

However, the AASB is significantly concerned with the inconsistent application of this distinction to leases of property and non-property assets. The AASB considers that an approach that results in different classification based on the nature of the leased asset lacks a conceptual basis, and has the potential to result in inconsistent accounting for transactions that are economically similar. The AASB does not consider that the basis for this approach,

[2] Some Australian constituents have indicated support for retaining the IAS 17 model based on risks and rewards to distinguish between Type A and Type B leases. If the IASB retains the view that there are two different types of models, the AASB can see some justification for retaining the IAS 17 approach to classification on the basis of costs versus benefits.

provided in paragraph BC51, offers a sufficiently robust rationale for treating property leases differently from other leases. In particular, the AASB considers the implication that the approach "would not always result in conclusions that are consistent with the principle" is not adequately addressed. The AASB considers that the application of a different classification approach to assets depending on their nature, rather than the economic substance of the transaction, has the potential to result in reduced comparability. For example, the financial statements of a lessee or lessor of property assets would not be comparable with the financial statements of a lessee or lessor of non-property assets, even though the economic benefits and outflows arising from their leasing arrangements were equivalent.

The AASB also notes the significant implications of any change in the definition of property for the classification of leases. If the IASB continues with the proposal to have a dual model for accounting for leases, the AASB does not support any amendment to the definition of property that would potentially broaden the types of assets that would meet the definition of property.[3]

In addition, the AASB sees no conceptual basis for the proposed difference in the classification criteria for assessing the lease term when classifying leases, namely relative to the remaining economic life of the underlying asset in the case of property but relative to the total economic life of the underlying asset in the case of assets other than property. The AASB disagrees with the reasons for this approach in paragraph BC125-BC126. Thus, if the IASB retains the dual model approach to lease accounting, the AASB considers that the classification criteria should be consistent for both property and non-property assets, that is, the criteria should be based on the *remaining* economic life of the asset. It is also unclear how to apply this requirement in the context of assets that are acquired part way through their useful life.

Primary asset

The AASB recommends that the requirements in paragraph 32 of the ED to "regard the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria" be removed from the proposals and replaced with a requirement to assess assets on an individual basis. Further, if the requirements in paragraph 32 of the ED are retained, the AASB recommends adding an example in which the primary asset is not a building, but rather land on which the building is located. It is our understanding that for many such leases the location of the leased land is significant as compared to the physical structure on the land.

Reassessment of lease classification

The AASB disagrees with the requirement to assess lease classification at commencement only, and not reassess classification after the commencement of the lease unless there is a substantive change in the contract. The AASB shares the concerns raised by Messrs Kalavacherla and Zhang, that the prevention of lease classification reassessment may give rise to structuring opportunities (see paragraph AV7), and recommends that conceptually,

[3] Refer, for example, to the ongoing discussion at the IFRS Interpretations Committee in relation to IAS 40 *Investment Property*—Accounting for a structure that appears to lack the physical characteristics of a building.

the approach taken to reassessment should be similar to that in IAS 36 *Impairment of Assets*, and that reassessment should be required when there has been a ‘trigger’ event.

Additional guidance

If the two-model proposals proceed the AASB recommends the IASB clarifies what is meant by ‘insignificant portion’, ‘substantially all’ and ‘major part’ to help avoid diversity arising in practice. Any clarification should be cognisant of the use of these terms in other standards (for example, the term ‘substantially all’ is also used in IFRS 11 *Joint Arrangements* and in IFRS 10).

ED/2013/6 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 AASB generally agrees with the proposed measurement of the lease term. The AASB agrees that the reassessment of the estimated lease term is necessary. However, consistent with the AASB’s comments on ED/2010/9 *Leases*, the AASB is concerned that the way in which the proposals are currently expressed would lead entities to reassess their estimations every reporting period. The AASB recommends that the approach taken to reassessment of the lease term be clarified to be similar to that in IAS 36. That is, reassessment should only be required when there has been a ‘trigger’ event that indicates reassessment may be required.

Further, the AASB recommends the IASB provides additional guidance to clarify the new terms being introduced into the standard, such as ‘significant economic incentive’.

ED/2013/6 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 AASB disagrees with the proposed accounting for variable lease payments, and considers that variable lease payments meet the definition of assets and liabilities and should be included in measurement of a lessee’s right-of-use asset and lease liability, and a lessor’s lease receivable.

The AASB is concerned that the approach to exclude variable lease payments from measurement of the lease asset and liability is inconsistent with the approach taken in other IASB standards and projects. For example, the requirements being developed in the *Revenue from Contracts with Customers* project would recognise variable consideration at an estimate of the amount of consideration the entity will be entitled to under the contract. Further, IFRS 3 *Business Combinations* requires the acquisition-date fair value of contingent consideration to be included in the measurement of consideration transferred. The AASB is of the view that standards should, to the extent possible, have a consistent approach in dealing with similar items.

The AASB also considers that the proposals to exclude variable payments from measurement of lease payments, except where they depend on an index or rate, or are in-substance fixed, does not reflect the economics of lease arrangements. The AASB considers that lease payments should not be treated differently solely because the amounts to be paid are uncertain or variable. As noted in the Conceptual Framework, there is a need to balance reporting information which is reliable (i.e. fixed/known) and which is timely, and "if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim". The AASB considers that when variable rentals are material, capitalising only some variable lease payments is not representationally faithful, and has the potential to misrepresent a lessee's obligations and a lessor's entitlement to receive payments under a lease arrangement.

From a lessor's point of view in particular, including variable lease payments in the measurement of the residual asset rather than the measurement of the lease receivable is not representative of the nature of the asset – which, unlike the gross residual asset, is in substance a receivable rather than a tangible asset. Consistent with this, it is misleading for lessors to be required to recognise an expense, as required by paragraph 83, representing the variable payments expected to be earned in the period. The expense so recognised appears to be inconsistent with the definition of an expense in the Conceptual Framework, as "a decrease in economic benefits", given that it represents a payment that is expected to be received by the entity in the period. The treatment is also inconsistent with how the receipt of an uncertain amount of funds is accounted for under other Standards.

The AASB is also concerned that the exclusion of variable lease payments from the measurement of lease payments may present structuring opportunities. For example, the proposed requirements would result in a lessee recognising no liability, and a lessor no receivable, where lease payments were based on a factor other than an index or rate (e.g. a percentage of the lessee's sales).

The AASB recommends including variable payments in the measurement of lease payments arising from a lease contract for both lessees and lessors, recognised and measured on a basis consistent with the approach adopted in the *Revenue from Contracts with Customers* project.

The AASB agrees that reassessment of variable lease payments is necessary; however, the AASB is concerned that the way in which the proposals are currently expressed would require entities to reassess their estimations of variable lease payments every reporting period. The AASB recommends the approach taken to reassessment of the lease term should be clarified to be similar to that in IAS 36. That is, reassessment should only be required when there has been a 'trigger' event that indicates reassessment may be required.

If the IASB decides to continue with the proposals, the AASB recommends the IASB provides additional guidance to clarify the meaning of 'in substance fixed payments' to help avoid diversity in practice arising.

ED/2013/6 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?

The AASB agrees with the proposal to allow lessees and lessors to adopt either a full or a partial retrospective approach to transition. General comments received from Australian constituents have indicated that the proposals would be very challenging to implement and would require a significant amount of time for transition.

The AASB would also like to highlight the interaction between the Leases proposals and the forthcoming *Revenue from Contracts with Customers* IFRS. Given the interaction, in particular in relation to the lessor proposals, the IASB will need to carefully consider the application date of the Leases proposals. The AASB considers that both proposals will require a significant amount of resources to implement and therefore sufficient time should be provided for entities to prepare for implementation of the proposals.

ED/2013/6 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 AASB considers that the overall volume of disclosure proposed in the ED to be excessive. The level of disclosure appears to highlight the significant complexity associated with the proposed model. In particular, the AASB notes that much of the proposed disclosure could be reduced if a single model, rather than a dual model, were to be adopted.

The AASB also questions the need for additional lease-accounting-specific disclosure requirements. The AASB's preference would be for lease disclosure to follow existing disclosure requirements of Standards, to the extent possible. For example, disclosures relating to right-of-use assets could be based on the existing requirements of IAS 38 if it is considered to be an intangible asset (alternatively, the disclosure requirements could be based on IAS 16 if the right-of-use is considered a tangible asset).

A number of Australian constituents have also expressed concern in relation to the usefulness of the proposed narrative information about the nature of lease arrangements. For entities with a significant number of leases of differing natures, this disclosure would be extremely lengthy, or summarised at such a high level as to lose any potential usefulness for users.

In terms of short-term leases the ED provides an exemption from the classification, recognition, measurement, and presentation requirements for lessees and lessors for short-term leases (discussed further below). However, many of the disclosure requirements would also appear to be irrelevant outside of the Type A/Type B accounting requirements – e.g. many of the requirements focus on disclosures about the 'lease liability and lease asset', this would technically mean that even less information would be provided about short-term leases than is currently provided about operating leases under IAS 17, since there's no liability or asset recognised. The AASB thinks it is generally unclear how short-term leases would be presented and which of the non-excluded disclosures would be relevant to them.

ED/2013/6 Question 12[4]: 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?

The AASB agrees with the proposed amendments to IAS 40.

Other issues

Short-term lease exception

The AASB has concerns with the exception from the recognition, measurement and presentation requirements for short-term leases in paragraphs 118-120 of the ED. The AASB considers that the exception has no conceptual basis and is a departure from the treatment of short-term receivables and obligations under other standards (e.g. financial instruments).

The AASB considers that the cost of providing additional information about short-term leases would not outweigh the benefit to users of information about such leases, where the rights and obligations arising from such leases are material. The AASB is of the view that the materiality concept in IAS 1 *Presentation of Financial Statements* could be applied to provide sufficient relief for entities with immaterial leases, regardless of their duration.

Furthermore, the AASB is of the view that while this exception may reduce some of the reporting burden on preparers, it has the effect of introducing additional complexity into lease accounting, by effectively adding a third approach to the model. As a result, users would need to look to yet another line item to understand the expected impact of leases on

[4] Questions 9-11 of the ED are FASB only questions.

an entity's financial position and performance. The AASB is of the view that to remove the exception would result in little additional cost to preparers (as they would already need to obtain information about their total lease obligation in order to present short-term lease payments on a straight-line basis) and yield significant benefits to users by simplifying the lease model, and bringing onto the statement of financial position any additional information about leases. On this basis, the AASB recommends removing the exception.

Finally, the AASB is concerned that the approach may present a structuring opportunity for entities (e.g. an entity may enter into a 12-month lease with no explicit extension options, but where a significant economic incentive exists for both the lessee and lessor to renew the lease on expiry).

If the IASB proceeds with the proposal to provide an exception for short-term leases, the AASB considers that the IASB should address the following issues, which arise out of the current drafting of paragraphs 118-120.

- It is unclear how lessees and lessors should account for variable lease payments arising under the lease (given that paragraphs 118 and 119 only refer to 'lease payments', and these are defined in Appendix A to exclude variable lease payments that do not depend on an index or rate, or are in substance fixed).

- Further guidance is needed around what presentation requirements are applicable to short-term leases. The AASB notes that among the paragraphs excluded by paragraph 118 is paragraph 57, which contains a requirement to present short-term lease payments separately in the statement of cash flows. No presentation requirements are included for cash flows arising from short-term leases.

- Paragraph 119 provides 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. The AASB recommends that a lessor in a short-term lease also be given optional relief from the recognition requirements in paragraph 68.

- Additional disclosures are required to enable users to understand the rights and obligations that are created under short-term lease arrangements for lessees and lessors. Although paragraphs 118 and 119 do not exclude the disclosure paragraphs in the ED, many of the disclosures required by those paragraphs are relevant only to Type A or Type B leases, and would not be applicable to short-term leases (e.g. they require disclosure about right-of-use assets, lease liabilities, or lease receivables). While the AASB does not see additional disclosures about short-term leases as an adequate remedy for the loss of information and additional reporting complexity arising from the exception, the AASB considers that additional disclosures are necessary to at least in part mitigate these impacts. In particular, in addition to the existing disclosures that appear to be relevant to short-term leases, the AASB would encourage the IASB to require disclosures about:

    - total future lease payments to be payable under short-term leases for lessees [IAS 17.35(a)];

- total future lease payments to be receivable under short-term leases for lessors [IAS 17.56(a)];
- short-term lease expense recognised in the period, with separate amounts for lease payments, variable lease payments not included in the straight-line lease expense calculation, and sublease payments, for lessees [IAS 17.35(c)]; and
- short-term lease income from variable lease payments not included in the straight-line lease income calculation for the period, for lessors [IAS 17.56(b)].

Scope: Leases of intangible assets

The AASB agrees with the proposal to exclude leases of intangible assets from the scope of the leasing proposals for lessors. However, the AASB considers it inappropriate to not require lessees to apply the lease accounting proposals to leases of intangible assets.

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

Lease incentives

The ED proposes to withdraw SIC-15 *Operating Leases – Incentives.* The AASB recommends that final Standard provides guidance to lessors regarding the recognition of lease incentives.