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

Dear David

IASB Exposure Draft ED/2010/9
Leases

The Australian Accounting Standards Board (AASB) is pleased to provide its comments on Exposure Draft ED/2010/9 *Leases*. In formulating these comments, the AASB sought and considered the views of Australian constituents. The comment letters received are published on the AASB's website.

Overall view

In summary, the AASB supports the proposal to remove the distinction between operating and finance leases. The AASB considers that the proposal would, overall, result in improved information for users of financial reports. This is because it would enable them to improve their assessments of the extent of the financing and resources deployed by entities to operate their business. However, the AASB does not agree with all aspects of the proposals, as noted in the appendix to this letter.

The AASB also supports the decision made by the IASB to proceed with a fundamental review of lessor accounting, but thinks that only one model should be applied to lessor accounting, namely the derecognition approach.

The AASB agrees that the review of lessee and lessor accounting should be performed concurrently. However, the AASB is concerned that the lessor proposals are not sufficiently advanced and thinks that the quality of the proposed Standard should not be compromised to meet a 30 June 2011 timeline.

Cost of the proposals

Concerns have been raised by Australian constituents regarding the cost burden the proposals might impose on lessees with a large volume of leases currently classed as operating leases under the existing Standard. This cost burden arises from the initial cost of complying with the proposals in the year of transition, namely capturing information for a large volume of leases, and from the ongoing cost of the proposals due to the need to reassess option periods

and contingent rents and maintain significantly expanded asset registers. The AASB encourages the IASB to continue its outreach efforts to ensure that the benefits of these proposals outweigh the costs.

Justification of assets and liabilities under a lease contract

Although the AASB agrees that a lease contract creates assets and liabilities, the AASB thinks that the proposals should better justify why leases are not executory contracts and how contingent rents and option periods not yet exercised give rise to assets and liabilities.

Service versus a Lease

The AASB is concerned that the proposals do not go far enough to help entities distinguish between a service contract and a lease contract, and how to separate payments in a contract that contains both service and lease elements. Although some of the guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease* has been included in the proposals, the AASB is concerned that the guidance is not sufficiently robust to deal with the variety of service/lease situations that would now be scrutinised due to the removal of the operating lease classification.

The AASB's specific comments on the questions in the exposure draft are set out in the attached submission.

If you have any queries regarding any matters in this submission, please contact me or Jessica Lion (jlion@aab.gov.au).

Yours sincerely

A handwritten signature in black ink that reads "K. M. Stevenson". The signature is written in a cursive style with a long, sweeping underline.

Kevin M. Stevenson
Chairman and CEO

**AASB's Specific Comments on the IASB Exposure Draft
ED/2010/9 Leases**

The AASB's views on the questions in the exposure draft are as follows:

Question 1:

- (a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- (b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Response to 1 (a) – proposed lessee model

Yes, the AASB agrees a lessee should recognise a right-of-use asset and a liability to make lease payments. Although the Basis for Conclusions contains a brief discussion about executory contracts, the AASB would prefer to see a more comprehensive discussion of why leases are not executory contracts.

Response to 1 (b) – amortisation and interest

Yes, the AASB agrees the right-of-use asset is an intangible asset and as such should be amortised in accordance with IAS 38 *Intangible Assets* and the liability to make lease payments is a loan and as such interest should be recognised. However, the AASB also thinks that the lessee should be able to fair value the liability to make lease payments, as an alternative accounting policy choice, to be consistent with the option available for the measurement of financial liabilities in IAS 32 *Financial Instruments: Presentation*/IAS 39 *Financial Instruments: Recognition and Measurement*/ IFRS 9 *Financial Instruments*, on the basis that this would provide more relevant information in circumstances where fair value can be reliably determined.

Question 2:

- (a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?
- (b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Response to 2 (a) – proposed lessor model

No, the AASB thinks that one approach should be applied to lessor accounting. The AASB is concerned that having two approaches to lessor accounting will result in a lack of comparability between entities and introduce significant judgement into lessor accounting that the Boards are trying to remove from lessee accounting.

The AASB prefers the ‘full’ derecognition approach, with revaluation of the residual asset allowed under IAS 16 *Property, Plant and Equipment*. The AASB thinks that the substance of a lease is providing access to an asset for a period, and the provision of finance for that arrangement, and that lease accounting should reflect this model consistently for both lessees and lessors. The AASB therefore supports the ‘full’ derecognition approach for the following reasons:

- the ‘full’ derecognition approach better reflects the economics of a lease transaction;
- it is more consistent with the proposed approach to lessee accounting (easier/more intuitive for sublessors and consolidations);
- the Basis for Conclusions states that avoiding day one profit/loss is one of the reasons for proposing a partial rather than full derecognition approach. However, the partial derecognition approach may result in day one profit/loss anyway, so this is not a valid argument for the partial derecognition approach instead of using the full derecognition approach;
- partial derecognition does not give intuitive outcomes when the fair value of the residual asset is greater than its carrying amount, as a profit may be recognised at the end of the lease contract if the residual asset is subsequently revalued;
- the lessor is required to obtain the fair value of the underlying asset to be able to apply the partial derecognition approach, yet it is the fair value of the residual asset that lessors currently focus on in managing their business, so ‘full’ derecognition is likely to be less costly for lessors to apply;
- the AASB considers the ‘full’ derecognition approach to be consistent with the revenue recognition proposals (although the AASB notes that others think the ‘full’ derecognition approach is inconsistent with the revenue proposals in ED/2010/6). This approach assumes that the performance obligation was satisfied with the transfer of the underlying asset on day one;
- the performance obligation approach assumes there is an ongoing obligation of the lessor, which some see as inconsistent with the lessee recognising an unconditional right to use the leased asset;
- the ‘full’ derecognition approach is more conceptually correct as there is no potential ‘double-counting’ as occurs with the performance obligation approach; and
- impairment testing is easier to apply when there is no potential for double counting of cash flows.

The AASB acknowledges there are challenges in the ‘full’ derecognition approach, particularly for leases of a portion of an asset, or leases where the lease term is for a relatively short period. However, the AASB does not consider that these challenges are sufficient to justify two models for lessor accounting.

The AASB thinks that, if the IASB concludes there are two different types of business models for lease accounting, these two models need to be reflected in both the lessee and lessor approaches to lease accounting. If the two model lessor proposals proceed:

- more guidance would be needed as to what constitutes ‘significant’ in the context of transferring risks and rewards. It would be useful to have more guidance as to how the concept of risk and rewards interacts with the concept of control in determining whether a sale has occurred. One view is that transferring significant risks and rewards is an indicator that control has passed;
- more guidance is needed on how to account for the underlying asset once it is returned to the lessor at the end of the lease;
- the residual asset should be allowed to be revalued. If this approach is not going to be taken then a method should be applied to the residual value that allows accretion up to the fair value of the residual asset when that fair value is greater than the residual asset carrying amount;
- the AASB is concerned that the proposal for the lessor to measure the performance obligation based on the pattern of usage of the underlying asset by the lessee is inconsistent with the proposals in ED/2010/06;
- guidance is needed on how to account for a residual asset if the fair value of the lease payments is greater than the fair value of the underlying asset, which may particularly occur for leases of long-term assets;
- more guidance is needed on how to determine whether to use the performance obligation approach or the derecognition approach for long-term leases of land, as often the lease term is insignificant in terms of the life of the asset and the present value of the underlying asset at the end of the least term is not expected to change significantly, and hence the proposed indicators to be used in determining which approach to adopt do not give a definitive answer as to which approach to adopt; and
- consider consistent wording for the discussion of risks and/or benefits, or explaining why different terms have been used. For example, use of the word ‘or’ in paragraph 29 with regards to ‘risks **or** benefits’ (emphasis added) compared to paragraph 8 (a) ‘risks **and** benefits’ (emphasis added).

Response to 2 (b) – assets/liabilities/income and expense for lessor model

As noted above the AASB supports the ‘full’ derecognition model with revaluation of the residual asset allowed, and hence agrees with the derecognition of the underlying asset, recognition of a lease receivable, recognition of a gain or loss on derecognition and recognition of interest income on the lease receivable.

Question 3:

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

- (a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the

underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

The AASB supports the proposals for simplified accounting for short-term leases for lessors.

However, the AASB thinks that the simplified accounting for short-term leases for lessees could be simplified further. The AASB would support an ‘accruals basis’ for short-term leases by lessees (as proposed for short-term leases of lessors). The AASB also thinks that the IASB should consider whether the disclosure requirements should be reduced for short-term leases, for both lessees and lessors (see the AASB response to Question 15).

Question 4:

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Response to 4 (a) – definition of a lease

The AASB agrees there is no need to retain the IAS 17 reference to non-cancellable periods. However, the Basis for Conclusions should identify why this distinction has been removed and how assets and liabilities can still be created by cancellable leases, particularly given the significance of the cancellable/non-cancellable distinction from which entities would be transitioning.

The AASB has concerns with the proposed definition of a lease, in regards to distinguishing whether a contract is for a lease or for a service. This definition will come under more scrutiny than before due to the removal of operating lease accounting. Although some of the guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease* is included in the proposals, there are concerns that it may not be sufficiently robust to be able to be applied to all situations, given it was written for a specific circumstance.

The AASB notes that the definition of a lease in the proposals refers to a ‘specified’ asset, where as IFRIC 4 refers to a ‘specific’ asset. It would be useful to understand why the Boards have made this change. Also the proposals need to be clear as to the meaning of specific/specified. For example, assume that an entity enters into a contract to make a series

of payments to use 1000 ABC laptop computers for 5 years, and the economic useful life of a computer is 3 years. The contract specifies that they must be ABC laptop computers, but does not contain information about the serial numbers of every computer and the computers can be swapped for new ABC laptop computers as needed. It is not clear as to whether the entity has leased 1000 computers (as the entity has a right to use a specified asset, they have specified ABC laptop computers); or taken out an IT service contract (as the assets are not individually specified in the contract because they can be exchanged if needed).

Response to 4 (b) – sale versus lease

The AASB is concerned that the notion of control is not being applied consistently across all standards and it is not clear how the notion of control and ‘risks and benefits’ interact. The AASB thinks that reference to, ‘all but a trivial amount of the risks and benefits’ should be removed from the criteria for a sale, and a notion of control used that is consistent with the revenue ED/2010/6. Also, more guidance should be included that uses examples of circumstances that frequently arise in lease contracts that are normally indicative of cases where control of the underlying asset has passed. If the proposals proceed, the AASB thinks that ‘trivial’ should be explained.

The AASB notes that sales of assets are scoped out of the proposals, yet the proposals go on to state the requirements for sales with a subsequent leaseback. To address this apparent inconsistency, the scope should be extended to include sale and leaseback transactions.

Response to 4 (c) – service versus lease

As noted above in the response to 4 (a), the AASB is concerned that the proposals do not go far enough to help entities determine when they have a service contract versus a lease. More guidance should also be included about how to split payments in a contract that contain both service and lease elements, especially as in many contracts there is no indicator of the split between the lease and service elements. One method could be to use the fair value of the asset(s) supplied under the contract compared to the value of the contract.

The AASB is also concerned with the proposal to account for the whole contract as a lease if the service element is not distinct. The substance of the contract should be considered.

Question 5:

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

The AASB does not agree with the scope of the lease proposals. The scope should not exclude leases of intangible assets. The AASB sees no reason to reduce the current scope of IAS 17. This reduction in scope would also have cost and practical implications. Suppose, for example, an entity leases a computer together with software. It would be possibly necessary for the lessee to bifurcate the lease payments into that relating to the hardware and that relating to the software, which may be costly and impractical.

Although the AASB agrees with the scope inclusion of leases of investment property carried at cost and the scope exclusion of investment property carried at fair value, the AASB thinks that these inclusions and exclusions should be better justified in the Basis for Conclusions.

Question 6:

The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

- (a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) the IASB proposes that:
 - (i) a lessee should apply the lease accounting requirements to the combined contract.
 - (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
 - (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in *Revenue from Contracts with Customers*.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

The AASB agrees with splitting distinct service components out of a lease contract and accounting for them under the proposals in ED/2010/6. However, the AASB thinks that guidance should be included in the proposals as to how this split is to be done, for example, splitting the payments in proportion to the fair value of the leased asset and services. The AASB is concerned with the proposal that non-distinct services must still be split under the derecognition approach, as the AASB is not clear on how this would be done in practice. A specific practical example arises in the real estate industry, where executory costs are included within the gross rental payment and are not often identified separately in the contract.

Consistent with the AASB's response to Question 4(c), the AASB is also concerned with the proposal to account for the whole contract as a lease if the service element is not distinct. The substance of the contract should be considered.

Question 7:

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

The AASB agrees with the proposals that leases with purchase options be accounted for as a sale once the purchase option has been exercised, unless the purchase option is a bargain purchase option and then it is possible a sale has occurred at the inception of the lease, before the option is exercised. However, the AASB is concerned regarding how these proposals will interact with inclusion of residual value guarantee payments in the calculation of the lease payments, as often purchase options and residual value guarantees are linked, for example, if the purchase option is priced at the residual value guarantee amount.

Implication of purchase options on amortisation

Consider a situation where a lease contract contains a bargain purchase option and the entity concludes they have a purchase not a lease. The amortisation period of the right-of-use asset could therefore be longer than the contractual period in the lease contract. IAS 17 contemplates that this could occur but the proposals do not.

Question 8:

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

No, the AASB does not agree with the proposals concerning lease term. The AASB would prefer a probability weighted average approach to determining the lease term.

The AASB prefers such an approach because of the concerns that have been raised with the IASB's proposed approach. Under the current proposals a minor change of view on the 'longest term more likely than not to occur' could lead to artificial volatility in the financial statements, given that renewal options are often for many years. For example, if there were a small change in the initial expectation made by management of extending a lease into another option period from 10% to 15%, due to the mathematical calculation of the lease term, the lease term may 'jump' into the next option period. If this next option period is long, significant changes to the lease assets and liabilities will result from the minor change in expectation. Under current lease accounting the 'high hurdle' for the recognition of additional option periods rarely leads to such significant changes in lease assets and liabilities from a minor change in expectations. Using a probability weighted average approach would minimise the potential for artificial volatility.

The AASB also thinks that the approach taken to accounting for uncertainty should be applied consistently across all standards.

The IASB should also consider including guidance on:

- whether the lease term can extend beyond the contractual period, for example, if management expectations are beyond the current contractual term and history has

shown that the landlord has previously extended the contract. The AASB thinks that the lease term should be limited to those periods identified in the contract;

- perpetual leases or leases that can be extended or rolled over on an 'at will' basis (for example, until further notice); and
- the impact on the lease term of the interaction between the contract and local law, if, for example, local law dictates that tenants can reside in the building for a period that extends beyond the term of the contract.

The AASB also thinks that the proposals should better justify why option periods not yet exercised give rise to assets and liabilities.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

The AASB thinks that lessees should be allowed to fair value the lease liability as an alternative accounting policy choice to be consistent with the option available for the measurement of financial liabilities in IAS 32 *Financial Instruments: Presentation*/IAS 39 *Financial Instruments: Recognition and Measurement*/ IFRS 9 *Financial Instruments*. The AASB also thinks that the IASB should commit to reviewing the standard in due course with a view to treating options that arise in a lease contract under IAS 32/IAS 39/IFRS 9.

The AASB agrees that contingent rentals and expected payments under term option penalties that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease contract using an expected outcome technique. However, the AASB thinks that the Basis for Conclusions should better justify how unexercised option periods and contingent rentals give rise to assets and liabilities.

Residual value guarantees (RVGs)

The AASB notes that the proposals change the existing accounting for RVGs and sees no justification for the change. The AASB thinks that lessors/lessees should include receipts/payments to be made under RVGs in the estimation of lease receipts/payments, that are either present in the lease contract, or to be made by a related party. Currently it is not clear if RVGs receipts/payments to be made by parties related to the lessee can be included.

Lessors should also include payments to be made under RVGs by unrelated parties in their estimation of total lease receipts. From an accounting perspective, to lessors it is irrelevant if RVGs payments come from lessees or other entities. The AASB is concerned that if RVGs are not included in the lessor's lease receivable there is scope for abuse.

Make good provisions

The Boards need to consider whether make good payments that are specified in a lease contract should be part of the estimation of lease payments included in the measurement of the right-of-use asset and lease liability or whether they should be excluded and hence accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Lease incentives

Given that the Boards propose to remove SIC-15 *Operating Leases - Incentives* the lease proposals need to consider how lease incentives are to be accounted for, especially non-monetary lease incentives.

Measure reliably criterion for lessor estimations

The AASB is concerned that the ED includes a ‘measure reliably’ criterion for lessor estimations but not for lessee estimations. The AASB questions whether this criterion is needed given that it is inherent in the recognition criterion in the IASB’s Conceptual Framework. However, the AASB agrees with making these proposals and the revenue recognition proposals consistent in this context. If the Boards decide to include ‘measure reliably’ in both the revenue and lessor proposals, the AASB thinks that ‘measure reliably’ should also be included within the lessee proposals, to ensure that there is no impression of bias in the final Standard.

Measurement of the lessor’s lease receivable

The AASB is concerned that the measurement of the lease receivable by a lessor is not consistent with the measurement model of IAS 39/IFRS 9, as effectively the lease receivable is a loan and should be accounted for consistently with other financial assets. The proposals state that the lease receivable should be tested for impairment in accordance with IAS 39 (although it is not clear where the existing IAS 39 impairment requirements might be retained). In the AASB’s comment letter on ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, the AASB noted it, “...is concerned that the IASB is abandoning the notion that like transactions should be treated in like ways by using different measurement methods for different types of financial assets that are declared as being measured at cost...Based on the tentative decisions taken to date by the IASB, the impairment model proposed in ED/2009/12 would probably not be readily applicable to the lessor accounting model being developed, under which a lessor would recognise lease receivables, leased assets and lease performance obligations.” The measurement (including impairment) of lease receivables should be determined on the same basis as for other financial assets. Any new proposals on the measurement of financial assets at amortised cost, should be considered in the context of their application to lease receivables, and guidance added to the lease requirements as necessary.

Question 10:

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

The AASB agrees that reassessment of estimates is necessary, however, 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 thinks that 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.

Adjustments from reassessment

The measurement principle for reassessments is not clear, that is, whether reassessment should be prospective, retrospective, or otherwise. When an adjustment is necessary to the statement of comprehensive income from a reassessment, the classification of that adjustment, (e.g. depreciation, interest or revenue) is also not clear.

Question 11:

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

Yes, the AASB agrees with the criteria for classification as a sale and leaseback. However, as noted in the AASB’s response to 4 (b), the AASB is concerned that the notion of control is not being applied consistently across all standards and it is not clear how the notion of control and ‘risks and benefits’ interact. The AASB thinks that the notion of control used should be consistent with the revenue ED/2010/6.

Question 12:

- (a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

General comment in response to Question 12

With regards to whether items should be presented on the face of the balance statement of financial position or in the notes, the AASB thinks that IAS 1 *Presentation of Financial Statements* contains sufficient guidance to allow entities to make this decision and therefore think that this issue does not need to be addressed in individual Standards.

Response to 12 (a) – presentation of lessee assets and liabilities

The AASB agrees that the underlying nature of the leased asset should be reflected in its presentation, such that right-of-use assets under the current scope of the proposals (leases of tangible assets) are presented as tangible assets separately from owned assets. However, the proposals should make it clear that the right-of-use asset is an intangible asset.

Response to 12 (b) – presentation of assets and liabilities under the performance obligation approach

The AASB does not support the performance obligation approach. However, if this approach were to go ahead the AASB thinks that presentation of the underlying asset and the lease liability together is appropriate, and hence the lease receivable should be shown separately..

Response to 12 (c) – presentation of assets and liabilities under the de-recognition approach

Yes, the AASB agrees that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment.

Response to 12 (d) – presentation of assets and liabilities under subleases

As noted in the AASB's general response to Question 12 above, the AASB thinks that IAS 1 provides enough guidance in this area and hence presentation on the face of the statement of financial position versus the notes should not be dealt with by these proposals.

Question 13:

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Yes, the AASB agrees that lease income and lease expense should be shown separately from other income and expense.. As noted in the AASB's general comment to Question 12, the AASB thinks that IAS 1 provides enough guidance in this area and hence, presentation

on the face of the statement of financial position versus the notes should not be dealt with by these proposals.

Question 14:

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Yes, the AASB agrees that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows, subject to materiality.

Question 15:

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

Yes, to both Questions 15(a) and (b).

The AASB has been informed by users that disclosures by lessees about leases that are soon to expire would assist them in making comparisons between entities that have ongoing leases. Such disclosure could include, for example, information about the lessee's expectations about taking up a new lease of an asset, similar to the one for which a lease is soon to expire.

The AASB is concerned about the volume of reconciliations appearing in proposals and thinks they are excessive (paragraph 77 and 80). The AASB also questions whether the proposals in paragraph 83 are necessary given they are inherent in IAS 1 *Presentation of Financial Statements*.

The AASB thinks that the IASB should also consider reducing the disclosure requirements for lessors and lessees with short term leases. It should also be made clear whether the disclosures could be made on an aggregate or portfolio basis.

Question 16:

- (a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Response to 16 (a) – simplified retrospective approach

The AASB agrees with the simplified retrospective approach proposed, but thinks that a full retrospective approach should also be allowed as an alternative.

Response to 16 (b) - full retrospective approach

Yes, as noted above, the AASB agrees that full retrospective application of lease accounting requirements should be allowed, as for some entities this approach will be less onerous than applying the ‘simplified’ retrospective approach.

Response to 16 (c) – other transitional issues

The AASB thinks that the approach to transition adopted for leases and revenue should be consistent because there are cross-cutting issues. Given the significant change entities may need to make to their information systems to implement the proposals the AASB thinks there should be a longer than normal time period for transition.

Question 17:

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Yes, the AASB thinks the benefits will outweigh the costs. However, the AASB notes the concerns raised by many constituents about increased administration costs, particularly those entities that currently have a large volume of operating leases. There are two main areas that were raised as an issue:

- transition accounting (capturing all open leases on transition in an information system); and
- buying new computer systems and training staff (as the systems will need to be far more sophisticated than that of a simple fixed asset register, due to all of the estimations and reassessments proposed and the need to split payments into interest and principal components).

Some constituents have concerns as to whether the proposals as drafted will outweigh the costs with regards to reassessments, onerous disclosures and short-term leases. Some have stated that better disclosures under the current standard would be sufficient without having to implement all of the proposed changes. The AASB notes that the changes to the proposals it has suggested included in this submission would address some of these concerns.

Question 18:

Do you have any other comments on the proposals?

The capitalisation of initial direct costs

The AASB has concerns that the treatment of initial direct costs is being applied inconsistently across standards. For example, the following literature all makes reference to initial direct costs, yet the treatments vary:

- IAS 39;
- IAS 16;
- IAS 38;
- IAS 3 *Business Combinations*;
- the insurance ED;
- the revenue ED; and
- the lease ED.

The AASB thinks that the IASB should work to resolve these inconsistencies and in the meantime the criteria for the capitalisation of initial direct costs for leases should be consistent with the criteria in IAS 16.

Commencement versus inception

The ED proposes that lease payments be measured at the inception of a lease and recognised at the commencement. The AASB thinks that measurement and recognition should occur concurrently on commencement. Given the amount of judgement and estimation in the proposals, entities may be able to make more reliable estimates at commencement. If the proposals proceed, the conceptual reason for the difference in the timing of measurement and recognition should be justified in the Basis for Conclusions. The Basis for Conclusions should also justify why assets and liabilities are not being recognised on inception of the lease and only on commencement.

Interaction with other literature

The IASB should consider how these proposals will interact with:

- the construction of a leased asset;
- IFRIC 12 *Service Concession Arrangements*;
- SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*;
- SIC-29 *Service Concession Arrangements: Disclosures*; and
- the forthcoming hedge accounting proposals and whether entities will be able to hedge exposures created by lease contracts.

Drafting

Paragraph 67(b), first sentence, appears to be incomplete.