Government of South Australia
Department of Treasury
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Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
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Dear Mr Stevenson

RE: Comments on Exposure Draft 202R – *Leases*

The South Australian Department of Treasury and Finance (SA Treasury) has reviewed the Exposure Draft (ED) 202R relating to the recognition, measurement and presentation of assets and liabilities arising from leases and the disclosure of information about leasing arrangements (including the assets and liabilities arising from them).

We support the AASB's consideration of this important issue. Whilst we agree that the existing standard (AASB 117) requires improvement, we do not support the underlying principles outlined in ED 202R.

SA Treasury's concerns relate to three main areas, namely:

- The proposed approach to recognising a lease commitment does not reflect the economic substance of the transaction. It potentially creates a logical inconsistency with other issue specific standards that if followed could result in the recognition of an unintended range of liabilities eg. social benefits, salary and wages under employment contracts;
- The cost of adopting the proposed model for lease accounting will far exceed any perceived benefits; and
- The proposed model will not substantially enhance the quality and usefulness of information to users of financial statements.

Detailed comments in relation to the above areas are contained in the attachment.

SA Treasury acknowledges the current criticism of the existing standard on lease accounting (AASB 117) and suggests that the AASB consider amending the existing standard such that the cash flow commitment over the operating lease term (ie projected cash flows) is disclosed in the notes accompanying the financial statements and that the AASB strengthen the classification criteria such that long-term core assets are classified as a finance lease arrangement.

We consider that a mandatory retrospective application would be onerous for SA public sector entities and accordingly we suggest that the transition rules be prospectively applied.

If you require further information or clarification, please contact Julie Sinclair, Team Leader, Financial Management on (08) 8226 1786.

Brett Rowse

Brett Rowse
ACTING UNDER TREASURER

Attachment

- Economic substance of the transaction – recognition of lease commitment

ED 202R requires assets and liabilities in all lease arrangements (unless excluded from the scope or certain short-term arrangements) to be reflected in the balance sheet (in contrast to the existing requirements where assets and liabilities are only recognised for finance leases).

This requirement appears to stem from a foundation within ED 202R that all leasing arrangements are a source of finance.

It is SA Treasury's view that assets and liabilities do not exist under all lease arrangements. We consider that commitments under lease agreements (ie operating lease arrangements) are similar in nature to other commitments. If the model proposed in ED 202R is adopted this potentially may have significant unintended implications for other commitments, for example social benefits, salary and wages under employment contracts.

Further, it is SA Treasury's view that management does not necessarily enter into (operating) leases as a means of financing but rather as a means of managing exposure to risk and / or residual value and to benefit from the flexibility that the operating lease arrangement provides.

Accordingly it is our view to ensure that the economic substance of the lease arrangements/transactions are reflected in entities financial statements that the accounting distinction of operating leases be retained. This will provide users of financial statements with a complete and understandable picture of an entity's leasing activities and decision-making.

- Application costs exceed benefits - the application of the proposed standard to short-term leases and / or leases for low value assets.

ED 202R outlines a simplified accounting treatment for short-term leases which are defined as leases having a maximum possible term (including options to renew or extend) of 12 months or less. In reality, the majority of short-term leases would exceed a 12 month term and consequently this simplified approach would have limited value from a practical application perspective.

It is SA Treasury's opinion that a simplified accounting treatment (similar to the current operating lease treatment) be applied to lease arrangements which are short-term and / or for low value assets. The SA Government would have many thousands of such contracts, which relate mainly to office equipment (eg photocopiers), IT (eg PCs, laptops) and cars.

SA Treasury acknowledges that short-term and / or low value asset lease arrangements are not inherently different from other lease arrangements.

However, it is our view that the application of this proposed standard to such arrangements would be administratively onerous; complex and impractical; and application costs would exceed the benefits. The substantial effort, time, mechanisms and systems required to identify, collate and consolidate this information; record, measure, reassess and maintain records relating to such arrangements; and the education of staff far exceed any potential benefits.

We do not believe the proposed approach for short-term and / or low value assets will enhance the usefulness of information to users of financial statements. Under the existing standard, these arrangements are classified as operating leases and users are able to ascertain an entity's obligations in relation to future lease payments via the financial statements or accompanying notes.

SA Treasury understands that the criticism of the current standard is in relation to long-term arrangements that involve core operating assets (eg planes) and not short-term, non-core, low value assets such office equipment and cars.

- Information that is useful and relevant to users of financial statements – application of the proposed "lease term"

ED 202R defines the lease term as the longest possible term that is more likely than not to occur (eg includes options to extend).

It is SA Treasury's opinion that only the base lease period (ie unavoidable terms of the signed contract) should be considered when accounting for assets and liabilities associated with the lease arrangement ie the lease term should not include options to renew or extend the lease.

Options to extend or terminate the lease should only be considered when they have been exercised by the lessee.

SA Treasury supports the recognition of assets and liabilities where it meets the definition of an asset and liability respectively under the current *Framework*.

We support the recognition of a liability where an entity has an unconditional obligation to pay rentals against a signed lease contract, as this meets the definition of a liability under the current *Framework*. It is our view that recognising an additional liability for the possibility of extending a lease under a renewal option sometime in the future is conceptually incorrect and will result in information which is not reliable, relevant or useful to users of financial statements.

In addition, the calculation method suggested by ED 202R involves estimating the probability for each possible term for each lease. The cost of developing systems, mechanisms, processes to implement and maintain this method will outweigh any potential benefits - particularly for the SA Government which has thousands of leases. In addition, estimating a probability will introduce subjectivity into the process, thereby decreasing the comparability and usefulness of this information.

- Information that is useful and relevant to users of financial statements – application to leased intangible assets

ED 202R excludes lease arrangements associated with intangible assets from its scope. The rationale and basis for this exclusion is unclear. ED 202R states that all leasing arrangements are sources of finance – accordingly based on this foundation statement there should not be a differentiation between tangible and intangible assets.

- Information that is useful and relevant to users of financial statements – reliable measurement of contingent rentals, expected payments under term option penalties and residual value guarantees

It is SA Treasury's opinion that contingent rentals, expected payments under term option penalties and residual value guarantees that are specified in the lease contract should not be included in the measurement of lease assets and lease liabilities since these amounts cannot be reliably measured at the inception of the contract. The estimation will introduce subjectivity into the process, thereby decreasing the comparability and usefulness of this information.

In addition, the proposed accounting model increases complexity with the reassessment of the lease term, contingent rentals and residual value guarantees at each reporting period which would require entities to develop and implement systems, mechanisms and processes. This process will be an administrative burden; increase subjectivity; and also further decrease comparability across industry. It is SA Treasury's view that the costs of implementing and sustaining such a process would far outweigh any perceived benefits to be received.