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Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8004

16 November 2010

Our Ref: dr

Dear Kevin

Re: Exposure Draft ED 202R *Leases*

We are pleased to respond to the Australian Accounting Standards Board (AASB) Exposure Draft ED 202R *Leases*, equivalent to the International Accounting Standards Board's (the IASB's) Exposure Draft ED/2010/9 *Leases* (collectively referred to as the 'exposure draft' or 'ED').

Based on our analysis of the proposals and on comments obtained locally from our clients, partners and staff, our main areas of concern are as follows:

- the carry forward of the 'IFRIC 4 criteria' as the basis for determining the existence of a 'right to use' a specified asset. We believe that the IASB should take the opportunity to reconsider the guidance surrounding the definition of a lease, and the distinction between lease contracts and service contracts
- the exclusion of leases of intangible assets from the scope of the ED. We believe the proposals should apply equally to both tangible and intangible assets
- the lack of symmetry between the accounting approach proposed for lessees and that proposed for lessors, due to the application of the 'performance obligation approach' by lessors where exposure to significant risks and rewards associated with the underlying asset is retained by the lessor. We believe the lessor accounting model requires further development by the IASB, with the objective of ultimately settling on a single approach to lessor accounting
- in the absence of the completion / full analysis of the results of the IASB's outreach activities, it is questionable as to whether the benefits of the 'improved financial reporting' exceed the cost. This is particularly so in the context of the proposals to distinguish lease payments from service payments in single contracts, including contingent rentals and renewal options in the measurement of lease liabilities and lease receivables, and the reassessment of the carrying amounts of lease liabilities and lease receivables arising from changes in facts and circumstances

- the proposed simplified requirements for short-term leases do not provide sufficient simplification for lessees. On cost / benefit grounds, we would be supportive of extending the simplified accounting of short-term leases by providing lessees with an election (on a lease by lease basis) not to recognise the right-of-use asset and the liability to make lease payments arising from short-term leases.

Our responses to the specific matters for comment are set out in Appendix A.

Due to the later IASB submission deadline for Exposure Draft ED/2010/9 *Leases*, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised in the IASB's Exposure Draft. Therefore, the views presented in this document in relation to ED 202R should be read in this context and may not necessarily represent the views of the global firm of Deloitte.

If you have any questions concerning our comments, please contact Darryn Rundell on (03) 9671 7916.

Yours sincerely

Darryn Rundell

Darryn Rundell
Partner
Deloitte Touche Tohmatsu

Appendix A
Specific matters for comment

Question 1: Lessees

(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?**

We agree in principle with the proposal for lessees to recognise a right-of-use asset and a liability to make lease payments, and with the subsequent recognition of amortisation expense and interest expense.

However, on the basis of comments obtained locally from our clients, partners and staff, and in the absence of the completion / full analysis of the results of the IASB's outreach activities, it is questionable as to whether the benefits of the 'improved financial reporting' exceed the cost. This is particularly so in the context of the proposals to distinguish lease payments from service payments in single contracts, including contingent rentals and renewal options in the measurement of lease liabilities and lease receivables, and the reassessment of the carrying amounts of lease liabilities and lease receivables arising from changes in facts and circumstances.

Question 2: Lessors

(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?**

We are concerned by the lack of symmetry between the accounting approach proposed for lessees and that proposed for lessors, due to the application of the 'performance obligation approach' by lessors where exposure to significant risks and rewards associated with the underlying asset is retained by the lessor.

We are also concerned that the IASB has not clearly articulated how the proposed approaches to lessor accounting reconcile with the Conceptual Framework and the proposed right-of-use model for lessees.

We would prefer a single lessor accounting model and recommend the IASB devote additional time to develop such an approach. We acknowledge the difficulty in developing a single lessor accounting model that can be applied to all leasing transactions. However, we believe that the benefits of producing a single, conceptually sound lease accounting model that can be applied to a wide range of leasing transactions is worth the effort.

Question 3: Short-term leases

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 profit or loss, 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?

On cost / benefit grounds, we would be supportive of extending the simplified accounting of short-term leases by providing lessees with an election (on a lease by lease basis) not to recognise the right-of-use asset and the liability to make lease payments arising from short-term leases.

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?

We have reservations regarding the appropriateness of the carry forward of the 'IFRIC 4 criteria' as the basis for determining the existence of a 'right to use' a specified asset.

We have experienced practical issues in the application of IFRIC 4, however, such issues were often not of significant concern as the difference between operating lease accounting and executory contract accounting was often not significant under the existing accounting standards. With the introduction of the proposed 'right-of-use' lease accounting model, the difference between lease accounting and executory contract accounting will be far more significant.

We therefore believe that the IASB should take the opportunity to reconsider the guidance surrounding the definition of a lease, and the distinction between lease contracts and service contracts

Question 5: Scope exclusions

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?

In principle, we draw no distinction between the lease of a tangible asset and a lease of an intangible asset and, accordingly, we believe the proposals should apply equally to both tangible and intangible assets.

We are supportive of the other scope exclusions (i.e., leases of biological assets, leases to explore for or use minerals, oil, natural gas and similar regenerative resources, investment property measured at fair value).

Question 6: Contracts that contain service components and lease components

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?

We agree in concept with the application of the proposals in *Revenue from Customer Contracts* to a distinct service component of a contract that contains both service and lease components.

However, we believe that more guidance is required to provide further assistance with respect to the identification / separation of distinct service components, specifically in the real estate industry, where executor costs are included within the gross rental payment, and not specifically separated.

Question 7: Purchase options

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?

At a conceptual level, we believe it would be more appropriate to separately account for options arising from lease contracts (e.g., renewal options, termination options and purchase options) either through recognition as a derivative or through recognition at intrinsic value.

If the IASB retains its position of measuring lease assets and lease liabilities inclusive of the expected impact of renewal options and termination options, we believe that purchase options should also be taken into account. This is on the basis that we believe there is little difference, at a conceptual level, between renewal options and purchase options, as both impact upon the extent to which a lessee controls the 'right to use' the underlying asset.

Question 8: Lease term

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?

As noted in our response to question 7, at a conceptual level, we believe it would be more appropriate to separately account for options arising from lease contracts (e.g., renewal options, termination options and purchase options) either through recognition as a derivative or through recognition at intrinsic value.

However, where such options are to be taken into account in the determination of the lease term, we believe that a higher level threshold should be adopted in place of the proposed 'longest possible term that is more likely than not to occur' principle. For example, consideration should be given to retaining the currently used "reasonably assured/certain" or "virtually certain" threshold.

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?

We believe that the measurement of the liability to make lease payments should be consistent with the approach adopted for the determination of the lease term and should, in principle, be inclusive of the expected lease payments to be made under the contract inclusive of contingent rentals. However, we favour the adoption of a 'best estimate' approach to the measurement of contingent rentals, rather than the proposed expected outcome technique based on probability weighting different outcomes.

Question 10: Reassessment

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?

We believe that it is appropriate for the lease assets and lease liabilities to be subject to reassessment. However, we are concerned that the proposed reassessment requirements (based on when changes in facts or circumstances indicate that there is a significant change in carrying value) may be misinterpreted in practice, resulting in reassessments being unnecessarily undertaken every reporting period.

We believe that more guidance is required in this area, for example, by way of providing discussion and examples of typical indicators or, alternatively, giving consideration to moving to a 'change in management expectation' approach.

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?

We are supportive of the proposed criteria for the classification of sale and leaseback transactions.

Question 12: Statement of financial position

(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?

We are supportive of the presentation proposals.

However, as noted in our response to question 2, we believe the lessor accounting model requires further development by the IASB, with the objective of ultimately settling on a single approach to lessor accounting. Such further development may necessitate amendment to the above proposed presentation requirements.

Question 13: Statement of comprehensive income

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?

We are supportive of the presentation proposals.

Question 14: Statement of cash flows

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?

We are supportive of the presentation proposals.

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?

We are supportive of the disclosure proposals.

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?

We are supportive of the proposed 'simplified' retrospective approach (rather than a mandatory 'full' retrospective approach). However, we believe that entities should not be prohibited from adopting a 'full' retrospective approach should they desire to do so, and have the necessary information.

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?

On the basis of comments obtained locally from our clients, partners and staff, and in the absence of the completion / full analysis of the results of the IASB's outreach activities, it is questionable as to whether the benefits of the 'improved financial reporting' exceed the cost. This is particularly so in the context of the proposals to distinguish lease payments from service payments in single contracts, including contingent rentals and renewal options in the measurement of lease liabilities and lease receivables, and the reassessment of the carrying amounts of lease liabilities and lease receivables arising from changes in facts and circumstances.

We encourage the IASB and AASB to continue with their outreach activities to better understand the costs and benefits of the proposals.

Question 18

Do you have any other comments on the proposals?

We have no other comments.