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Dear Bruce

Invitation to Comment - ITC 20 Request for Comment on IASB Discussion Paper DP/2009/1 Leases – Preliminary Views

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ITC 20 which is a re-badged copy of the International Accounting Standards Board's and the US Financial Accounting Standards Board's joint Discussion Paper DP/2009/1 (the DP).

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies and businesses, and this submission has benefited with some initial input from our clients, Grant Thornton International which is working on a global submission to the IASB, and discussions with key constituents.

Whilst we are broadly supportive of the principal objective which is to put current operating leases onto the balance sheet, these are preliminary views, and a more detailed submission will be provided to the AASB as Grant Thornton's global submission is finalised by the IASB's due date of 17 July 2009.

Appendix 1 contains our preliminary responses to both the IASB's and the AASB's questions.

If you require any further information or comment, please contact me.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

Keith Reilly
National Head of Professional Standards

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Grant Thornton

Appendix 1:
Responses to Exposure Draft Questions

Invitation to comment questions
Chapter 2: Scope of lease accounting standard

Question 1
The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?

If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

Comment
There are two conceptual models one can use for a lease transaction – an asset model and an obligation model. Which is used dictates whether it is appropriate to base the scope on the scope in the existing standard. An asset model focuses on the right to use an asset that is conveyed in the transaction. An obligation model focuses on the obligation to make future payments that is embodied in the lease document.

The existing lease standards use an obligation model. The logical conclusion under this model is that the entire obligation is a liability and there is an equal-value asset at the lease inception. In particular, there is no separate treatment of the portion of lease payments applicable to executory costs, such as for maintenance of the leased asset.

The proposed standard uses an asset model. The focus is on the right to use an asset. This suggests that the scope of the standard should be reconsidered. There are many transactions that are not leases but that nevertheless create rights to use assets. As noted in 2.7(c), for example, licenses of intangible assets create right-to-use assets that are economically no different from leases of tangible assets. If the final standard employs an asset model, then all contracts creating such a right-to-use asset should be within the standard's scope.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.

Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Comment

We see no reason to exclude leases of non-core assets from the scope of the standard. Such leases create the same rights and obligations as other leases, with the only difference being how the leased asset is used. In addition, exclusion of leases of non-core assets would likely lead to abuse as firms would have a financial reporting incentive to misclassify assets as non-core.

We believe it is appropriate to exclude short-term leases if the effect on the balance sheet would be immaterial. For example, excluding the asset and obligation from the December 31 balance sheet related to a one-month lease running from December 15 to January 15 would be appropriate. However, in determining the effect, firms should evaluate the excluded leases in the aggregate. So, firms with a large number of relatively short-term leases should not exclude those leases. Thus, we view the appropriate exclusion as a de minimis exclusion, not based on the length of the lease per se.

Chapter 3: Approach to lessee accounting

Question 3

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Comment

The analysis in this chapter through 3.28 is based on a simple lease contract. In that limited scenario, we agree with the analysis. However, as discussed later in this letter, we believe that when the Boards considered more complex leases, such as those containing options, residual guarantees, or executory costs, the Boards did not take into account how the analysis would differ from the simple case. For example, under the asset model concept suggested in this proposal, the right to use an asset would exclude the portion of the lease payments associated with executory costs, such as maintenance of the asset (See 9.25.) Thus, even at the inception of the lease, there would be a difference between the value of the obligation and the value of the right-to-use asset. It is not clear in the proposal how that difference would be treated. Furthermore, it is conceptually difficult to separate the right to use an asset from the lessor's obligation to keep it in good working order. The right to use an asset that does not function is worthless. So, the value associated with the lessor's obligation to maintain is integral to and inextricably linked with the right to use the asset.

Question 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:

a an asset representing its right to use the leased item for the lease term (the right-of-use asset)

b a liability for its obligation to pay rentals.

Appendix C describes some possible accounting approaches that were rejected by the boards.

Do you support the proposed approach?

If you support an alternative approach, please describe the approach and explain why you support it.

Comments

As we discussed in our response to question 3, the Boards' analysis is based on a lease with no executory costs. When executory costs are considered, we believe what the Boards mean is that an asset and a liability would be recognized for the right to use an asset (but not the future executory costs associated with it) and the portion of the obligation not associated with the executory costs. Thus the balance sheet would report on the asset side the right to use an asset but not the right to have that asset in working condition, and on the liability side a portion of the obligation created by the lease. Because it is impossible to separate the right to use an asset from the right to have the asset in working condition, we believe this approach is conceptually flawed. In addition, because the obligation uses debt capacity whether it is associated with the asset itself or the right to have the asset in working condition, the liability would be understated. This would leave analysts with a continuing need to constructively capitalize certain future lease payments as they must do now with operating leases.

Question 5

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:

a a single right-of-use asset that includes rights acquired under options

b a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

Do you support this proposed approach? If not, why?

Comment

We disagree with the premise that the proposal does not adopt a components approach. It does so at times. As noted in our response to question 4, the Boards have proposed a components approach to the asset. That is, payments are separated into those associated with the right to use an asset versus other services, such as maintenance of the asset. We have previously voiced our objection to the components approach for the asset as we believe it is not conceptually sound.

The Boards' rejection of the components approach applies only to contingent obligations. We believe this leads to conclusions that are difficult to accept conceptually. In Chapter 6, the Boards concluded that for a lease with a purchase option the lease payments to be discounted should either include or exclude the option's exercise price, depending on the probability of exercise. Consider a lease with an option that is sufficiently likely to be exercised that the payment is included. This creates the odd result that a liability is recognized as a result of existence of holding an option, whose value can only be positive.

We believe that a components approach to the obligation is necessary to achieve sensible accounting.

Chapter 4: Initial measurement

Question 6

Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Comment

It is clear in the analysis in Chapter 4 that the Boards are implicitly assuming the simple lease case it analyzed in the beginning of Chapter 3. However, the conclusions are not appropriate for a lease with executory costs. Thus, the conclusion in Chapter 4, which sounds reasonable, really is to value the obligation initially at the present value of the portion of the lease payments associated with the right to use the asset, but excluding executory costs. We would not separate the executory costs and therefore would value the obligation at the present value of all minimum rental payments.

As for the discount rate, we believe the incremental borrowing rate approximates the appropriate discount rate only in certain circumstances. Conceptually, the lease obligation is a debt instrument, suggesting the appropriate discount rate is the incremental borrowing rate. However, the lessor's ability to repossess the leased asset is generally stronger than a lender's ability to seize collateral. In jurisdictions that provide relatively strong rights to lenders, this difference may not be significant and the incremental borrowing rate reasonably approximates the discount rate the lessor would have used in assessing the lease. However, in jurisdictions that make it relatively difficult for lenders to seize assets, the protection afforded by a lease could significantly reduce the rate of return the lender demands. Thus we believe that in determining the discount rate, firms should be permitted to adjust the incremental borrowing rate to reflect such differences.

Question 7

Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?

If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Comment

Similar to our response to question 6, we believe the Boards are implicitly assuming the simple lease case they analyzed in the beginning of Chapter 3. However, the conclusions are not appropriate for a lease with executory costs. Thus, the conclusion in Chapter 4, which sounds reasonable, really is to value the asset initially at the present value of the portion of the lease payments associated with the right to use the asset, but excluding executory costs. We would not separate the executory costs and therefore would value the asset at the present value of all the minimum rental payments.

Chapter 5: Subsequent measurement

Question 8

The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.

Do you agree with this proposed approach?

If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

Comment

We agree with the amortized cost approach to subsequent measurement of the asset and liability. Further, we agree with the Boards' decision not to link subsequent measurements of the asset and liability. There is no reason to believe that the asset is consumed in the pattern determined by the timing of the lease payments, so there is no reason to link the two measurements.

Question 9

Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Comment

The purpose of the fair value option was to allow firms to mark to market assets and liabilities that naturally offset without having to implement complex hedge accounting rules. As the right-to-use asset will not be marked to market, there is no reason to allow the liability to be marked to market. Doing so would only invite manipulation.

Question 10

Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.

Comment
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

We believe the obligation should be treated like any other debt instrument and should not be revalued to reflect interest rate changes. In addition, doing so would create the possibility that a lessee whose financial position was deteriorating could record gains as its incremental borrowing rate increased.

Question 11
In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.

Do you agree with the proposed approach taken by the boards?

If you disagree, please explain why.

Comment
The amortized cost approach is consistent with accounting for other debt instruments. We agree that this should be stated in the standard so that it is clear that other measurement approaches, e.g. fair value, are explicitly excluded.

Question 12
Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.

Would you support this approach? If so, for which leases? Please explain your reasons.

Comment
Although we understand the argument that rental expense is a cost incurred for the right to use an asset, we believe that such usage would be confusing to financial statement readers. As it is customary to amortize assets that have been recognized as their productive abilities are consumed, we believe characterizing the expense as amortization is more descriptive.

Chapter 6: Leases with options

Question 13
The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Comment
We disagree with the approach the Boards took. As noted earlier, this creates a liability as a result of holding an option, which can only have a positive value. It also ignores two fundamental elements of holding an option. First, there has to be an asset associated with the option as the option is valuable to the holder. Second, one cannot apply simple probabilitistic techniques to options because the probability of exercising is related to the value of the asset.

We believe the value of an option granted to the lessee under the lease agreement should be valued and recorded in the balance sheet as an asset. In fact, part of the lease obligation arises because of such an option – presumably the lease payments would have been lower had the option not been included in the lease agreement.

As an example, suppose a 10-year lease with annual payments of $1 million contains a purchase option valued at $2 million. Assuming a 6% discount rate and payments at the beginning of each year, the total value of the lease payments is $7,801,692. The lessee should record a right-of-use asset for $5,801,692 and an option worth $2,000,000. This would be offset by a $1,000,000 reduction in cash and recognition of a lease obligation $6,801,692.

The lessee could allocate the value of the lease payments between the option and the right-to-use asset in one of two ways: (a) directly estimate the value of the option using an option pricing model and assign the remaining value to the right-to-use asset, or (b) assign to the right-of-use asset the present value of the lease payments that would be required under an otherwise similar lease not containing the option and assigning the remainder of the total value to the option.

Subsequently, the option should be accounted for as it would if the option had been purchased separately – by marking the option to fair value and applying hedge accounting if the option qualified for that treatment.

Question 14
The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

Comment
Reassessing the lease term would become moot if the approach we described in our response to question 13 were followed. The right-of-use asset would reflect only the term of the existing lease. The option would be revalued as the asset value, and hence the probability of exercise, changed.

Question 15
The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.

Do you agree with the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Comment
We agree the treatments should be similar. However, we disagree with the treatment the Boards proposed, as discussed in our responses to questions 13 and 14.

Chapter 7: Contingent rentals and residual value guarantees
Contingent rentals
Question 16
The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.

Do you support the proposed approach?

If you disagree with the proposed approach, what alternative approach would you recommend and why?

Comment
We disagree with the Boards' conclusion regarding contingent rental arrangements for contingencies related to performance of the leased asset. We agree that contingent rentals should be included in the obligation for contingencies unrelated to performance of the leased asset.

Performance contingencies would principally be percentage-of-sales rental arrangements. Until the sales are made, no transaction or event requiring the payment of rent has taken place and there is no liability. We disagree with the Boards' argument at ¶7.8(a) that not including these contingent rentals understates the value of the right-of-use asset. We believe under such arrangements that the lessor holds an undivided percentage interest in future sales to be generated by the asset. Until those sales are generated, the lessor has no right to receive any compensation and the lessee has no obligation to make any payments.

Furthermore, including these contingent rentals in the obligation would record as a liability would recognize a cost in a period different from the period of the revenue that caused the cost to be incurred.

Non-performance contingent rental payments should be included in the obligation. For example, rent escalations based on an inflation index should be included based on a best estimate of the future values of the index. Although one could argue that no obligation to pay the higher rent exists until the index actually increases, the lease agreement was made with an expectation of particular values of the index, and the value of the right-of-use will be best approximated by the value of the obligation given reasonable assumptions about the future index values.

Question 17
The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.

Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Comment
As noted in our response to question 16, we disagree with both of these approaches with respect to rentals contingent on performance. With respect to non-performance contingencies, such as rent escalation due to inflation, we believe a probability-weighted approach is most logical, for it represents the best expectation of the ultimate cash outflow.

Question 18
The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.

Do you support the proposed approach? Please explain your reasons.

Comment
We disagree with the DP's conclusion. The value of the obligation at the lease inception should be a best estimate of the economic value of the obligation. That necessarily requires use of a forecast of the future value of the index. The DP's approach does not avoid the necessity of forecasting the index. It is tantamount to forecasting that the index will not change. This will result in systematic misstatements of the values of lease obligation, most likely understating those values significantly.

Question 19
The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.

Do you support the proposed approach? If not, please explain why.

Comment
With respect to changes in rental payments contingent on performance, this issue becomes moot if our recommendation not to include such contingent rentals in the lease obligation is taken.

With respect to rentals that are contingent on an index, we believe that such leases should not be revalued. This is to keep the accounting for such obligations consistent with accounting for otherwise similar debt instruments. If a fair value option is permitted, then lessees should be permitted to revalue obligations to reflect changed expectations for the future values of indices.

Question 20
The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:

a recognise any change in the liability in profit or loss

b recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.

Which of these two approaches do you support? Please explain your reasons.

If you support neither approach, please describe any alternative approach you would prefer and why.

Comment
As we do not support linking the accounting for the right-of-use asset and the obligation subsequent to the lease inception, we reject alternative (b). Thus, although we do not support recognizing changes in the value of the obligation (other than under the effective interest method) in the first place, if that were to be done, we would prefer alternative (a) to alternative (b).

Residual value guarantees
Question 21
The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.

Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Comment
When a lessee takes on a residual value guarantee, it has written put option on the underlying asset. It should be accounted for as such and the lessee should record a liability at the lease inception for the value of the put option. We believe a residual value guarantee is a derivative and should be accounted for as such, including application of hedge accounting rules if the requirements for doing so are met.

Chapter 8: Presentation
Question 22
Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.

What additional information would separate presentation provide?

Comment
We do not believe any additional useful information is provided by separating the lease obligation in the face of the balance sheet. Presumably, the debt footnote will have a separate amount for lease obligations that would provide any information that users might want.

Question 23
This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.

How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons.

What additional disclosures (if any) do you think are necessary under each of the approaches?

Comment
We believe the right-of-use assets should be classified based on the nature of the assets under lease. For example, the right to use a building should be including in buildings; the right to use equipment should be included in equipment; etc. What is important about a lease is the nature of the asset it transfers the rights over and that will be employed in the operations of the enterprise.

Chapter 9: Other lessee issues
Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

Comment
We have not as yet completed our research in to this are but nothing has yet come to our attention.

Chapter 10: Lessor accounting
Question 25
Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Comment
Yes, it does. A right to receive rentals is a resource that will be converted into cash when the rental payments are made. It meets the conceptual definition of an asset.

Question 26
This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.

Which of these two approaches do you support? Please explain your reasons.

Comment
We believe approach (b) double-counts some of the lessor's assets. In Example 11, the machine ceases to have any economic value to the lessor except for the rental payments it will generate. Thus once the lease receivable is recorded, the machine is no longer an asset from the perspective of the lessor and should be derecognized.

Question 27
Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

Comment
Yes. When a lessor acts as both a provider of goods and a financial institution, as in what are currently classified as sales-type leases, it is appropriate for lessors to recognize gross profit on the provision of goods when they are provided. Failure to do so would induce firms to find third parties to purchase the asset and provide lease financing to the lessee, so that the firm could recognize gross profit on the sale. As a result, similar transactions would be accounted for differently depending on whether the lessor provided financing or a third party was used.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Comment
We see no reason to exclude investment properties from the scope of the standard.

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

Comment
We have not as yet completed our research in to this are but nothing has yet come to our attention.

Specific AASB Questions

a Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

   i not-for-profit entities;

   ii public sector entities;

We are not aware of any regulatory issues that may effect the implementation of the proposals

b Whether overall, the proposals would result in financial statements that would be useful to users;

We believe that the proposals will result in financial statements that would be useful to users; and

c Whether the proposals are in the best interests of the Australian economy.

We believe that the proposals are in the best interests of the Australian economy.