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Mr Bruce Porter
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Dear ~~Mr Porter~~ Bruce

ITC 20 LEASES – PRELIMINARY VIEWS

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to respond to the AASB's Invitation to Comment ITC 20 *Request for Comment on IASB Discussion Paper DP/2009/1 Leases*.

HoTARAC agrees that the present lease accounting model is conceptually flawed and therefore supports the Paper's fundamental concept that lessees should recognise all assets and liabilities arising from leasing contracts. Although HoTARAC members express a range of views on the effectiveness of the proposals to address the current problems, the general consensus is that the proposals are moving in the right direction. On balance, HoTARAC members consider that recognising a right of use asset and an obligation to make payments would be more robust than the present approach, which is based on a somewhat arbitrary distinction between operating and finance leases.

However, some jurisdictions consider the proposals would create more problems than they would fix and propose that the present model's shortcomings be addressed through increased disclosures.

Major concerns

HoTARAC has several major concerns with the proposals, particularly:

- applying the proposal to cancellable leases;
- dealing with term and purchase options, contingent rentals and residual value guarantees;
- deferring consideration of lessor accounting; and
- addressing scoping issues.

Applying the proposal to cancellable leases (Questions 3 and 4)

Chapter 3 of the Discussion Paper proposes that a lessee would recognise an asset and a liability for all leases, including those presently classified as operating leases.

Paragraphs 3.16 and 3.17 conclude that a lessee's right to use a leased item is an asset because, among other things, the lessee controls the right to use the leased item during the lease term as the lessor is unable to recover or have access to the resource without the consent of the lessee (or breach of contract).

Paragraphs 3.20 and 3.21 conclude that the lessee's obligation to pay rentals is a liability because, among other things, it represents a present obligation.

These conclusions arise from considering a simple non-cancellable lease (Example 1).

HoTARAC agrees with these conclusions where a lease contract is non-cancellable but not where the lease is cancellable. The Discussion Paper's two paragraph analysis (3.19 and 3.20) of why a lessee has a liability is superficial and does not envisage the possibility of a lease being cancellable and, although Chapter 6 of the Discussion Paper deals with term options (including early-termination options), it does not specifically discuss leases that are cancellable.

HoTARAC considers that the proposal should be explicit about cancellable leases, either by scoping them out or by describing them as executory contracts, or both.

HoTARAC notes that some lease contracts are cancellable at the option of either party (or both), possibly after some short period of notice, while other lease contracts become cancellable after an agreed period of non-cancellability. Many tenancy agreements have this feature.

Where a lease is cancellable, HoTARAC considers that the lessee has little or no present obligation and little or no control over the leased item. If a lessee has an option to cancel the lease, it has no liability. If a lessor has an option to cancel, the lessee has no right-of-use asset. Such agreements are in the nature of executory contracts.

However, HoTARAC also acknowledges that treating some leases as executory contracts and others as assets and liabilities, would effectively continue the distinction between operating and finance leases. This could give rise to structuring opportunities to achieve particular accounting outcomes. Nonetheless, the Discussion Paper's proposals will move the boundary significantly and many more leases will be recognised as assets and liabilities.

Dealing with term and purchase options, contingent rentals and residual value guarantees (Questions 13, 14, 15, 16, 19 and 21).

Paragraphs 6.36 and 6.57 propose that, if a lease contains a term or purchase option, the lessee should determine the most likely option to be exercised and recognise the lease asset and liability accordingly. Paragraphs 6.47 and 6.48 propose that the lessee should review such determinations at each reporting date in the light of any new facts and circumstances.

Paragraphs 7.20 and 7.39 propose that, if a lease contains contingent rentals or a residual value guarantee, the lessee should estimate their value and measure the lease asset and liability accordingly. Paragraphs 7.25 and 7.48 propose that the lessee should review such estimates if circumstances change.

While HoTARAC conceptually agrees with these proposals, it considers that, in many cases, determining the most likely term and purchase options will be difficult. Similarly, contingent rentals and residual value guarantees will often be difficult to reliably estimate. This is especially the case where the determination or estimate is to be made well in advance of the ultimate event. Such determinations and estimates rely on management's judgement and therefore could be manipulated to achieve particular accounting outcomes such as liability minimisation. Structuring opportunities could also arise. Moreover, lessees evaluation abilities and risk-aversion will influence such determinations and estimates.

These factors will reduce the comparability of lessees financial reports.

In addition, a lessor and lessee may have different expectations in relation to the same economic event, thereby distorting the reciprocity of reporting for that event.

HoTARAC therefore encourages the Boards to develop strong criteria and guidance to ensure recognition only occurs on a consistent and reliable basis using robust methodology.

Deferring consideration of lessor accounting

Paragraphs 1.20 and 10.01 note the Boards tentative decision to defer consideration of lessor accounting and concentrate on an improved lessee accounting model.

HoTARAC is concerned that the Boards have deferred considering lessor accounting.

Lessee and lessor accounting are two sides of the same coin and it seems inappropriate to revisit the conceptual basis for one without addressing the other. This approach risks overlooking important factors. Basing each side of a transaction on different accounting models seems illogical and will make financial reports less understandable. It is unlikely to have any conceptual validity.

Paragraph 1.22 notes that there are disadvantages to deferring consideration of lessor accounting. These include the possibility of gaining further insights into lessee accounting, the possibility of having to make further changes to lessee accounting and the problem of having different conceptual models for lessor and lessee accounting.

HoTARAC therefore urges the Boards to consider both lessee and lessor accounting concurrently.

Addressing scoping issues (Question 1)

Paragraph 2.6 notes that the existing pronouncements on leases have some scoping issues that can result in inappropriate classification, inconsistent accounting and structuring opportunities. However, the Boards do not propose to review or change the existing scope when developing the proposed new approach to lease accounting.

HoTARAC considers that to introduce a fundamentally new approach to lease accounting without also reviewing the scope and attempting to remedy some of the known scoping issues would be a missed opportunity. It is unlikely that these issues will be addressed in the near future if they are not reviewed now. Known issues should be addressed rather than perpetuated.

Other concerns

HoTARAC has concerns with several other matters, which are not covered in the responses to specific questions.

The elimination of the distinction between finance and operating leases will give rise to GFS harmonisation issues for public sector entities. GFS distinguishes between operating and finance leases.

The Discussion Paper seems to assume that all leases are a means of financing. HoTARAC does not consider that all leases necessarily contain a financing element.

The Discussion Paper's measurement proposals for assets and liabilities appear to be a hybrid approach. They do not represent cost, fair value or any other previously identified measurement basis.

Responses to specific questions

HoTARAC's responses to the specific questions raised in the Paper are set out in Attachment 1.

If you have any queries regarding HoTARAC's comments, please contact Robert Williams at NSW Treasury on 02 9228 3019.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

14 June 2009

Encl

Contact: Amy Huxley
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ATTACHMENT 1

Responses to specific questions

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.

HoTARAC disagrees with the proposed approach and urges the Boards to address scoping issues concurrently with developing the new approach to lease accounting.

The Boards propose a new approach to lease accounting, based on determining the parties rights and obligations in relation to the leased item rather than determining which party has the risks and rewards of ownership of the leased item.

Paragraph 2.6 notes that the existing pronouncements on leases have some scoping issues that can result in inappropriate classification, inconsistent accounting, and structuring opportunities. However, the Boards do not propose to review or change the existing scope when developing the proposed new approach to lease accounting.

HoTARAC notes, for example, that Interpretation 4 *Determining Whether an Arrangement Contains a Lease* inappropriately requires certain purchase contracts to be accounted for as leases. A purchaser may acquire a custom-built asset (such as a building) and receive title on delivery. The purchaser might pay the builder (a) in full on delivery, (b) 90 per cent on delivery and 10 per cent after a defects period has elapsed, or (c) by a series of agreed payments over a period of time. As the transaction gives the purchaser (as owner) a right to use the specific asset, Interpretation 4 requires it to be treated as a lease under AASB 117, thereby necessitating additional disclosures. This issue could be remedied by excluding up-front purchases from the scope.

HoTARAC considers that to introduce a fundamentally new approach to lease accounting without also reviewing the scope and attempting to remedy some of the known scoping issues would be a missed opportunity. It is unlikely that these issues will be addressed in the near future if they are not reviewed now. Known issues should be addressed rather than perpetuated.

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.

HoTARAC considers that the proposed new standard should not exclude non-core asset leases or short term leases as there is no conceptual basis for doing so. However, in practice, some such leases may be immaterial and therefore effectively scoped out for some individual reporting entities.

Approach to lease 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.

HoTARAC agrees with these conclusions where a lease contract is non-cancellable but not where the lease is cancellable. The Paper's two paragraph analysis (3.19 and 3.20) of why a lessee has a liability is superficial and does not envisage the possibility of a lease being cancellable and although Chapter 6 of the Discussion Paper deals with term options (including early-termination options), it does not specifically discuss leases that are cancellable.

HoTARAC considers that the proposal should be explicit about cancellable leases, either by scoping them out or by describing them as executory contracts, or both.

HoTARAC notes that some lease contracts are cancellable at the option of either party (or both), possibly after some short period of notice, while other lease contracts become cancellable after an agreed period of non-cancellability. Many tenancy agreements have this feature.

Where a lease is cancellable, HoTARAC considers that the lessee has little or no present obligation and little or no control over the leased item. If a lessee has an option to cancel the lease, it has no liability. If a lessor has an option to cancel, the lessee has no right-of-use asset. Such agreements are in the nature of executory contracts.

However, HoTARAC also acknowledges that treating some leases as executory contracts and others as assets and liabilities, would effectively continue the distinction between operating and finance leases. This could give rise to structuring opportunities to achieve particular accounting outcomes. Nonetheless the Discussion Paper's proposals will move the boundary significantly and many more leases will be recognised as assets and liabilities.

Question 4: The boards tentatively decided to adopt an approach to lease 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.

HoTARAC agrees with these conclusions where a lease contract is non-cancellable but not where it is cancellable. See response to Question 3

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 options arising under contingent rental arrangements and residual value guarantees

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

HoTARAC supports the tentative decisions to recognise a single right-of-use asset and a single obligation to pay rentals.

However, HoTARAC also considers that the nature and amount of any material component of a recognised lease asset or lease liability (for example a term or purchase option) should be disclosed in the Notes.

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.

HoTARAC disagrees. The Boards appear to have chosen the approach on the basis of ease of measurement rather than conceptual superiority.

HoTARAC considers that the interest rate implicit in the lease is the conceptually superior approach to discounting as it is specific to the transaction in question. Moreover, the incremental borrowing rate may not be easier to determine as such rates will vary based on the riskiness of the item being funded and will not necessarily be readily obtainable. The incremental borrowing rate is likely to be difficult to determine in cases where the lease term is long, for example 30, 50 or 99 years.

Given that Paragraph 4.16 notes that both approaches should give similar information, HoTARAC considers that the interest rate implicit in the lease should be the preferred approach and that the incremental borrowing cost might be used as a permitted alternative where the interest rate implicit in the lease cannot be determined.

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.

HoTARAC agrees.

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.

HoTARAC agrees with subsequently measuring the rental obligation at amortised cost but considers the right-of-use asset should be measured at cost or fair value for consistency with the approach to subsequently measuring similar owned items.

Moreover, the most appropriate measurement approach cannot be determined separately from the decision about appropriate classification of the lease asset. Paragraph 8.16 of the Discussion Paper notes the Boards tentative decision to present the right-of-use asset according to the nature of the underlying leased item (for example, a leased motor vehicle would be presented alongside other motor vehicles, but as a separate line item). This treatment implies that the future economic benefits the entity will receive from the asset are consistent with the future economic benefits from an equivalent owned asset. That being the case, the same measurement requirements should also apply: subsequent measurement should be either on the cost or revaluation model as per AASB 116 *Property Plant and Equipment*.

Other reasons for not measuring the right-of-use asset at amortised cost include:

- there is questionable logic in having the same measurement approach for an asset and liability that reflect the same contractual arrangement and may substantially offset each other (depending on the final measurement approaches determined);
- future economic benefits arising from an asset would generally differ from the present obligations inherent in a liability;
- although many financial instruments are subsequently measured at amortised cost, AASB 139 *Financial Instruments: Recognition and Measurement* scopes out leases (except in the case of derecognition and impairment); and
- it is important for Standards to apply classification and measurement concepts consistently.

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.

HoTARAC does not support measuring rental obligations at fair value.

HoTARAC supports measuring such liabilities at amortised cost and agrees with the supporting rationale given in Paragraphs 5.16 and 5.18 of the Discussion Paper, particularly the desirability of measuring lease and non-lease financial liabilities consistently.

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. 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.

HoTARAC does not support the reassessing of the incremental borrowing rate. See also response to Question 6.

HoTARAC agrees with the disadvantages of reassessing the incremental borrowing rate noted in Paragraph 5.23 of the Paper, particularly the resulting inconsistency with measuring non-lease financial liabilities. Further, any reassessment of the incremental borrowing rate would only be logical if it reflected a true change in the inherent economic “value” of the lease during the lease term.

Reassessing the incremental borrowing rate would also mask the impact of economic conditions that applied when the original decision was made.

For entities to which IASs are normally addressed, the financial report is typically only prepared at the consolidated level, occasionally also including the parent entity. Consequently, the incremental borrowing rate for the entity is not an issue. By contrast, Australian public sector jurisdictions commonly prepare financial reports for the whole-of-government and a multitude of subsidiary entities. While some of these may arrange their own borrowing, typically most government borrowing is arranged centrally. However, these borrowings and funds raised from taxes will be distributed to the subsidiaries by a variety of grants, lending and appropriations, resulting in a great variety of entity incremental borrowing rates. This then leaves the question of whether the subsidiary entities should ignore these and just apply a common economic entity rate. If not, what are the practical implications for consolidation? Any expectation of consolidation adjustments would be impractical and is also opposed on cost benefit grounds.

Using an incremental borrowing rate would also give rise to measurement inconsistency between lessor and lessee. Again this would have particular implications in the Australian public sector where agencies lease to each other.

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 the lessee 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.

HoTARAC agrees, because:

- AASB 139 *Financial Instruments: Recognition and Measurement* scopes out leases accounted for under AASB 117 (except in the case of derecognition and impairment); and
- this measurement issue is so fundamental to a new Standard on leases that a cross-reference to another Standard would be insufficient.

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.

HoTARAC does not support classifying the decrease in value of the right-of-use asset as rental expense.

As explained in the response to Question 8, HoTARAC considers that classification and measurement concepts should be consistent across all Standards. Therefore, the classification of a lease expense should reflect the classification of the lease asset. See also the response to Question 23.

Paragraph 8.16 of the Discussion Paper notes the Boards tentative decision to present the right-of-use asset according to the nature of the underlying leased item (for example, a leased motor vehicle would be presented alongside other motor vehicles, but as a separate line item). This treatment implies that the future economic benefits the entity will receive from the asset are consistent with the future economic benefits from an equivalent owned asset. That being the case, the decrease in the value of the right-of-use asset should represent depreciation (or amortisation, if the underlying leased item is an intangible asset).

Options

Question 13: The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie 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.

While HoTARAC conceptually supports the proposal, it considers that in many cases the likelihood of exercising term and purchase options will be difficult to reliably determine. This is especially the case where the determination is to be made well in advance of the ultimate event. Such determinations, being reliant on management's judgement, could also be manipulated to achieve particular accounting outcomes such as liability minimisation. Structuring opportunities could also arise. Moreover, lessees' evaluation abilities and risk-aversion will influence such determinations. The results may also be difficult to verify.

These factors will reduce the comparability of lessees' financial reports. In addition, a lessor and lessee may have different expectations in relation to the same economic event, thereby distorting the reciprocity of reporting for that event.

HoTARAC therefore encourages the Boards to develop strong criteria and guidance to ensure recognition only occurs on a consistent and reliable basis using robust methodology.

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 the financial statements with more relevant information? Please explain why?

HoTARAC supports reassessing the lease term at each reporting date, subject to the concerns expressed in response to Question 13. Such reassessment would potentially provide more up-to-date and therefore relevant information on lease assets and liabilities.

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?

See response to Question 13.

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?

HoTARAC believes contingent rentals should not be included in the measurement of the lease asset and liability until such time as the amount of the contingent rental can be determined with certainty. This is broadly consistent with the current philosophy for contingent rentals in AASB 117 *Leases*.

HoTARAC believes there is significantly more measurement uncertainty in respect of contingent rentals (over which a lessee is likely to have little or no control) compared with term and purchase options.

This is especially the case where contingent rentals are estimated well in advance of the ultimate event. Such estimates, being reliant on management's judgement, could also be manipulated to achieve particular accounting outcomes such as liability minimisation. Structuring opportunities could also arise. Moreover, lessees evaluation abilities and risk-aversion will influence such estimates. The results may also be difficult to verify.

These factors will reduce the comparability of lessees financial reports.

In addition, a lessor and lessee may have different expectations in relation to the same economic event, thereby distorting the reciprocity of reporting for that event.

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.

As mentioned in the response to Question 16, HoTARAC does not support contingent rentals being included in the measurement of the lease asset or liability until such time as the amount of the contingent rental can be determined with certainty.

Apart from this concern, under a probability-weighted approach, estimates would be made according to the relative probability of what is most likely, least likely etc. This is arguably a means of subjectively determining one (most likely) result. Also, care may be needed with a probability-weighted approach to ensure the (somewhat arbitrary) numerical result is actually possible according to the terms and conditions of the lease.

Question 18: The FASB tentatively decided that if lease rentals are contingent on changes in an index 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.

As mentioned above in response to Question 16, HoTARAC does not support contingent rentals being included in the measurement of the lease asset or liability until such time as the amount of the contingent rental can be determined with certainty.

HoTARAC considers it inappropriate to use an index or rate existing at the inception of the lease as a surrogate for a later index or rate. Such a proposal simply highlights the difficulty in forecasting something based on future events, over which the entity has little or no control.

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.

As mentioned above in response to Question 16, HoTARAC does not support contingent rentals being included in the measurement of the lease asset or liability until such time as the amount of the contingent rental can be determined with certainty.

However, HoTARAC supports the general concept of remeasurement for other items, as this is consistent with accounting practice for many other balances.

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 and 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.

As mentioned above in response to Question 16, HoTARAC does not support contingent rentals being included in the measurement of the lease asset/liability until such time as the amount of the contingent rental can be determined with certainty.

Subject to this concern, HoTARAC supports approach (b) as it is consistent with the proposed approach for recognising changes arising from a reassessment of the lease term as dealt with in Question 14.

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?

HoTARAC believes that there is significant measurement uncertainty over residual value guarantees due to factors outside the lessee's control.

HoTARAC's concerns in relation to contingent rentals set out in response to Question 16 are equally relevant to residual value guarantees.

Further, HoTARAC supports the Boards tentative decision to not require residual value guarantees to be separated from the lease contract and accounted for as derivatives.

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?

HoTARAC does not consider rental obligations need to be separately presented in the Statement of Financial Position. The nature of such obligations does not differ significantly from other financial liabilities. However, given that leases are a distinct type of financing arrangement, HoTARAC supports rental obligations being separately disclosed in the notes to the financial report.

For those who understand the lease accounting arrangements, separate presentation in the notes would identify that there is an associated asset recognised. Therefore, separate presentation would indicate that the obligation to pay rentals is offset to some extent by future economic benefits controlled by the entity.

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?

HoTARAC considers it important for standards to apply classification and measurement concepts consistently. HoTARAC agrees with the tentative decision in Paragraph 8.16 of the Discussion Paper that the right-of-use asset should be presented according to the nature of the underlying leased item (eg, a leased motor vehicle would be presented alongside other motor vehicles, but as a separate line item). This treatment is believed to be the most appropriate as the nature of future economic benefits, the entity will receive from the asset during the lease term, is consistent with the future economic benefits from an equivalent owned asset.

Under the tentative decision in Paragraph 8.12, HoTARAC agrees with the proposal that leased assets be presented separately from owned assets in the notes to the Statement of Financial Position. Further appropriate disclosures, under such an approach, would include the initial and subsequent measurement basis for the asset, terms and conditions of the associated leases, the range of lease options available in future, and contingent rentals and residual value guarantees (if applicable). Most of these disclosures would apply to both the asset and the liability.

If the right-of-use asset is presented as an intangible asset, further disclosure would be necessary to explain the nature of the underlying assets. Further appropriate disclosures, under an intangible asset approach, would include the initial and subsequent measurement basis for the asset, terms and conditions of the associated leases, the range of lease options available in future, and contingent rentals and residual value guarantees (if applicable). As mentioned above, most of these disclosures would apply to both the asset and the liability.

If the right-of-use asset is presented according to whether it is an in-substance purchase or not, much more disclosure would be necessary to explain the presentation of leases according to whether they are individually classified as an in-substance purchase or not, as well as the specific circumstances that influenced the classification of actual leases recognised. Further appropriate disclosures, under this approach, would include the nature of the leased assets themselves, initial and subsequent measurement bases for the asset (according to its classification as an in-substance purchase or not), terms and conditions of the associated leases, the range of lease options available in future, and contingent rentals and residual value guarantees (if applicable). As mentioned above, most of these disclosures would apply to both the asset and the liability.

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.

HoTARAC notes that some finance lease arrangements provide for the construction of the leased item prior to the commencement of the lease term. The lessee often has a significant role in specifying the features of the leased item, which is typically leased for all or most of its economic life, yet remains the property of the lessor.

Questions arise as to the accounting treatment by each party during the construction period: after the inception of the lease but before the commencement of the lease term.

At present, AASB 117 *Leases* requires a lessee to recognise a finance lease asset and liability at the beginning of the lease term (i.e. not before). However, in some cases, the lessee may control the item prior to this time.

In the case of a construction contract, the purchaser may recognise the partly completed work as its asset (capital work in progress). The Framework applies in the absence of a specific Accounting Standard. The recent IASB Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* also challenges some established notions on when constructed assets are to recognised.

HoTARAC considers that it would be helpful for the proposed new Accounting Standard on leases to give guidance for this situation, based on the parties rights and obligations.

Another issue not dealt with in the Discussion Paper is accounting for the incurrence of direct costs by the lessee. Paragraph 20 of AASB 117 *Leases* states "any initial direct costs of the lessee are added to the amount recognised as an asset". Given the specific measurement approaches proposed in the Discussion Paper, HoTARAC recommends that the Exposure Draft deal explicitly with the treatment of initial direct costs. Given the proposal to remove the distinction between operating and finance leases, HoTARAC notes that a review will need to be undertaken of SIC 15 *Operating Leases – Incentives*.

Given the range of tentative decisions put forward in the Discussion Paper, HoTARAC recommends that the Exposure Draft include a comprehensive worked example that clearly illustrates the practical application of all decisions.

In addition to the above issues, HoTARAC suggests that the future Exposure Draft should address transitional issues ie, whether or not the requirements of the new Standard will need to be applied to those leases already in existence.

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.

HoTARAC agrees with these conclusions where a lease contract is non-cancellable but not where it is cancellable. See response to Question 3

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.

HoTARAC can see valid aspects in each approach described in the Discussion Paper.

On balance, HoTARAC supports approach (b) for conceptual consistency with the approach proposed for lessee accounting.

However, according to Paragraph 10.17 of the Discussion Paper, under such an approach, it is envisaged that the lessor would continue to recognise the leased item as its economic resource. This highlights the problems with separately dealing with lessee and lessor accounting. For example, if it is eventually decided that the lessee classify the leased item according to its nature (for example, motor vehicle), it is arguably inappropriate for the lessor to also recognise the item as a motor vehicle during the lease term, if the lessor has effectively transferred the motor vehicle's future economic benefits to the lessee during the lease term. In such an example, the asset that the lessor does control during the lease term is a right to receive future lease payments.

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.

Yes. To ensure all inter-related lease accounting issues are identified for lessees and lessors, HoTARAC considers that the Boards should give proper consideration to the circumstances in which it is appropriate for a lessor to recognise income at the inception of a lease.

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

Leases over investment property are a common type of lease arrangement. Therefore, to ensure all inter-related lease accounting issues are identified for lessees and lessors, and appropriate measurement approaches are used (for example fair value vs amortised cost), HoTARAC believes any proposed new standard for lessor accounting should include full consideration of the accounting for investment properties subject to leases.

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

See response to Question 24.

Lessee and lessor accounting are two sides of the same coin and HoTARAC considers it inappropriate to revisit the conceptual basis for one without addressing the other. This approach risks overlooking important factors. Basing each side of a transaction on different accounting models seems illogical, will make financial reports less understandable, and is unlikely to have any conceptual validity.

Paragraph 1.22 of the Discussion Paper notes that there are disadvantages to deferring consideration of lessor accounting. These include the possibility of gaining further insights into lessee accounting, the possibility of having to make further changes to lessee accounting and the problem of having different conceptual models for lessor and lessee accounting.

HoTARAC therefore urges the Boards to properly consider both lessee and lessor accounting concurrently.