

# **LEASES**

## **AASB ED 202**

**Submission by**

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## INTRODUCTION

Our firm provides specialist financial and administration consulting services solely to Local Government throughout Australia. Our senior principal, David Maxwell, is a Fellow of the Institute of Chartered Accountants and an Associate of Local Government Managers Australia with over 35 years experience as Local Government Auditor, Principal Accounting Officer, Chief Executive Officer and Consultant.

Under the name Coalface Software Solutions - who supply a range of spreadsheet templates to assist Council officers in the preparation of the Annual Financial Statements - we have been contracted by the Local Government Association of South Australia to prepare the Model Financial Statements for use by Councils in that State. Coalface Software Solutions prepares Annual Financial Statements template formats to comply with legislative and reporting requirements for New South Wales, Northern Territory and South Australian Councils.

Coalface Software Solutions sponsors the NSW Annual Financial Statements Award presented by the NSW LGMA Financial Professionals Group, judged by nominees of the NSW Local Government Auditors Association, Finance Professionals Group and Coalface Software Solutions.

Our comments are directed principally in relation to Local Government in Australia, but we believe that they would be widely applicable to other not-for-profit entities. We note that ED 198 (IASB ED/2010/6) *Revenue from Contracts with Customers* particularly invited comment to the FASB in relation to not-for-profit entities, but cannot identify a similar request in this exposure draft.

There are no matters that we request be treated in a confidential manner.

## PREFACE

In general, we support the thrust of the proposals, particularly the effect of recognising the effects of all leases in the statement of financial position. However, we do have reservations about the detailed application in a series of circumstances that, although more common in not-for-profit entities, are by no means limited only to them.

There is a segment of the finance industry that has been promoting "off balance sheet" transactions that appear to meet the specific requirements of *operating leases* as defined in existing AASB 117. In every instance that we have reviewed, the construction of the lease document as a whole makes it clear that these are more appropriately classified as *finance leases*. However, where the lessee perceives advantages in an *operating lease* classification, it is very difficult to ensure that the correct accounting treatment is applied.

## IASB Question 1: Lessees

We support these proposals.

One consequence that we envisage is that existing entity records will need to be upgraded to ensure that all leases are correctly recorded in order to form the basis for the accounting entries. We do not view this as a disadvantage.



## IASB Question 2: Lessors

We are not comfortable with the existence of two alternative accounting treatments for lessors, although we accept that, if there is to be differentiation, the proposed basis is appropriate.

The exposure draft proposals will result in a dramatic change in the accounting treatment for leases. At such a time, especial value attaches to ensuring that the new requirements are as clear and simple as possible in order to minimise confusion. We are concerned that the existence of two different treatments for lessor accounting - albeit in relation to contracts that are significantly different in key attributes - will serve as a focal point for confusion. Indeed, we have seen evidence of such confusion in "explanatory notes" prepared in relation to the exposure draft.

We therefore would support the use of the derecognition approach only.

This would not preclude a subsequent change to the standard in (say) 10 years time, once the basic procedures are fully bedded down, and provided there is convincing evidence that the additional treatment is justified, and confusion arising from the additional treatment can be minimised.

## IASB Question 3: Short-term leases

### Lessees

While accepting the reasoning behind the proposal to offer simplified requirements for short-term leases, we would suggest a different approach, possibly located in the Application Guidance. We would suggest that the Application Guidance could state that, in the case of short-term leases, as defined, and always subject to the requirements of AASB 1031 *Materiality*, a reasonable approximation to the requirements of the standard can be achieved by the proposed simplified requirements.

We suggest that the sentence "*such lessees would recognise lease payments in profit and loss over the lease term*" should read "*such lessees would recognise total amounts equal to lease payments in profit and loss over the lease term*". (If the gross amount of lease payments is recognised at the inception of the lease, and again at reporting date, then the amortisation of the right-to-use asset would equal the amount of the lease payments, but would be described as *amortisation* rather than as a *lease payment*.)

### Lessors

We are concerned at the inconsistency between requiring lessees to recognise assets and liabilities arising from short-term leases, and not requiring lessors to recognise the equivalent liabilities and assets.

Further, we would suggest that a short-term lease (as defined) would more commonly not involve the transfer of the significant risks or benefits of the underlying asset, in which case the derecognition approach would not be used, and the reference to it is redundant.

## IASB Question 4: Definition of a lease

We accept the definition, and the distinguishing guidance.



## **IASB Question 5: Scope exclusions**

The excluded areas are not generally applicable to Local Government, but the exclusions appear sound and are generally consistent with other accounting standards.

## **IASB Question 6: Contracts that contain service components**

We support the FASB approach.

## **IASB Question 7: Purchase options**

We support this approach. However, it may be appropriate to insert in paragraph 15 a reference to bargain purchase options as expressed in paragraphs B9 and B10.

## **IASB Question 8: Lease term**

We support the definition of the lease term, but consider that the application guidance should be expanded and suggest the following areas for consideration:

### **Limitation of term to the existing contract**

We are aware of many commercial instances where a lessee has leased premises from a lessor over a period of many years, by way of a series of discrete lease contracts. The lease term should be based only the existing contract(s) even where the contract provides the existing lessee with a priority right to negotiate a new lease for the premises.

### **Leases for an unspecified term**

It frequently happens in Local Government that (say) a cricket ground and club rooms are leased to a local cricket club. No formal lease term is specified in the Council resolution, and hence cannot be specified in the contract. We submit that a reasonable interpretation would be to regard the lease as being on a season to season basis, in which case the short-term lease treatments may be appropriate.

We consider that the fact that the same (cricket club) has occupied the same club rooms on the same basis for (say) 50 years should be irrelevant in assessing the lease term. The continuation of the lease depends entirely on the viability and support for the continued existence of the club, not its history.

A similar situation exists in some jurisdictions where residential tenancies continue on an *at will* basis after the expiry of the initial lease term.

### **Very long term leases**

99 year leases are not uncommon in government affairs. A proportion of these are at "*peppercorn rentals*", and in almost all such instances the fair value of the assets leased greatly exceeds the rental received. Accordingly, there is a serious mis-match in the fair value of the right-to-use asset/liability, and the present value of the future lease rentals. We have not been able to identify any reference to such mis-matches in the exposure draft material.



## Perpetual leases

Very large portions of the more remote areas of Australia are leased (including leases to substantial listed public companies) on a perpetual lease basis, frequently with rental payments that approximate full commercial rates. (The relationship between rentals payable and full commercial rates tends to vary with the political process, and the pastoral success of recent seasons.) We would expect to experience practical difficulties in calculating the present value of an infinite series of future payments where the rental increases at a rate comparable to the discount rate.

## IASB Question 9: Lease payments

We concur with the proposals.

We seek clarification in paragraph B19 as to whether a residual value guarantee involves expected and actual *residual* values, or expected and actual *fair* values, but have interpreted this in the latter sense.

## IASB Question 10: Reassessment

We concur with the proposals.

## IASB Question 11: Sale and leaseback

We concur with the proposals.

## IASB Question 12: Presentation

### Statement of Financial Position

Liabilities to make lease payments should be separately identified from other financial liabilities, but separate disclosure on the face of the statement of financial position should depend on the materiality of the amounts involved. Similarly, separate identification of right-to-use assets on the face of the statement of financial position may be appropriate, again depending on the materiality of the amounts involved. At the very least, both liabilities to make lease payments and right-to-use assets must be separately identified in the notes.

We would apply the same philosophy to disclosures for lessors and for sub-lessees / sub-lessors.

### Property, Plant & Equipment Note

The formatting and presentation of this note is likely to present practical difficulties to many entities, and we submit that examples should be included in the Application Guidance. Under the current proposals, and entity may have to separately disclose:

- owned property, plant and equipment, separately by classes,



- right-to-use to property, plant and equipment, (not stated, but implied) separately by classes,
- residual leased assets, (separately by classes?),
- underlying assets, (separately by classes?), and
- sub-leased assets - any of right-to-use, residual or underlying as applicable.

The question of the amelioration of disclosure requirements under certain circumstances should also be addressed.

### **IASB Question 13: Statement of comprehensive income**

We would again apply the same philosophy, noting that for a lessor the expense would be partly the unwinding of the present value discount and partly amortisation of the right-to-use asset (and the equivalent for lessors).

### **IASB Question 14: Statement of Cash Flows**

We concur with the proposals, and differentiate our responses to the previous questions on the basis, partly that there should not be difficulty in formatting this statement to include this information (there is usually plenty of space on the page) and partly, that it is appropriate to present the gross cash outflows / inflows relating to leases as a single figure.

### **IASB Question 15: Disclosure**

There are certain entities for whom full disclosure of all matters listed in paragraphs 73-86 would be appropriate. However, we would prefer to see paragraph 71 in bold type, with the addition of the following sentence.

*"Except where matters referred to in paragraph 86 have had a material effect on the results for the reporting period, these disclosures would not normally constitute significant accounting policies."*

We suggest that the last sentence of paragraph 77 duplicates the requirement to disclose cash flows arising from leases separately in the statement of cash flows.

### **IASB Question 16: Transition**

In our view, the proposed transitional procedures are acceptable.

### **IASB Questions 17 & 18**

No comment.



## **AASB Question 1: Not-for-profit entities**

Some 25 years ago, there were strict controls on the gross amounts permitted to be borrowed by various government entities, including Local Government. In more recent times, these controls have not been applied as strictly. Indeed, we are uncertain whether these controls still exist (but are set far in excess of requirements), or whether they have been fully dismantled.

Full accounting recognition that future lease payments are liabilities - *borrowings* - may have the unintentional effect of calling some of these restrictions into play, if they still exist.

It is possible that legislation in some jurisdictions may need some consequential adjustment.

In our response to IASB Question 1 above, we have foreshadowed a need for a significant upgrading of records in order to identify all existing and future leases in order to form the basis for the accounting entries.

In particular, we note that there are many thousands of Crown reserves of various types that are under the care and control of Local Government, many of which are subject to some form of annual licence fee, and the fees for which vary from "*peppercorn*" to full commercial equivalent rental. In many cases the original terms and conditions are lost in the past, and would require a research project to locate the details.

We therefore anticipate that in some respects compliance with the new standard by Local Government will be "patchy", as the necessary information is accumulated. However, although individual amounts in some instances may be significant, we do not expect these to invalidate the financial data of the industry taken as a whole.

## **AASB Question 2: Reduced disclosures requirements**

For the reduced disclosure regime to apply in any State jurisdiction, that State would have to modify its legislation, and the data collection requirements for the Local Government Grants Commission, within that jurisdiction to permit small Councils to take advantage of the reduced disclosure.

We cannot foresee that happening, and therefore do not expect that the reduced disclosure requirements will have any relevance in a Local Government context.

## **AASB Question 3: GAAP/GFS harmonisation**

The harmonisation process to date has not involved Local Government, and we regret that we are unable to comment.

## **AASB Question 4: General comments**

Subject to the above comments, we support the basic thrust of the proposed new Standard, and particularly the removal of the operating / finance lease distinction, which we consider to have been wilfully misinterpreted by many entities.

