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24 November 2010

Mr Angus Thomson,
Technical Director
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria, 8007
By email: athomson@asb.com.au

Dear Mr Thomson

Re: FINSIA RESPONSE TO IFRS EXPOSURE DRAFT ON LEASES (ED 202)

Finsia (the Financial Services Institute of Australasia) is a professional association representing more than 16,000 individuals working across the spectrum of the financial services industry in Australia and New Zealand.

Finsia's responses to the Exposure Draft are set out in the attachment.

We appreciate the opportunity to respond to the Exposure Draft. As noted in the attachment, we support the proposed standard because its application would result in the primary financial statements being more reflective of economic reality and financial risk. However, the proposed standard falls short of providing the account balances or disclosures needed to enable financial markets to reliably estimate the operating capital attaching to leased assets, and this is reflected in our response.

If you would like to discuss this submission, please contact Sean Molloy, Senior Policy Advisor on 02 9275 7967 or s.molloy@finsia.com.

Yours Sincerely

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Enc.

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FINSIA RESPONSE TO IFRS EXPOSURE DRAFT ON LEASES (ED 202)

Overview

In our view, it is vital that the true amount of capital tied up in an enterprise can be identified:

- (i) to be able to ascertain whether the enterprise is earning more or less than its cost of capital, thereby providing the signaling mechanism so critical to an efficient rationing and allocation of capital within the economy; and
- (ii) to determine the likely consumption of capital (cash) necessary to fund growth, and thereby provide users of financial reports with the information necessary to perform discounted cash flow analysis in order to reliably value and efficiently price equity and debt in financial markets.

We support the proposed standard because its application would result in the primary financial statements being more reflective of economic reality and financial risk. However, the proposed standard falls short of providing the account balances or disclosures needed to enable financial markets to reliably estimate the operating capital attaching to leased assets.

Our response to the ED is made fully within the framework of the 17 “Questions for Respondents”. Our suggested changes relate principally to disclosures – specifically the disclosures we feel necessary to bridge the gap between (i) the ED’s “lease liability approach” (wherein asset values on a lessee’s balance sheet are a function of the remaining identifiable lease liability) and (ii) the lessee’s sustainable asset base and capital (i.e. that necessary for the business to continue as a going concern beyond the end of the lease period).

Realising that a “sustainable asset approach” to leased assets is difficult to effect via double-entry accounting, in our response to Question 15 we seek the information necessary for financial statement users to complete the conversion through more comprehensive disclosures.

The only contention we have regarding the proposed accounting treatments themselves relates to the requirement for lessors under the performance obligation approach to account for the leased assets on their balance sheets and to depreciate them, while at the same time recording the finance receivable and liability. In our opinion, this is an “each-way” bet that fails to fully recognise lease contracts for what they are – just another means of financing assets. Furthermore, it would unnecessarily clutter and confuse financial statements.

In summary, the project is a significant step forward but, from our point of view, it only decisively passes the cost-benefit test if it also includes additional disclosures to enable estimation of sustainable operating capital.

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Question 1: Lessees

- (a) We agree a lessee should recognise a right-of-use asset and a liability to make lease payments as this reflects the substance of a long-term rental or lease.
- (b) We agree that a lessee should amortise the right-of-use asset and interest on the lease liability, once again as to do so reflects the substance of a long-term rental or lease.
 - > However, we take issue with the use of the term “amortization” which we believe should be “depreciation” in order to reflect the substance and economic reality of assets used under leases which, operating or finance, are simply financing mechanisms. To use the words “amortise’ and “amortization” only serves to perpetuate the thinking that the assets financed by leases are somehow different in their utility to the firm.

Question 2: Lessors

- (a) We understand why a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset, and (ii) the de-recognition approach otherwise. This is a legal approach based on title and supportable on those grounds.
 - > However, if the objective is to reflect substance, then the performance obligation approach fails because it leaves the asset on the books of the lessor even though the lessor does not have the right to use it. Taking a consolidated view of lessor and lessees, it is undesirable because the same asset is recorded as a fixed asset of both lessor and lessee, whereas there is only one asset in existence in the economy. To us it looks as though IASB is having an “each way” bet in proposing the performance obligation approach. In our view it is unnecessary because the reality of the lease contract is that it is a form of financing; so only a finance receivable need be recorded in the accounts of the lessor. The fact that the lessor is exposed to significant risks or benefits attaching to an asset needs to be communicated, but this can be done by way of note, where we would also recommend disclosure of cost and accumulated depreciation to provide an indication of the age profile of the assets under lease.
- (b) Putting aside our reservation regarding the performance obligation approach, we agree with the proposals for the recognition of assets, liabilities, income & expense for the performance obligation and de-recognition approaches to lessor accounting as they are consistent with what is trying to be achieved, and logical.

Question 3: Short-term leases

We agree with the concept of providing a simplified accounting treatment for short-term leases. We are alert to the opportunity that a short-term lease option may provide to avoid the purpose of the proposed standard. We think this risk is mitigated by the definition (i.e. the 12 months includes options to renew or extend) and by the commercial reality that lessees are unlikely to risk renting key operating assets under such short-term arrangements i.e. assets under short-term leases (as defined) are likely to be immaterial and/or for genuine ad hoc rental of ancillary assets.

However, we query the utility of requiring lessees to record an asset and liability of approximately equal amount in respect of these leases. To be consistent, any other contractual commitments (e.g. a

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9 month contract for the supply of materials) would have to be recorded as an asset and liability. This would clutter the balance sheet for little gain e.g. attaching to a short-term lease, the asset recorded would be unlikely to reflect the value of the capital tied up in the business (which would be useful to know – see discussion below)

Consistent with our above view, we believe that the lessor accounting prescribed for short-term leases is appropriate.

Question 4: Definition of a lease

- (a) We agree with the definition of a lease as it captures the three elements of a lease contract: transfer of right to use an asset (as opposed to title thereto), a defined period, and consideration.
- (b) We believe that defining a sale as one which involves “transferring control” needs to be reconsidered. A lessee has some “control” (operational) over an asset under lease, even though he does not have the ability to dispose of it. The emphasis should be on ownership (including the option to own).

Question 5: Scope exclusions

In our opinion there is little logic in treating leased intangibles (e.g. computer software) or leased biological assets (e.g. an orchard) differently from leased tangibles, typically Property, Plant & Equipment (or “PP & E”).

We draw the line at exploration and mining leases which are akin to permit fees, and where any capitalised amounts payable under such leases would only coincidentally reflect the economic value (unlike the cost of PP & E).

Question 6: Contracts with service components

We strongly disagree with the FASB proposal to apply the lease accounting requirement to both service and lease components. Again, to be consistent, this would require a similar treatment for any service contract of over 12 months, which in turn would mean populating statements of financial position with balances not regarded as “capital” by users or financial markets generally.

Estimation will be required to separate the service component from the lease component but modern accounting already requires bolder estimations to be made elsewhere and should not be an impediment to the accounting proposed by the IASB in ED 202 which is consistent with the principles underlying the proposed standard.

Question 7: Purchase options

Lessees and lessors should be required to account for purchase options only when they are exercised because until this point the lessee is committed to leasing as a form of finance (as opposed to equity or conventional balance sheet debt).

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However, if it a lease is structured to include a “bargain purchase option”, the exercise price should be included in the present value of lease payments - similarly, if it becomes probable that a purchase option is likely to be exercised (because it represents a “bargain” and is therefore rational to exercise it).

Questions 8, 9 and 10: Lease term, payments and reassessment

We believe that these elements of the proposed standard are particularly progressive. These requirements mean that the future payments capitalised will span a greater portion of the useful life of an asset. The capitalised value will therefore more fully reflect the true “store of value” in the asset and bring us closer to users’ end goal of being able to identify all of a firm’s operating capital (of which operating assets at depreciated cost are a part).

Consistent with our observations in the preceding point, we believe that:

- (i) reassessment and re-measurement should be ongoing as any new information about the value of an asset or liability needs to be impounded; and
- (ii) the “reliably measured” test for lessor should be relaxed to “reasonably measured” (which would require estimation based on past experience, discussions with lessees, etc as opposed to giving lessors an “out”, resulting in more conservative but less realistic balance sheet values.

Question 11: Sale and leaseback

We agree with the definition and treatment proposed for sales and leasebacks.

Question 12 (Presentation): Statement of Financial Position

- (a) We agree that lessees should present lease liabilities separate from other financial liabilities principally because of the degree of estimation (and therefore their potential volatility e.g. upon entering into new leases in respect of the same or replacement assets). Other characteristics which set them apart from more conventional forms of debt are their cash servicing requirements being are typically different (in that they effectively require principal repayments as well as interest, whereas many loans today are interest only), security arrangements are different, etc.

We also strongly support the notion that right-of-use assets should be presented as if they were tangible but separately from assets owned outright, for two reasons:

- > As mentioned elsewhere, the application of the standard as proposed will only partly or coincidentally result in getting all of a firm’s fixed asset operating capital on to the balance sheet. By separately classifying and presenting them, users will be put on notice as to the assets which need to be subject to further analysis and quantification for notional addition to balance sheet capital to arrive at true economic capital; and
 - > In related fashion, these assets will be subject to an above-average degree of estimation and their carrying value will be potentially volatile (mirroring the liabilities discussed in (a) above). So their segregation will put users on notice of that.
- (b) For reasons mentioned elsewhere regarding the performance obligation approach, consistent with our view that leases are no more than a form of financing, we believe that details relating to underlying assets (cost and depreciation), while useful, are not central, and should be presented in the Notes.

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- (c) In our view, it would be desirable for lessors applying the de-recognition approach to present lease receivables separately from other financial assets principally because of the degree of estimation involved in their quantification (and therefore their potential volatility e.g. changed probability attaching to extension of term, re-assessment of contingent rentals, etc).

We agree that residual assets should be presented separately (because of the liquidity and realization risks attaching to these assets) but we see little value in classifying them as PP&E. The lessor is in the business of financing assets and has no interest in holding or operating the assets themselves. The receipt of the asset at the end of the lease is part of the repayment of finance provided by the lessor. As such, it is financing receivable – the fact that it is receivable in a form other than cash doesn't change that. However, between the time the lessor takes delivery of the asset and the time the lessor realises it, it should be disclosed as a residual asset held for sale (to distinguish it from residual assets being operated under lease by customers).

- (d) We think a requirement to distinguish assets and liabilities arising from sub-leases is not worth the cost in terms of financial statement clutter. Leases are no more than a form of financing. Accounting standards do not require a lender who has borrowed money from another lender to earmark receivables funded by another lender. At best this requirement should be relegated to the Notes.

Question 13 (Presentation): Statement of Comprehensive Income

We agree with the proposed presentation with two exceptions:

- > Para 44: as elsewhere noted, we believe depreciation expense on assets leased by a lessor does not belong in the lessor's profit and loss; however, we believe information relating to the age and rate of decline in utility of leased assets is valuable; so notional depreciation and accumulated depreciation should be disclosed in the Notes.
- > Para 61 (b): allowing a lessor to present lease income and lease expense on a net basis inconsistent with the remainder of the proposed standard which almost without exception promotes a "gross" basis of presentation.

The P&L disclosure requirements call for segregation of income and expense relating to leased assets (lessees) and lease receivables (lessors). We agree with this because:

- > In the case of amortization/depreciation of leased assets (lessees), users are on notice that further adjustment may be required to this line item for the economic outcome;
- > Other items depend on estimation to a greater degree than their conventional equivalents.

Question 14 (Presentation): Statement of Cash Flows

We have no issue with the proposals relating to classification of the cash flows as the proposed classifications reflect the true nature of the cash flows i.e. they are financing transactions for lessees, and operating for lessors.

Question 15: Disclosure

We agree with the disclosure objectives in para 70 and we would fully support the disclosures required by para 73 and 83 if only a few leased assets were involved. However, we are concerned that para 73

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and 83, for any lessor or lessee with a portfolio of leased assets, will of practical necessity result in lengthy generic descriptions of the sort that characterise modern day financial reports. This is to be avoided.

The identification of the portion of short-term leases subject to “new vs old” lease accounting, when compared across similar firms, would be useful pointer to the degree of conservatism applied in striking balance sheet assets values.

In the name of transparency, we fully support the “roll-forwards” mandated by paras 77 and 80. We encourage a stipulation by the standard of the types of movements to be disclosed so that there is reduced scope to bucket and/or offset individually significant movements within “Other” (e.g. impairment, acquisitions and disposals, changes resulting from reassessment of expected contingent rentals vs reassessment of probable lease term).

The requirements of paras 85 and 86 to disclose maturity analyses on an undiscounted cash flow basis and on both a minimum and expected payments basis receive our full support. We think these disclosures will enhance the ability to project cash flows and solvency. However, we feel strongly that lumping all cash flows beyond 5 years into one bucket is premature and undue concentration. Given the duration of real estate leases (commonly up to 25 years), buckets of 6 to 10 years, 11 to 15 years, 16 to 20 years, 21 to 25 years and 26 years+ are suggested.

Our primary concern is to have presented the information necessary to estimate an enterprise’s sustainable asset base. If, for example, a critical long-life operating asset is subject to a lease which has only one year to expiry, under the proposed accounting standard, its balance sheet value will materially understate the cost of, and investment in assets necessary to sustain the business. When a new lease is entered into, balance sheet assets and capital will increase materially, even though in reality nothing of substance may have changed in terms of the physical assets required to sustain the business.

In order to estimate a business’s sustainable capital and requirements for future capital, users of financial reports of lessees need the following:

- (i) A detailed breakdown of leased assets, grouped by type (class) of asset (see (ii) below);
- (ii) For each class of leased asset, the class depreciation rate (or economic life) with a rate range of no more than 5 percentage points (any more should result in the creation of a separate class) to prevent the current poorly regulated practice of disclosing economic lives of fixed assets with ranges as wide as “3 to 20 years” which is literally useless;
- (iii) For each class of leased asset, the cost and notional depreciation and accumulated depreciation of the underlying asset, recognising that this cost is very likely to differ from the amount at which a right-of-use asset is recorded in the books of a lessee under the ED;
- (iv) For each class of leased asset, the lease payment obligation (i.e. accruals basis) for the year (being “principal” plus interest) and future undiscounted lease payment obligations (“principal” plus interest) for at least the next financial year (minimum and expected) to enable notional capitalization using the disclosed depreciation rate and user-chosen interest rates.

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Question 16: Transition

We have not formulated a view on this aspect of the standard but are in support of allowing full retrospective application given our view that it is a step forward for financial reporting.

Question 17: Benefits and costs

We believe the requirement under the performance obligation approach for lessors to account for assets on their balance sheets and depreciate them fails the cost-benefit test.

Furthermore, while the ED is a step forward it only decisively passes the cost-benefit test with the additional disclosures we seek to enable estimation of sustainable operating capital.

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