



6 December 2010

Mr Kevin Stevenson  
The Chairman  
Australian Accounting Standards Board  
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Dear Mr Stevenson

**IASB Exposure Draft: Leases**

Thank you for the opportunity to provide our comments on the International Accounting Standards Board (IASB or Board) Exposure Draft (ED) *Leases*.

The Property Council is the peak body representing the interests of investors in Australia's \$400 billion commercial property investment industry. The Property Council has over 2000 members, ranging from Australia's largest institutions to private investors and developers covering the four quadrants of real estate investing - public, private, debt and equity.

The Property Council supports enhanced comparability of financial information between real estate companies worldwide.

In summary the Property Council:

- strongly supports the view that investment property recognised at fair value is excluded from the ED.  
IAS 40 is well understood and provides useful information to preparers and other users of financial statements. This is supported by the letter submitted by REESA to the IASB and FASB on 5 October 2010. We have further articulated our arguments for our view below;
- recommends that the Proposed Standard provide guidance with respect to recognition of lease incentives given the withdrawal of SIC-15 *Operating Leases – Incentives*.

The **Voice** of Leadership

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**PROPERTY COUNCIL**  
of Australia

## **Investment Property**

More specifically, in support of our view that investment property recognised at fair value is excluded from the ED, we agree with the Board's view in IAS 40 B6 that the real estate industry is unique because:

- real estate is fundamentally different from other leased assets - it provides the right to benefit from demand to occupy the space above or below ground on a specified plot that is unlimited by time.
- the investor of a lessor views a lease as part of a constantly changing indivisible property asset, the valuation of which is highly developed and understood. In addition, the residual value is likely to be significant to the overall value
- real estate investment requires considerable active and intensive management to create value. The level of lessor participation exceeds that typically found in equipment.
- lessees of real estate are looking for more than financing. In many cases the tenant is unable or unwilling to directly buy the asset. For example, for a retailer seeking premises in a shopping centre, in which there are no individual units available for sale and in which the owner/manager has created an ambience of exclusivity and attractiveness which suits the tenants' market image. We therefore recommend that IAS 40 is the one-stop standard for accounting for investment property.

In addition, we are of the view that IAS 40 is well understood by the real estate industry, investors and analysts. Fair value enables the user of the accounts to understand the property performance based on the value enhancement/destruction caused by management actions and changing market value for rents and valuation yields.

IAS 40 also reports full rental income in the profit and loss account. This is fundamental for investors to be able to assess the performance and investment quality of property companies. Removing this metric would represent a step backward in the usefulness of information that property companies would communicate to investors, financial analysts and other users of financial statements. This is supported by the letter submitted by REESA to the IASB and FASB on 5 October 2010, and undersigned by investors and property sector analysts worldwide.

## **LandLords & Tenants – Implications for Lessees**

Our views expressed above are focused on our members' perspective as property lessors. However, as part of the tenant/landlord relationship, our members are in regular communication with tenants and have a clear interest in understanding how such a major change in the reporting framework will impact their business.

We understand that the tenants have significant concerns with respect to the proposals for lessees, especially whether cost of implementing these proposals exceeds the cost given the complexity and degree of judgment

that the proposals create and the significant business implications.  
Accordingly, we have highlighted a number of these concerns in Appendix A.

We are keen to assist you with any queries you may have so please call me  
on 0406 454 549 at any time.

Yours sincerely



**Andrew Mihno**  
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**Property Council of Australia**  
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## **Appendix A – Implications for lessees**

We are concerned about the business implications for tenants and the significant complexity that the ED creates. Specifically our concerns include:

### Contingent rentals

We do not agree that contingent rentals based on usage, such as turnover, should be included in the measurement of the lease liability because the lessee does not have an unconditional obligation to make these lease payments.

In addition, the result created by the ED would not create a fair representation of the economic substance of such contingent rental arrangements. For example, where a retailer leases space for a period of 10 years for AUD1 million per annum, plus turnover rent of 10% on all sales above AUD10 million, this effectively reduces the property company's risk that rent is too low in the later years. It also reduces the retailer's risk, such that the additional rental is only paid if the retailer's sales grow.

The ED would result in present valuing these additional payments and recognising the related interest and amortisation in relation to the total payment, including the turnover rent estimated in the later years. The front-ending of the expense results in a profit profile opposite to the economics of the transaction being portrayed.

In addition, the use of a weighted average probability estimate for contingent rentals creates significant complexity for tenants across long-term leases. For example if a company had 1,000 leases for 10 years, with 3 different estimates for each year for each lease this would result in 30,000 outcomes. The benefit of these estimates would not appear to outweigh the cost. Therefore if the IASB propose to go ahead with the proposals for contingent rentals we recommend that a best estimate approach be used.

### Lease term

We do not agree that the lease term should be the "longest possible term that is more likely than not" because the lessee does not have an unconditional obligation to make lease payment in respect of the renewal periods. Renewal is a separate economic decision which is made when the lessee exercises its right of renewal.

We understand that the IASB may be concerned around structuring of shorter term leases with more renewals, however, we believe that there is an economic disincentive for lessees to do this as lessors will increase the cash cost of the rental payment.

In addition, the IASB may wish consider including a "virtually certain" hurdle which would take account of renewals which do not have substance because the lease payments post renewal are expected to be at a such a

significant discount to market or with such a significant penalty for non-renewal that the renewal will be virtually certain of occurring.

#### Reassessment of lease payments

The requirement to reassess expected lease payments each reporting date is very onerous. While the ED provides that reassessment should take place if "facts or circumstances indicate that there would be a significant change in the liability since the previous report period" this would indicate that an analysis of each and every lease needs to be performed each reporting period to make such an assessment.

In addition, the statement in BC 133 does not appear to be carried through to into the Proposed Standard that a "detailed examination of every lease is not required unless there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability". We believe that this guidance be carried over to the Proposed Standard and further guidance should be given providing indicators of such changes in such facts and circumstances that would require reassessment.

#### Separation of services

While we agree with concept of identifying distinct goods or services in order to account for these separately from the lease, the application of this guidance may be difficult to apply in the context of real estate leases. We therefore recommend that to ensure consistency of similar costs that further guidance is provided in respect of items such as insurance, maintenance, taxes, especially in the context of "gross leases" where the lease payment includes the reimbursement of these costs, although not specified separately in the agreement with the tenant.

Further clarity should be provided regarding the treatment of initial direct costs and the allocation between the lease payment and service payment.

#### Sale and leaseback guidance

Consistent with our comments in respect of the Exposure Draft *Revenue From Contracts With Customers* ("Revenue ED") we note that the proposed sale and leaseback guidance is inconsistent with that in the revenue recognition proposals with respect to sale and repurchase agreements, as well as the guidance in IAS 39 *Financial Instruments: Recognition and Measurement* AG.51 in respect of sale and repurchases of financial assets.

The Lease ED provides that an entity cannot recognise the sale in a sale and leaseback transaction unless the seller transfers to the buyer control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset (B9 and B10). B31 provides an example of a situation which would preclude recognition of a sale: "(a) The seller/lessee has an obligation or an option to repurchase the asset at an

amount that is not fair value at the time of repurchase, or the buyer/lessor can compel the seller/lessee to repurchase the asset."

This guidance appears to conflict with the revenue recognition guidance on two fronts:

- The Revenue ED states that if the seller has an obligation to repurchase the asset it is not a sale because the buyer does not have control, however there is no mention of the repurchase price
- The Revenue ED states that a sale can be recognised where the option to put back the asset is at the buyer's option because the buyer does have control.

We recommend that the guidance be clarified to resolve these inconsistencies.

#### Cost-benefit analysis and investor and analyst input

We encourage the IASB to complete a complete cost-benefit analysis of the proposals and to examine whether the benefits exceeds the costs. This analysis should include:

- extensive input from preparers, investors and analysts as to whether the change in profit profile will be understood and provide useful information
- whether preparers will need to report additional information (such as 'adjustments to statutory profit') to provide users with an understanding of the results presented
- whether analysts will consider it necessary to make further adjustments to the information presented under the ED
- consideration of contingent rentals, assessment of renewal options and separation of services from lease.

#### Transitional provisions and effective date

While we are supportive of the proposed 'simplified' retrospective approach, we would also suggest the IASB consider allowing a 'full' retrospective approach as this will negate a number of concerns regarding the front-ending of expenses that will arise through the 'simplified' retrospective approach.

We would also suggest that, to the extent the proposals are not substantially changed prior to the issue of the Final Standard, 18 months would be insufficient time for companies to put the appropriate systems and processes in place to implement the proposals. We would therefore recommend a timeframe of at least two and a half years.

## **Appendix B – Other comments**

### Clarification of wording

Paragraph 7, states that "An entity shall apply this [draft] IFRS to investment property that it holds under a lease."

To fully reflect the IASB conclusion in BC57 that "the IASB proposes that the lessor requirements would not apply to a lessor that accounts for investment property at fair value in accordance IAS 40" we recommend that the wording in Paragraph 7 be amended to clarify that the exemption applies to all investment property recognised at fair value, whether the property is held under a lease or as an owner.