FINPRO
Local Government Finance Professionals

12 November 2010

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Vic 8007

COMMENTS ON ED 202R "LEASES"

1. FinPro – Local Government Finance Professionals

FinPro is the professional association representing finance professionals working in Local Government entities in Victoria, Australia. Our members are chief financial officers, financial and management accountants and Council officers working in the finance field.

The predominant users of financial reports prepared by Councils are ratepayers and other community members, many of whom are not experienced in reading financial statements and rely on the expertise of the financial professionals to present the information in an easy-to-understand format.

The comments provided in this submission represent the views of our members.

2. Response to Specific Issues Requested by AASB and IASB

The AASB has requested a response highlighting any regulatory issues in the implementation of the proposals by not for profit entities.

The following implementation issues have been identified for local government entities in Victoria.

2.1 Implementation issues - recognition of current operating leases as borrowings on the balance sheet (AASB Question 1)

The recognition of the proposals in relation to leases currently classified as "operating leases" would most likely result in a materially neutral net effect on a Council's balance sheet as both an asset and a liability is also recognized. However, these leases would be classified as borrowings by a Council.

The Local Government Act (Vic) 1989 currently refers specifically to finance leases as being included in borrowings, but *only* refers to finance leases, as distinguished from operating leases.

> *Section 144 Local Government Act (Vic) 1989*
>
> *(1) Subject to the principles of sound financial management, a Council may borrow money to enable the Council to perform the functions and exercise the powers conferred on Council under this Act or any other Act.*
>
> *(2) This section also applies to borrowing in the form of finance leases.*
>
> *Section 3 Local Government Act (Vic) 1989*
>
> *Finance lease means a finance lease within the meaning of the Australian Accounting Standards issued by the Australian Accounting Research Foundation. (sic)*

The Local Government Act (Vic) 1989 would therefore require amendment to realign the definition of leases as borrowings, and provide direction as to the inclusion of leases under section 144.

All borrowings by Council must be approved in the Council's annual budget *(Local Government Regulations (Vic) 2004, Regulation 8(a))*. At the point of transition to ED 202R, leases currently classified as operating leases would be recognised as borrowings but *would not* have been approved in a previous budget.

Borrowings by Council are also subject to approval by the Australian Loan Council. Previous incarnations of the Australian Loan Council set prudential requirements for borrowings which compared the debt commitment to Council's rate revenue, as an indicator of the Council's ability to service the debt. Council's level of assets was not taken into account. Therefore, the recognition of operating leases "on balance sheet", as proposed by ED 202R, would have resulted in increased debt levels; a constant level of rate income; and a perceived reduced ability to service the debt even though no new commitments are introduced and the pattern of cash flows does not change.

The assessment criteria currently applied by the Australian Loan Council for approval of Council borrowings are not as transparent or widely known as previous oversight regimes, but debt levels would need to be revised if operating lease commitments are not currently included in the consideration of borrowing commitments and debt serviceability.

2.2 The expected term of lease includes contingent events (IASB Question 8)

The right-to-use asset and lease payment liability recognised by lessees is measured as the present value of lease payments over the expected term of the lease. The lessee is required to determine the lease term by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease *(ED 202R paragraph 13)*

The IASB Basis for Conclusions (paragraph BC 115) suggests this is a practical solution to an alternative model that would require separate measurement and accounting for the exercise of options.

However, the proposed, simplified and practical solution would not be achieved in practice as the lease term will still be reassessed in accordance with paragraph 56 of ED 202R, in response to changing circumstances.

The inclusion of options in the initial recognition of lease assets and liabilities is not consistent with the Australian Accounting Framework definition of a liability, or the AASB 137 "Provisions, Contingent Liabilities and Contingent Assets" distinction between liabilities and contingent liabilities.

The Framework and AASB 137 definition of a liability is:

> *A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.*

The exercise of an option to extend a lease term does not fit this definition, as it is not a present obligation at the time of the initial recognition of the lease payment liability, and the relevant event is the decision to exercise the option, which is not a past event at that time.

AASB 137 would define a lease option that is yet to be exercised as a contingent liability, to be disclosed but not yet recognized on balance sheet.

The practical impediment to reliable measurement of a lease term that includes options is the ability of the financial statement preparer to support their assessment of the probability of exercise of an option in a lease term with objective evidence.

The intention of including options in lease contracts is to allow the lessee to react to changing business circumstances, without any disincentive or penalty. The intention of ED 202R is to improve financial reporting, but the inclusion of contingent events in the measurement of the asset and liability could result in increased volatility as lessees re-measure lease assets and liabilities as options are exercised, or not exercised. The proposals in this Exposure Draft do not remove that element of judgement.

2.3 The cost to Council of the proposed method of accounting will be high (IASB Question 17)

The proposals contained in ED 202R focus on the quality of balance sheet reporting through the recognition of all assets and liabilities relating to lease contracts.

The impact of the proposed methodology on the Statement of Comprehensive Income will be minimal, as the replacement of operating lease payments with amortisation of the right-to-use asset plus any interest expense is likely to materially the same. Similarly, the impact on the Statement of Cash Flows will be neutral.

For Councils as lessee, many of whom have extensive lease portfolios covering buildings, vehicle fleets, and computer equipment, new systems will need to be developed to measure the assets and liabilities; assess the expected term of the lease at commencement, and reassess the term of each lease if conditions change.

Councils act as lessor in numerous arrangements, as it is a common occurrence that the Council provides assets to meet community service objectives, not financial or investment objectives.

The full, diverse variety of arrangements that Council's enter as lessor includes:

- Appointment as Committee of Management, with a range of degrees of delegation of rights and responsibilities.
- Long term (for example, 20 – 99 years) occupation of sites by community groups, often with an unspecified term and for a nominal or "peppercorn" rental.
- Assignment of responsibility for Crown Land, recognized as an asset by Councils on the basis of control, not ownership. Therefore, unable to be de-recognised even when rights and responsibilities are predominantly re-assigned under a lease.

Council would need to assess each arrangement as to what extent the rights and obligations associated with the asset are retained, in order to determine whether to apply the performance obligation or de-recognition approach.

The basis for conclusions appended to ED 202R acknowledges concerns about the cost of applying the proposed methodology, but dismisses this as outweighed by improvements to the quality of financial reporting.

The annual reporting process by Councils is aimed at providing information about Council's performance to members of the local community, many of whom do not have a financial reporting background. The current distinction between finance and operating leases can be explained in plain English as finance of a purchase versus rental, and can be understood. The majority of these users will not understand the concept of intangible rights to use assets and offsetting liabilities for future payments recognised on the Statement of Financial Position.

FinPro do not agree that the benefits for local government entities of adopting the proposed changes are outweighed by the costs of implementation and ongoing application, given the profile of the readers of our financial reports.

3. Contact details:

Please contact the FinPro Technical Committee for further information.

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