AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

16 September 2013

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria 8007

Dear Mr Stevenson

IASB Exposure Draft ED/2013/6 – *Leases*

Attached for your information is a copy of the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

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ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

13 September 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst

IASB Exposure Draft ED/2013/6 - *Leases*

Please find attached the Australasian Council of Auditors-General (ACAG) response to the questions in IASB Exposure Draft ED/2013/6 ('the ED'). The views expressed in this submission represent those of all Australian members of ACAG.

ACAG supports a lease accounting model that recognises all leases in the statement of financial position. However, ACAG does not support the dual model approach proposed in the ED as we believe it is overly complex and costly for preparers to implement and maintain.

ACAG supports a single model that is broadly consistent with that described as a Type A lease in the ED. ACAG believes the Type A model to be more conceptually sound the than the proposed Type B model notwithstanding the proposed Type B model may potentially be simpler to implement. ACAG also recommends:

- The lessor accounting proposed under the Type A model would benefit greatly from reduced complexity in the calculation of both the lease receivable and residual asset, and
- Regardless of the model ultimately chosen by the IASB, we recommend generous concessions are made in respect of the mandatory application date of the final standard as we believe entities will need significant time to prepare for implementation.

The attachment to this letter addresses the specific questions asked by the IASB and articulates our views in more detail. The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
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Attachment

Questions for respondents

Scope

Question 1: Identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and
(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Response:

ACAG is generally supportive of the proposed requirements for how an entity would determine whether a contract contains a lease.

One objective of the Boards in developing the ED, as expressed by BC3(b), was to address the structuring opportunities present in the existing standard. While noting that the approach taken by the Boards in requiring all but short-term leases to be recognised on the balance sheet will reduce these opportunities, ACAG sees some remaining potential for structuring of contracts to avoid being captured by the requirements of the ED.

For example ACAG considers the substitution rights aspects of the ED creates potential structuring opportunities. An arrangement does not constitute a lease for the purposes of the ED if a supplier has the substantive right of substitution of the asset(s), per paragraph 8. Paragraphs 9(a) and 9(b) outline that a substantive right of substitution would only exist where the supplier can substitute the asset without the consent of the customer and there are no barriers (economic or otherwise) which prevent substitution occurring.

Notwithstanding the content of paragraphs 9(a) and 9(b), or the Boards' views as expressed in BC105(b), ACAG can see the potential for contracts for certain assets to be structured in a manner which places them outside of the ED. A contract for the provision of cars, for example, may be deliberately structured to avoid these requirements by avoiding the identification of specific vehicles.

In considering potential areas, ACAG notes the Boards' view as expressed in BC370, that structuring to avoid the requirements of the ED will not be easy. Even so, ACAG considers that the complexity of accounting, the impacts on the statement of financial position, and the 'front-loading' of expenses for Type A leases would still provide sufficient incentive for some entities to structure contracts to avoid the requirements of the ED.

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

ACAG is not supportive of the dual model approach as contained in the Type A and Type B lessee accounting models (see also our response to Question 4 for more discussion on this issue). If, however, the Boards elect to implement this approach, ACAG makes the following observations regarding areas where further clarity would be beneficial.

ACAG notes that there are a number of areas within the ED that provide options regarding the accounting treatment of like transactions. ACAG notes that the inclusion of options of this nature may not provide for the level of comparability between similar entities originally sought. One example of these options concerns the option in paragraph 5 that allows for, but does not require, lessees to apply the requirements in the ED to intangible assets. ACAG recommends that the Boards scope intangibles out of the resulting leases standard in their entirety, until the Boards have completed a separate and comprehensive review of the accounting for intangible assets (as noted in BC81).

ACAG is concerned that the option to combine owned property, plant and equipment (PPE) and right-of-use assets within the one class of PPE as permitted by paragraph 55 will lead to a lack of clear and comparable information for users, due to the interaction with the requirements of IAS 16 *Property, Plant and Equipment*. ACAG believes by virtue of the depreciation pattern for a Type B lease, the lessee should disclose right-of-use assets as a separate class of property, plant and equipment. Without this, it may be difficult for a user to interpret the information about depreciation of PPE.

If the Boards implement the Type B model, ACAG requests further explanation regarding how the balancing figure calculation of amortisation for the right-of-use asset ties to the concept of amortisation within the Conceptual Framework. Specifically, it is unclear how the increasing amortisation figure, throughout the lease term, reflects an expense pattern consistent with how the asset is consumed.

Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

ACAG is not supportive of the lessor accounting model for Type B leases as we believe that a lessor should apply a derecognition approach. Therefore, as noted above, we support the consistent application of an approach based on the Type A model included in the ED. ACAG has identified some specific matters of concern in relation to Type A leases as currently described in the ED, as outlined below.

ACAG understands the Boards see a necessity for including in-substance fixed variable lease payments within the lease receivable of the lessor in order to match the liability recorded by the lessee, as outlined in BC216. ACAG also understands the Boards' view, as outlined in BC229, that entering into a lease, from a lessor's perspective, is not akin to a sale of the underlying asset, resulting in a conclusion that it would be inappropriate to recognise profit associated with the residual asset before the residual asset is sold. While noting this background, ACAG considers that the initial and subsequent measurement and recognition requirements outlined in paragraphs 71-83 and B19-21 of the ED for a Type A lease receivable and residual asset is overly complex and will likely result in the need for specialised skills and/or software for lessor entities. The measurement requirements have the potential to be costly to implement and maintain, particularly given annual re-measurement requirements for leases which reference an index rate (e.g. CPI). In the case of lessor entities whose core business is not leasing, the calculations appear to be particularly onerous.

ACAG believes that the number of assumptions and the degree of estimation uncertainty involved in measuring the lease receivable and residual asset are likely to lead to increased audit costs in auditing lease receivables, residual asset balances and associated profit or loss impacts.

ACAG notes that the ED requires lessors to categorise variable lease payments (e.g. in-substance fixed payments or variable), and depending on this assessment, include them in either the lease receivable or residual asset (paragraph 72). This requirement is likely to lead to divergent practices and therefore contribute to a potential lack of comparability between like entities.

ACAG also notes that both the measurement differences regarding the residual asset, and the judgement regarding which component the variable lease payments are recognised in, will lead to consolidation issues where there are leases between common control entities, such as for whole-of-government financial statements. Accordingly, ACAG recommends the Boards either develop guidance around how the elimination entries work in this situation or consider specific concessions regarding entities under common control. In particular we would like confirmation that any measurement differences between the lessee and lessor are put to equity within the consolidated entity.

Question 4: Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response:

ACAG does not support the Type A and Type B lease classification. ACAG believes that the dual model approach will increase the cost of implementation for many preparers. ACAG's view is that a single model approach reduces cost as it eliminates the costs associated with appropriate determination and audit of initial classification. ACAG also believes that a model consistent with that described by Type A lease model is more conceptually sound as it supports the view that all leases contain a financing element and will avoid a rules-based approach such as that proposed for Type B leases under the ED.

Nonetheless, if the Boards adopt the dual model approach, ACAG considers that there are areas for potential improvement to the ED regarding lease classification, as outlined below.

ACAG believes it would be highly beneficial for the Boards to use more descriptive terminology for the different types of leases under the standard (Type A and Type B) that provide more decision-useful information to general users of financial statements. We note one proposal is to refer to 'accelerated leases' and 'straight-line leases'.

Paragraphs 29 and 30 of the ED use a number of undefined terms that are open for debate as to their meaning. Terms such as "insignificant", "major part" and "substantially all" are likely to be interpreted by different parties in an inconsistent manner. ACAG therefore supports the comments expressed in AV5 that additional guidance is needed in relation to the Boards intended meanings for these terms.

ACAG considers that the current criteria in paragraph 30(b) is likely to result in many more property leases being reported as Type A leases than appears to have been the intention of the Boards. BC56 outlines the intention of the Boards not to capture standard commercial leases of property for periods of up to 15 years. BC56 makes it clear that the Boards consider that both the lease term and the present value of minimum lease payments are unlikely to satisfy the criteria in paragraph 30 requiring recognition as a Type A lease. ACAG believes the current criteria in paragraph 30(b) may still result in a number of property leases being captured as a Type A lease, despite the Boards' stated intention that this not be the case.

Measurement

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Response:

ACAG supports the revised proposals regarding the lease term reflected in the ED, requiring only the non-cancellable period plus periods for which the lessee has a significant economic incentive to exercise extension options to be included. ACAG sees that this change has the potential to reduce complexity and estimation uncertainty in measuring the lease liability and receivable.

ACAG is, however, concerned that the term 'significant economic incentive' is unlikely to be interpreted consistently. ACAG therefore believes the Boards should provide additional guidance regarding the term 'significant economic incentive'.

Question 6: Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Response:

Majority view

The majority of ACAG members support the approach taken by the Boards in relation to variable lease payments for lessees. ACAG supports the cost-benefit/reliability of measurement argument set out in BC152. Also, ACAG agrees that reassessment of the lease liability and right-of-use asset is warranted when there is a material change in an index or a rate used to determine the lease payments. However, as noted at Question 3, ACAG believes a more simplified and consistent approach should be applied to the measurement of the in-substance fixed variable lease payments for a lessor.

ACAG notes guidance surrounding the term 'in-substance fixed lease payments' is not included in the ED. Rather, the guidance has been included in the Illustrative Examples, of which there are relatively few to provide context for the term. ACAG believes it would be appropriate to include appropriate guidance within the standard (or within an intrinsic appendix to the standard), which illustrates the Boards' intended meaning behind this term.

ACAG believes that asymmetry will be created by the requirements of paragraphs 39 and 71-72 of the ED. Paragraph 39 requires the lessee to only recognise in the lease liability variable lease payments to the extent those payments are dependent on an index or a rate or are in-substance fixed payments. However, a lessor must, by virtue of paragraphs 71-72, estimate the present value of expected variable lease payments and include that amount in the measurement of the residual asset to the extent they are not included in the lease receivable. Accordingly, ACAG requests that the Boards provide guidance on how to account for the measurement difference on consolidation when there is a lease between entities under common control.

Alternate view

Two ACAG members do not support the approach proposed for variable lease payments. These members believe that all variable lease payments should be measured and recognised by both the lessee and lessor. Allowing the lessee not to recognise the variable lease payments provides an opportunity to structure leases so that a greater proportion of leases are subject to variables. This, in turn, provides the opportunity to arbitrarily exclude amounts from the lease liability, and right-of-use asset. These ACAG members believe the recognition model for the lessee is conceptually flawed as it does not provide for faithful representation of the lease liability and right-of-use asset.

Transition

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

Response:

ACAG supports the modified retrospective approach to transition proposed by the Boards. ACAG agrees with the Boards' views at paragraph BC306 that the costs of a fully retrospective approach would significantly outweigh the benefits. ACAG is, however, supportive of providing the option of a full retrospective approach for preparers who wish to adopt such an option.

ACAG notes that paragraph C9 allows a lessee to apply a single discount rate to a portfolio of leases with reasonably similar characteristics on transition. Example 25 indicates that the lessee's incremental borrowing rate is that as at the effective date of transition (that is, the date to be inserted in paragraph C1). ACAG recommends the Boards make this clear within Appendix C, rather than relying on Example 25 to provide clarification regarding the appropriate date at which the rate should be determined.

ACAG notes the intention of the Boards in providing a modified retrospective approach is to approximate the amounts that would be recognised under a full retrospective approach, as outlined in BC308. ACAG considers there is potential for the amounts recognised under a modified retrospective approach and a full retrospective approach to be materially different. This is particularly the case where a single discount rate, allowed under paragraph C9, is applied to a portfolio of leases and there have been significant changes in the incremental borrowing rate between the commencement dates of the leases and the effective date. Accordingly, ACAG suggests the Boards consider requiring a specific disclosure on transition where the modified retrospective approach is adopted that the amounts recognised would likely materially differ from those which would have been recognised under if a full retrospective approach was adopted.

Irrespective of the lease accounting method adopted by the Boards, ACAG recommends that generous concessions be made in respect of the mandatory application date of the final standard as we believe entities will need significant time to prepare for implementation. We also recommend that the standard not be implemented before the implementation of *Revenue from Contracts with Customers* standard as the ED contains a number of cross references to *Revenue from Contracts with Customers* standard.

Disclosure

Question 8: Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Response:

ACAG believes that the disclosure requirements as outlined in the ED are excessive, in particular for entities where leasing is not fundamental to their business. ACAG notes that paragraphs 59 and 99 of the ED indicate that an entity would only include the level of detail to satisfy the disclosure objectives of paragraphs of 58 and 98 respectively. ACAG requests that the wording of paragraphs 59 and 99 be strengthened to more clearly express that an entity only need consider those disclosures that materially benefit the users' understanding of the entity's exposure to leasing activities.

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Questions 9, 10 and 11

Response:

ACAG has no comments on Questions 9, 10 and 11.

Investment Property

Question 12: Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 *Investment Property*. The amendments to IAS 40 propose that a right-of-use asset arising from a lease property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if a leased property meets the definition of investment property? If not, what alternative would you propose and why?

ACAG has no comments regarding Question 12.

OTHER OBSERVATIONS

As identified at Question 3 and Question 6, ACAG believes additional guidance regarding the consolidation process where the lessor and lessee are both part of a consolidated group is warranted. At Question 3 ACAG has highlighted asymmetry as a result of different assessments regarding categorisation and measurement of variable lease payments. At Question 6 ACAG highlighted asymmetry arising from the lack of measurement and recognition of other variable lease payments by the lessee. ACAG further notes that asymmetry would also arise from the inconsistent treatment of residual value guarantees by lessees and lessors, and differences in the lessee's and lessor's expected lease term. Additional asymmetry would occur where a lessee measures (as allowed by paragraphs 52-53 of the ED) a leased property asset as a revalued item of property, plant and equipment or investment property measured at fair value. Accordingly, ACAG believes additional guidance is required on the treatment of such measurement differences on consolidation of lessees and lessors under common control. The current proposals would pose significant challenges on consolidation of large group entities such as whole-of-government financial statements.

When finalising the standard, ACAG requests that Boards specifically consider how peppercorn leases should be accounted for from both a lessee and lessor perspective. Peppercorn leases are those where a lease is entered into and the lessee pays the lessor a minimal amount for the right to use an asset for a fixed period of time. We understand such leases are in widespread use to facilitate access to specific legal rights in relation to leased assets. Notwithstanding the discussion on onerous contracts at BC84-85, which may apply to some peppercorn leases, we request that Board provides specific guidance within the final standard as to how the Boards intend such lease arrangements to be treated.

ACAG notes that under SIC 15 lessees currently recognise a liability for lease incentives received on operating leases. The liability is then released to income on a straight-line basis over the term of the lease. ACAG notes that the ED describes how to remove the incentive received and receivable from the liability and the right-of-use asset. ACAG presumes that lease incentives will be accounted for in accordance with the *Revenue from Contracts with Customers* standard, nonetheless ACAG believes it would be beneficial for the scoping section of the standard resulting from the ED to make clear which standard applies to the accounting for lease incentives.

ACAG suggests that paragraph 33 be worded to more explicitly provide for circumstances where there are multiple buildings with different useful lives which may not be componentised within the lease agreement.