Defence Housing
AUSTRALIA

14 August 2013

The Chairman
Australian Accounting Standards Board
Level 7, 600 Bourke Street
MELBOURNE VIC 3000

Dear Sir

Submission – Exposure Draft 242 Leases

This submission provides general concerns and comments to the Australian Accounting Standards Board on the proposals outlined in exposure draft 242 – Leases.

Background

Defence Housing Australia (DHA) was formed under the *Defence Housing Australia Act 1987* with the main function of DHA being to provide housing and related services to members of the Defence Force and their families. DHA is the preferred supplier of housing for married members of the ADF and competes with private rental markets in the provision of off-base housing for Defence singles (apartments).

DHA is a Government Business Enterprise (GBE) which operates under the provisions of the *Commonwealth Authorities and Companies Act 1997*. In addition to meeting Defence requirements it must maintain a strong balance sheet and meet shareholder return obligations.

DHA is active in the Australian property market as a developer, creating sustainable communities of mixed Defence and private owners and tenants. Its current portfolio includes projects with a total value in excess of $1 billion in Darwin, Townsville, Brisbane, Sydney, Canberra and Adelaide. DHA also constructs, purchases and leases houses and apartments.

DHA leases over 16,000 residential properties to members of the Defence Force via a Services Agreement with the Department of Defence. The agreement to provide these 16,000 properties has an estimate net present value of $2.8 billion to DHA. More than 12,500 of these residential properties are owned privately by investors and are leased to DHA through a long term sale and leaseback or direct lease arrangement. Typically, DHA will lease a property from a private investor for 12 years with options to extend by up to 3 years. This term represents a relatively low proportion of a houses expected useful life. Principal risks and rewards related to financial returns relate to rental and capital growth and these lie with the private investor, not DHA. The lease obligations for these properties are estimated to have a net present value of approximately $2.3 billion and are on-leased to Defence.

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Although fully Government owned, DHA is not funded from the Federal Budget. Its main source of funding is revenues from Defence for the provision of housing, the sale of properties on its sale and leaseback program and the disposal of land and residential property excess to requirements. In the 2013-14 financial year DHA will have total revenues in excess of $1 billion of which $375 million will be from the sale and leaseback of residential property.

Under current accounting standards all the residential property leases with private investors are accounted for as operating leases with disclosures within the financial statements of future lease payments as commitments.

DHA also holds a fleet of motor vehicles and occupies commercial properties which are currently recognised as operating leases.

General Concerns with the Proposed Approach

When reviewing the changes proposed in exposure draft 242 and applying them to DHA a number of significant issues were identified. These issues are practical in nature and reveal concerning impacts to financial information provided to users.

<u>Type A and Type B Lease Accounting Classifications</u>

The difference in definition and treatment of Type A and Type B leases is based on the premise of whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

DHA has considered these lease type classifications in respect of leased residential property. The useful life of a property is generally well in excess of the DHA lease term and the property may increase in capital and rental value (due to land value and location). Therefore generally the economic benefits of the underlying asset are not consumed and are consequently treated as Type B leases.

The proposed leasing classifications do not take into consideration the circumstances of the lessee in classifying the lease type but the circumstances of the owner of the property. Property may increase in value but no longer meet changing community or, more importantly for DHA, Defence standards in regards to what a residential property should comprise. Such a property is a regular issue for DHA as older leased properties are required to be exited from the portfolio as they are of no further use for meeting Defence housing requirements and therefore lose their economic benefit to DHA. However, that property will retain its economic benefit in the broader residential property market.

Furthermore, the classification of leases does not seem to be consistent with the objective of recognising forms of financing on the Balance Sheet. The type A leases are treated as a form of financing through the profit and loss statement but are not classified using financing principles, rather concentrating on the concept of consumption of economic benefits. Type B leases are required to be recognised on the Balance Sheet but not treated as a source of finance.

The classification and subsequent treatment of the leases does not seem to be connected to the actual objective or purpose of undertaking the lease. This is especially the case when the leasing of assets is a business in itself (as is the case of DHA) as opposed to a form of financing.

Measurement of Variable Lease Payments

DHA understands after the initial recognition of the lease that reassessment of variable lease payments will only occur if there is a change in an index or rate used to determine lease payments. Subsequent to the initial recognition, a change in market rent on a property would not change the value of the Right of Use Asset or Lease Liability. The rental for DHA properties are independently valued each year, and consequently, DHA's future lease obligation or benefit would not be accurately recognised on the Balance Sheet. This would make the Balance Sheet information for users redundant after the 1st year of a long term lease as market rent on DHA's portfolio is updated each financial year. DHA has experienced significant movements in rental values (up to 20%) in some locations within a financial year.

Recognition of Make good

DHA currently recognises a make good obligation as an expense in the profit and loss statement on the inception of a lease with a private investor. The proposed leasing standard is unclear on whether the make good cost is required to be capitalised as part of the right of use asset or whether DHA will be able to continue to recognise the cost as an expense.

Inventory v Investment Property

DHA holds approximately $1.1 billion worth of property planned to be sold via a sale of leaseback arrangement. These properties are recognised on DHA's Balance Sheet as Inventory properties. The properties are already leased to members of the Defence Force and will continue to be leased after the sale and leaseback transaction to members of the Defence Force. The proposal to recognise the right of use asset as an Investment Property will move the underlying asset from an inventory classification to an investment classification after it is sold. Notwithstanding the anomaly of such a re-classification it also puts into question whether property planned to be sold on a sale and leaseback basis should be recognised as Inventory stock. Further consideration may be required to the Inventory standard.

Cyclical or Seasonal Lease Commencements

The recognition of amortisation and interest expense in the Profit and Loss Statement for Type A leases will result in higher expenditure or revenue in the early years of a lease. Although DHA does not hold a significant number of Type A leases, there is a concern about the impacts on profitability when lease commencements are cyclical or seasonal in nature. An entity with a large number of Type A leases may show unusual profit and loss patterns providing misleading information to users. Over the life of the lease, total expenses or revenues on the lease are the same but a timing disparity is created which could result in higher or lower profits depending on the age of the leased portfolio. This would increase the risk of users of financial statements forming views based on a misunderstanding of an entity's true underlying financial position and performance.

Resourcing

As at 30 June 2013, DHA held approximately 12,500 lease transactions as lessee and undertakes each year approximately 600 new sale and leaseback transactions, re-leases 300 existing leases on a further term, exercises 900 lease options, enters into 150 new direct leases and manages over 1,500 lease ends. The systems and resourcing required to facilitate and manage the requirements of the proposed leasing standard is anticipated to be substantial.

Key Performance Indicators

The significant change in DHA's Assets and Liabilities impacts a number of DHA's Financial Key Performance Indicators. General calculations used to indicate performance or highlight risk factors of an entity such as Current Ratio, Interest Times Cover Ratio, Gearing Ratio and Debt to Equity Ratio are heavily impacted if performed under the proposed accounting standard. Users of the financial statements may consider these ratios difficult to interpret as a result of the classification of different lease types, artificial (right of use) assets being recognised as Investment properties and lease obligations being unable to be adjusted to reflect current market lease payments. This would increase the risk of users of DHA financial statements forming views about DHA based on a misunderstanding of DHA's true underlying financial position and performance.

Balance Sheet Impacts

The lessee proposals as presented would result in a significant increase in the size of DHA'S Balance Sheet. The magnitude of DHA's lease commitments means the Balance Sheet will be dominated by leasing obligations and impact or confuse other disclosed Balance Sheet items, in particular Investment Properties held.

Forecasting

The number of variables involved in calculating the present value of lease payments makes it extremely difficult to reliably forecast results. This would be more difficult with the inability to vary obligations as rental markets move. Financial Statements look at a single point of time however users need reliable information when making informed decisions. DHA does not believe the information supplied would be reliable for users.

Recommended Approach

DHA believes that the current proposal would create unnecessary complexities for preparers and has the potential to provide misleading information to financial report users. The use of artificial assets and liabilities will provide complications for businesses and will surpass any benefits obtained by users from including operating lease obligations on the Balance Sheet. The proposal seems to have progressed away from the original scope of recognising financing arrangements on the Balance Sheet and incorporates treatments inconsistent with financing principles.

The use of an operating lease (or similar definition) disclosure note for receivable and payable commitments will provide the same information to users without creating the balance sheet and profit and loss statement issues identified. This option deserves consideration.

DHA also believes further consideration should be given to the scope to when an entity should be required to apply the standard. An entity whose primary business is leasing (as opposed to the traditional leasing of an asset under a financial arrangement) should be given flexibility to elect not to apply the standard. Government agencies may also be considered to be out scope of the standard taking into consideration the current requirement to disclose future commitments.

Should you wish to discuss DHA's submission further, please do not hesitate to contact me.

Yours faithfully

Jon Brocklehurst
Chief Financial Officer