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Dear Kevin

Exposure Draft ED 242 – Leases

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board (AASB) with its comments on ED 242 Leases (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

Grant Thornton's response reflects our position as auditors and business advisers to the Australian business community. We work with listed and privately held companies, government, industry, and not-for-profit organisations (NFPs). This submission has benefited with input from our clients, Grant Thornton International, and discussions with key constituents.

The main views in this response are consistent with those of Grant Thornton International, although the proposed Grant Thornton International submission has not yet been finalised due to the significant difference between the closing dates for submissions to the AASB and the IASB. Nevertheless, our comments in this submission are expected to be largely consistent with Grant Thornton International's submission to the IASB and FASB. We have also included some additional comments that are not necessarily consistent with the Grant Thornton International views.

General comments

We welcome the Boards' decision to re-expose their leasing proposals. We also commend the Boards for continuing to work jointly on this critical and high profile project. We continue to support the Boards efforts to improve lease accounting. However, we are not in favour of proceeding with finalisation of the ED at this time. While we appreciate the efforts that the Boards have expended in undertaking to address the issues raised with the first ED, we do not believe that the proposed revisions would constitute an improvement to financial reporting.

In our view, the revisions to the first ED are symptomatic of broader conceptual issues with the right of use asset approach to lease accounting. The first ED allowed for practical exceptions to the right of use asset model for short term leases and investment properties recorded at fair value. During the comment process it became apparent to us that the receivable and residual approach for lessors would not be practicable for all leasing arrangements and that lead to the realisation that not all leases would fit into a single model based on a right of use asset. We became concerned that the results of applying the right of use asset model would not be representationally faithful in all cases. By focusing on the right to use tangible assets, the model creates a distinction between service activities and rights of use that would create opportunities to structure transactions to not meet the definition of a lease. We also became concerned as time went on with the relevance of the information in terms of measurement of the assets and liabilities and revenue and expense recognition and the relationship of those measures to the timing and amount of future cash flows. The process of allocation of contractual payments to lease and non-leases elements adds complexity and the result ultimately may not provide the information that users need in terms of committed cash flows of the lessee in an understandable and convenient format.

At this time, we are not convinced that accounting for a right of use asset as tangible property is always representationally faithful. While amortisation and impairment testing may be appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not, nor would revaluation under IFRS be the appropriate model. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation. If control of the asset has passed to the lessee, there is no need for a separate right of use asset: the lessee should account for the underlying asset.

We also identified other inconsistencies that could arise from application of the right of use model to transactions to acquire groups of assets. If control of the underlying assets passes to the lessee, the transaction may be a business combination. If control of the underlying assets does not pass to the lessee, the arrangement would appear to be an executory supply arrangement. The right of use model would not appear appropriate for these transactions.

The Boards' efforts to address some of those concerns introduced additional complexity into an already overly complex model. We do not believe that the end result in this ED is conceptually consistent with the accounting in the Revenue Recognition project, the Consolidations project, nor the Conceptual Framework at the IASB. At this point, the significant anomalies identified with the right of return asset model have accrued to such an extent that we believe that it is time to develop an alternative approach.

A model based on control of the underlying asset

We believe that it is possible to develop a model that would provide users with information that is more relevant and representationally faithful, more understandable, less complex, and conceptually consistent with the accounting for similar transactions with customers or acquisitions. We encourage the Boards to further develop a model for classifying leases in a manner that would curtail current abuses and provide relevant and representationally faithful information to the users of the financial statements.

We suggest that the Boards develop a model for lessor accounting for a lease that is similar to the accounting for economically similar contracts with a customer, either a sale or an executory arrangement. Similarly, lessee accounting should be similar to the accounting for economically similar acquisitions, whether an asset purchase, a business combination, or an executory arrangement. In the long run, given the direction of Revenue Recognition, Business Combinations, and the Conceptual Framework, we believe a control based model combined with a model for accounting for executory arrangements is the only long-term solution to lease accounting.

We believe that the recognition, measurement and presentation of the assets, liabilities, expenses, and cash flows arising from a lease should differ based on whether control of the underlying asset has transferred from the lessor to the lessee. A control based model would be more consistent with the models for revenue recognition, consolidation, and the proposed change in the definition of an asset in the conceptual framework. A distinction, based on control of the underlying asset, was described in paragraph 8 of the Discussion Paper. In that document, the Boards proposed separate accounting for "a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity." To that end, we would not use the term trivial in describing the risks and rewards and would also consider other indicators of control, such as the length of the lease term relative to the economic life of the asset, existence of options to renew a lease for the economic life of the underlying asset, purchase options, the ability to refinance, and perhaps other factors. We would prefer to see in this project an updated definition of control that would align with that in Revenue Recognition so that the opportunities to achieve a particular result through structuring are limited or non-existent.

A control based model should be based on control of the underlying asset not the right of use asset. We are not convinced that accounting for a leased asset as tangible property is always representationally faithful. While amortisation and impairment testing may be appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not, nor would revaluation under IFRS be an appropriate model. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation. Recognition and measurement of the rights and obligations created by the contracts for the lessor should be determined by the Revenue Recognition project. Recognition and measurement of the rights and obligations of the lessee should be part of this project and determined consistently with the intent of the Board in the Conceptual Framework project.

If you require any further information or comment, please contact Peter Kidd or myself.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

A J Archer

Andrew Archer
National Head of Audit

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.

Grant Thornton Comments:

We do not agree with the current definition of a lease. Our main objections stem from concerns about whether the definition would be operational as a means of distinguishing between a lease contract and a service contract or between lease elements and non-lease elements within a contract. Specifically, we are concerned that the criteria for control of the right to use the asset and specified assets could lead to significantly different accounting outcomes for economically similar transactions, a result that is a major shortcoming of the current model. Potential ambiguity between what is a lease contract or element and what is an executory contract or element creates opportunities to structure transactions to achieve a particular accounting result. Even if structuring of transactions was not a concern, the degree of judgment required to distinguish whether an arrangement contains a lease could lead to diversity in practice.

We are concerned that the criteria for a specified asset will not result in financial statements that provide useful information. Application of these criteria would provide inconsistent information to users, create structuring opportunities, and potentially lead to diversity in application. The right to control the use of an asset appears to offer criteria in Examples 2 and 3 that would not be met by some owned asset and the determination relies heavily on whether consumables are available from third parties regardless of whether the customer has the right to use those consumables. We believe that the relevant information for users centres on the timing and amount of non-cancellable future cash flows. Whether consumables are or are not available in the marketplace would not appear to be relevant. Time spent evaluating, documenting and auditing the judgments made would therefore be a suboptimal use of scarce resources better employed elsewhere.

We are concerned that in many cases distinguishing between lease elements and non-lease elements will not provide the most useful information to the users of the financial statements. Users of the financial statements are interested in information about all the cash flows from all future commitments. The current definition of a lease will not provide that information.

We believe that a user is more interested in the committed cash flows than whether the contract conveys the right to use a particular strand or a comparable amount of capacity. The requirement to identify a specified asset also creates opportunities for structuring a transaction to obtain a particular accounting result in certain industries, including transportation and storage.

In addition, we note that, as written, there is potential for structuring between accounting for a transaction as a lease or a purchase of a group of assets. Under IFRS 3, a purchase of a group of assets that constitute a business would be accounted for as a business combination, including recognition of an unrecognised intangible assets and goodwill. However, if the transaction is structured as a lease, it would fall under the right of use asset model, a significantly different accounting result. We believe that transactions such as those described in Examples 1-3 should be evaluated under the consolidation literature first and, if not consolidated, accounted for as a supply agreement. If the group of assets does not meet the definition of a business, the acquisition should be accounted for as an asset purchase if the acquirer has control of the underlying assets as per IFRS 3 or, if the acquirer does not obtain control of the assets, as a supply agreement. We do not believe that power supply arrangements and similar contracts should be included within the right of use asset model. While we would not object to accounting for power supply arrangement as an operating lease, we believe it would be preferable to separately promulgate disclosure requirements for power supply agreements and similar non-cancellable contracts. We would include rights to use fibre optic cables, indefeasible rights of use (IRUs) in that same category.

Therefore we strongly prefer that the Boards develop a model for lessor accounting for a lease that is similar to the accounting for economically similar contracts with a customer, either a sale or an executory arrangement. Similarly, lessee accounting should be similar to the accounting for economically similar acquisitions, whether an asset purchase, a business combination, or an executory arrangement. In the long run, given the direction of revenue recognition, business combinations, and the conceptual framework, we believe a control based model combined with a model for accounting for executory arrangements is the preferable long-term solution to lease accounting.

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash 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?

Grant Thornton Comments:

We agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases but do not agree with a model based on consumption alone. Nor do we agree with the accounting model proposed for Type B leases.

We believe that the recognition, measurement and presentation of the assets, liabilities, expenses, and cash flows arising from a lease should differ based on whether control of the underlying asset has transferred from the lessor to the lessee. Consumption may be one of the indicators of whether control of the underlying asset has been transferred to the lessee. We believe that a control based model would be more consistent with the models for revenue recognition, consolidation, and the proposed change in the definition of an asset in the conceptual framework.

There was a distinction based on control of the underlying asset, described in paragraph 8 of the Discussion Paper. In that document, the Boards proposed separate accounting for "a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity." We encourage the Boards to further develop that distinction as a means of classifying leases in a manner that would curtail current abuses and provide relevant and representationally faithful information to the users of the financial statements.

We would prefer to see in this project an updated definition of control that would align with that in Revenue Recognition so that the opportunities to achieve a particular accounting result through structuring are limited or non-existent. To that end, we would not use the term trivial in describing the risks and rewards and would also consider other indicators of control, such as the existence of options to renew a lease for the economic life of the underlying asset, purchase options, and perhaps other factors.

We also do not agree with the accounting model proposed for Type B leases. At this time, we are not convinced that accounting for a right of use asset as tangible property is the correct model. While amortisation and impairment testing are appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation.

In the long run, given the direction of Revenue Recognition, Business Combinations, and the Conceptual Framework, we believe a control-based model combined with a model for accounting for executory arrangements is the best long-term solution to lease accounting. We believe that a control-based model for leases and similar transactions would be more conceptually consistent, and therefore more understandable, and more likely to provide useful information than the current right of use asset approach.

Measurement basis for right-of-use asset for Type B leases

We are concerned that the determination of a lease expense on a straight-line basis for Type B leases ignores the commercial reality that all leases have a financing element and results in a right-of-use asset that is a 'balancing number' that is not based on any clear principles.

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?

Grant Thornton Comments:
We agree that consumption is one of the factors that could be considered for classification of leases, but not the only factor. Consumption is another way of describing the extent to which the benefits of the underlying property accrue to the lessee, and is one of the current criteria in IAS 17. We believe that other factors would be relevant for determining whether control of the underlying asset has passed to the customer.

We believe that a better classification scheme would be to distinguish between those leases that are in substance a sale of the underlying asset (a Type A lease) and those that are not (in substance an executory contract that will be completed over time). Such a model, based on control of the underlying asset, was described in paragraph 8 of the Discussion Paper. In that document, the Boards proposed separate accounting for "a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity." A Type B lease would be a lease that does not transfer control of the underlying asset to the lessee and therefore is not a sale but a performance obligation that will be satisfied over time.

If the Boards elect to continue with the proposed model, we believe that the classification criteria should be applied uniformly to property and non-property leases. We do not agree with classifying leases from the perspective of the lessor based on transfer of more than an insignificant portion of the economic benefits to the lessee. We note that this is not consistent with the criteria in revenue recognition for transfer of the significant risks and rewards of ownership of the asset. The proposed model therefore creates the potential for different accounting treatments for economically similar transactions. Therefore, we would prefer that the criteria for classifying property be used for all leases, in part because it is more consistent with the model in revenue recognition.

Complexity for Type A leases
Lessor accounting for Type A leases will be significantly more complex than for finance leases under the current requirements. Lessors would also need to establish processes to identify certain changes (e.g., changes in lease term, assumptions about any significant economic incentive to exercise an option to purchase the underlying asset, indexes or rates on which variable lease payments are based) that could trigger a reassessment of the lease receivable.

Type B leases – comparison to lessee accounting
Lessors would account for Type B leases by continuing to recognise the underlying asset and, at lease commencement, would not recognise a lease receivable (or residual asset) on the balance sheet or initial profit. We have some concerns that both the lessee and lessor would be recognising what is essentially the same asset. While it is acknowledged that lessee and lessor accounting does not necessarily have to be symmetrical, this does appear to be counterintuitive.

Type B leases – recognition of lease payments

The ED would require lessors to recognise lease payments from Type B leases over the lease term on either a straight-line basis or another systematic basis if that basis better represents the pattern in which income is earned from the underlying asset. Currently, when rental payments for an operating lease are not made on a straight-line basis, IAS 17 requires lessors to recognise lease income on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property (in which case that basis should be used). This requirement usually results in lessors recognising operating lease income on a straight-line basis.

It is unclear what the ED intends 'earned' to mean, as it relates to other systematic bases of lease income recognition. The basis for conclusions suggests that for stepped rent increases when those stepped rents are expected to compensate the lessor for increases in market rentals, recognising lease income as lease payments are received would better reflect the pattern in which income is earned from the underlying asset.

It is not clear whether a lessor receiving straight-line rent payments for the lease of an asset for which it expects market rentals to increase over the lease term could, by analogy, recognise lease income in a pattern reflecting higher periodic income in later periods (as it would also better reflect the pattern in which income is earned from the underlying asset).

Determining that lease payments in a Type B lease should be recognised on a basis other than straight-line would likely require significant judgement. In many cases, there will not be a clear distinction between increases in contractual lease payments that reflect the pattern in which lease income is earned (e.g., 'stepped' increases intended to compensate the lessor for changes in the market rentals) and other contractual increases that do not. Additional guidance may be needed.

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?

Grant Thornton Comments:

We agree that consumption of the underlying asset is one of the indicators of whether control of the underlying asset has transferred to the customer. We do not believe that it is the only factor that should be considered in making that determination. We would prefer that the Boards develop a model based on transfer of control of the underlying asset to distinguish between those contracts that should be accounted for as a sale and purchase and those contracts that do not and therefore are executory in nature.

Meaning of 'insignificant' – Type A leases

The revised ED does not define 'insignificant' for purposes of assessing the exception criteria for classifying leases of assets other than property, nor does it include much guidance on how this criteria should be applied. Therefore, evaluating whether a non-property lease meets either of the exception criteria would likely be subjective and require careful judgement. It is unclear whether 'insignificant' might be considered to be similar to 'minor' (i.e., 10%) in the current US lease standard or whether other criteria might be considered. We believe that guidance needs to be included in the Standard.

Meaning of 'major part' or 'substantially all' – Type B leases
Similarly, the revised ED does not define 'major part' or 'substantially all' for purposes of assessing the exception criteria for classifying leases of property assets, nor does it include much guidance on how these criteria should be applied. However, these terms are used to describe the indicators included today under IFRS to distinguish between finance and operating leases. Although these terms are used in IAS 17 today, they were introduced into IFRS by borrowing from the principles behind the bright-line 75% of the economic life and 90% of the fair value tests used for lease classification in the current US lease standard. Therefore, this could provide arguments to apply the 75% and 90% tests often used today except that there would be no bright-lines. We believe that guidance needs to be included in the Standard.

Land and buildings
The ED provides specific guidance for classifying a single lease component that contains both land and a building. In those instances, entities would refer to the remaining economic life of the building when classifying the lease (paragraph 33), which overrides the requirement to use the economic life of the primary asset (paragraph 32). This could result in a different classification than if the lease of land was assessed separately.

Land and buildings as one asset for this purpose does not make sense in many situations. For example, a lease of land and an older building, where the lease term is for the major of the remaining economic life of the building, but most of the economic use by the lessee is of the land would be classified as Type A. The substance would suggest that the lease should either be classified as Type B or split with the building lease as Type A and the land lease as Type B.

The lease classification criteria may also lead to opportunities for structuring leases into Type B when the substance is that they should be in Type A.

Definition of property
Additional guidance on the definition of property may be needed. For example, it is not clear whether certain structures that are attached to land, or buried under land, would be considered property assets or non-property assets under the ED. The distinction could affect the classification of leases for such assets.

Lease that includes the rights to use both a property asset and a non-property property asset
The determination of the primary asset in a lease that includes the rights to use both a property asset and a non-property property asset (i.e., the lease component contains the right to use more than one interrelated asset) might be difficult when the property asset and the non-property asset are dependent upon each other (i.e., the lessee cannot benefit from either asset without the other). Additional guidance may be needed to help entities apply this concept because the determination of the primary asset would affect the classification of the lease as well as the related accounting.

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?

Grant Thornton Comments:
In general, we do not agree with reassessment of the lease term absent a modification of the lease. The proposed guidance on reassessment of the lease term is an element of the right of use asset approach that has not proven its ability to provide useful information to investors. In our view, optional renewal periods would be a factor in determining whether control of the underlying asset has passed to the customer and therefore is determining whether the transaction is a completed sale or an executory contract. Reassessments of whether the transaction has transferred control to the customer should be rare unless there has been a modification of the contract.

If control has transferred to the lessee, the lessee should account for the underlying asset with a corresponding obligation to pay or return the asset. On exercise, the obligation to return would reclassify as an obligation to pay. A change in the likelihood of exercise should not change the accounting until it occurs. If control has not transferred to the lessee, the contract would be accounted for on exercise of the option.

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?

Grant Thornton Comments:
We do not agree with the proposals. We are not convinced that the proposals would provide users with relevant information. Our preference would be that the lessor use the same measurement prescribed in the Revenue Recognition project. A similar model should be developed for lessee.

Variable payments are a broad group and include many payments that are very different in economic substance. For example, assuming that control of the underlying asset has passed to the lessee, the asset should be recorded at its entry price. A subsequent change in a variable payment that that is due to a change in an inflation or interest rate index would affect the cost of financing the acquisition, but not of the cost of the asset and should be accounted for as such. Variable payments based on usage or sales may be may be an indicator as to whether control of the underlying asset has or has not transferred to the lessee. The payments may be executory in nature or may be a factor in determining the value of the residual asset of the lessor or obligation of the lessee at the end of the lease term. We believe that the accounting model should reflect those differences.

Question 7: transition
The ED proposes a modified retrospective approach to transition as an alternative to a full retrospective approach. The modified retrospective approach permits the use of certain ‘short-cut’ calculations to initially measure the lease-related assets and liabilities. In addition, entities would be able to use hindsight to determine the lease term or whether an existing arrangement contains a lease. The modified retrospective approach is intended to be lower cost and effort than the 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?

Grant Thornton Comments:
We are satisfied that the modified retrospective approach represents a reasonable alternative to the full retrospective approach.

It is unclear whether entities would classify arrangements previously classified as operating leases at transition using information as of the lease commencement date or another date (e.g., beginning of the earliest period presented in the financial statements). Exception criteria may be met when assessed as of a particular date (e.g., the commencement date) and not met when assessed as of a different date (e.g., the effective date).

For current finance leases, the ED does not address lessors' accounting for the lease receivable balance (effectively the residual asset) that remains at the end of the lease. It appears that lessors would reclassify such amounts to the appropriate category of asset (e.g., property, plant or equipment), but additional implementation guidance might be needed.

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?

Grant Thornton Comments:
Given that all leases are proposed to be 'on balance sheet', we have some concern that there appears to be a significant increase in the amount of disclosure for both lessees and lessors. While there are no specific disclosures that we consider to be unwarranted, we encourage the Boards to review the proposed disclosures and only require disclosures that are considered absolutely necessary.

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 of 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 the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Grant Thornton Comments:
Yes. Not aware of any major issues.

AASB Specific Matters for Comment
We have no comments on the AASB specific matters.