19 August 2013

Mr Kevin Stevenson
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Dear Mr Stevenson,

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

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

The Property Council is the peak body for owners and investors in Australia's $680 billion property investment sector. The Property Council represents members across all four quadrants of property investment, debt, equity, public and private.

We commend the Board for its extensive consultation and the proposed treatment for property leases.

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

It is essential that the IASB and US Financial Accounting Standards Board (FASB) issue a single agreed leasing standard because leasing is a major commercial imperative of the real estate industry.

We agree that aligning leasing standards across the globe requires recognising different approaches based on widely used commercial imperatives. We agree that the leasing standard should specifically support fair value accounting for property investment due to heavy reliance on fair value metrics by the industry.

The Property Council strongly supports the proposal that a lessor of investment property should apply IAS 40 for property leases (Type B leases).

In Australia, the fair value model is applied to most investment properties. IAS 40 is well understood and provides critical information to the real estate industry, investors and analysts.

Fair value is essential to understand Australian property performance, based on the value enhancement / destruction caused by management actions as well as changing market value for rents and valuation yields.

IAS 40 also requires reporting the total rental income in profit or loss. This is fundamental for investors to be able to assess the performance and investment quality of property companies. Removing this metric will adversely impact the information that property companies communicate to investors, financial analysts and other users of financial statements

We agree with the Board's view 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;
- an 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; and
- lessees of real estate are looking for more than financing. In many cases, a tenant is unable or unwilling to directly buy the asset. For example, a retailer seeking premises in a shopping centre and there are no individual units available for sale and the owner/manager has created an ambience of exclusivity and attractiveness which suits the tenants' market image.

The Property Council understands that some respondents consider the lessee model for Type B leases is inconsistent with the lessor model. The lease should be recognised on the balance sheet of the lessor because the lessor retains the value of the asset.

Irrespective of the lessee treatment for leases, accounting for Type B property leases should remain consistent with the revised ED i.e. that IAS 40 should be applied. This is because investors rely on IAS 40 to assess the investment quality and performance of real estate companies which is key to their investment decisions.

Comments on the specific questions in the revised ED are contained in the attached submission.

We are keen to discuss our recommendations with you further at your convenience. Please do not hesitate to contact Darren Davis on (02) 9033 1936 or myself to discuss the issue.

Yours sincerely

Andrew Mihno

Executive Director International & Capital Markets

Property Council of Australia

0406 454 549

IASB Exposure Draft
ED/2013/6: Leases

Property Council of Australia
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Lessor accounting

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?

The Property Council strongly supports the accounting treatment for investment properties in the revised ED i.e. that a lessor of investment property would apply IAS 40 for Type B leases.

In Australia, the fair value model is commonly applied to investment properties. IAS 40 is well understood and relied on to provide critical information to the real estate industry, investors and analysts.

Fair value is important to help users understand the property's performance. The Australian market uses fair value to assess an investment through the value enhancement / destruction caused by management actions and changing market value for rents and valuation yields.

IAS 40 also requires reporting the total rental income in profit or loss. This is fundamental for investors to be able to assess the performance and investment quality of property companies. Removing this metric will adversely impact the information that property companies communicate to investors, financial analysts and other users of financial statements.

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?

The Property Council agrees that comparing the lease term to the economic life of the property and the lease payments to the fair value of the property is an appropriate basis for determining whether or not a real estate lessor should apply investment property accounting.

However, the lease term should be compared to the total economic life, rather than the remaining economic life of the building.

While this scenario is unlikely to arise frequently in the real estate context, it is not appropriate for a five year lease of property with a ten year remaining economic life to be recognised differently from a five year lease of property with a five year remaining economic life (where the total economic life of both properties was originally 50 years).

Rentals payments made by the tenant to the landlord relate partly to the floor space being occupied, but also more significantly to the location of the property. This is demonstrated through different rates per square metre being charged for properties of the same quality in different locations. The value of the location continues to exist at the end of the building's economic life and the landlord holds the residual interest in the property. This enables redevelopment should the landlord choose.

It would therefore not be appropriate to reflect a five year lease of property with a five year remaining economic life (where the total economic life was originally 50 years) as a type A lease, unless the present value test is met.

We agree with paragraph 33 that land and buildings should be assessed together for the purpose of determining the appropriate classification of a lease. However, we concerned that the revised ED requires that the economic life of the building should always be considered to be the economic life of the underlying asset for the purposes of classifying the lease.

There are circumstances in which the land element is significantly more valuable than the building, for example in industrial type assets. In these cases, it is incorrect to default to the remaining economic life of the building because the land is the more valuable underlying asset.

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?

The Property Council agrees that the lease term is the non-cancellable period for which a lessee has the right to use the property. However, we recommend that the current concept of "reasonably certain" be retained because:

- the Board has acknowledged in BC 140 that the current concept works well in practice and the threshold is expected to be similar to the current concept of 'reasonably certain'; and
- the definition of 'significant economic incentive' is unclear.

We understand that the IASB is concerned that entities will structure shorter term leases with more renewals. However, there is an economic disincentive for lessees to do this as lessors will increase the cash cost of the rental payment.

In addition, it is common for new lease incentives to be negotiated when the terms of a renewal are being negotiated. Straight-lining the lease incentive across a period beyond the non-cancellable period of the lease is inappropriate.

The Property Council is concerned about the continuous reassessment of the lease term. While the revised ED only requires reassessment when a lessee has, or no longer has a significant economic incentive to renew, we question whether practically this is any different to requiring a reassessment at each reporting date.

The factors considered in the assessment of 'significant economic incentive' are very broad (contract based, asset-based, market-based and entity-based) which makes the assessment across a large portfolio of real estate very onerous.

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?

The Property Council agrees with the requirements in the revised ED for real estate lessors to recognise variable lease payments that depend on an index or rate in profit or loss in the period in which that income is earned.

We recommend that the use of the term 'lease payments' in paragraph 93 is clarified to only refer to "fixed payments, less any lease incentives received or receivable from the lessor".

Appendix A of the revised ED defines lease payments to include variable lease payments, exercise price of options to purchase and penalties for terminating. Given the "Basis for Conclusions", we do not consider that it is the intention of the Boards for these payments to be taken into account in determining the straight-line income recognised in profit or loss.

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?

As the recognition of investment properties is not expected to change, we do not anticipate significant transitional impacts.

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?

The revised ED requires disclosure about:

- the nature of a lessor's real estate leases (including a general description);
- the basis and terms and conditions on which variable lease payments are determined;
- the existence and terms and conditions of options to extend or terminate the leases; and
- the existence and terms and conditions of options for a lessee to purchase the underlying real estate.

The Property Council is concerned that it will not be possible to present this information in a meaningful manner because:

- the portfolio is so diverse that this disclosure will significantly extend the length of the financial statements; or

- the portfolio may be smaller and presenting this information will result in the disclosure of commercially sensitive information.

The revised ED requires disclosure of a maturity analysis of lease payments for each of the first five years and the total of the amounts for the remaining years.

Consistent with IFRS 7 Disclosures, entities should be able to determine the appropriate number of time bands so that the information provided is useful (rather than being provided merely for compliance purposes).

We support the IASB reviewing the existing disclosure requirements in IFRSs and developing a disclosure framework. This is consistent with our comments on IASB's Agenda Consultation.

Before finalising the Leases standard, the disclosures should be in line with the objective and recommendations of the IASB's Financial Reporting Disclosure Project.

Question 12 (IASB-only): 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?

We 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).

The removal of the option results in greater consistency in accounting for investment properties.

Other comments

<u>Lease incentives</u>

Given the withdrawal of SIC-15 *Operating Leases – Incentives,* the final Standard should provide guidance to lessors regarding the recognition of lease incentives.

As noted in our response to question 4, the amortisation period should be consistent with the contractual period of the lease.

Lessee 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?

The Property Council agrees with the Board that the nature of real estate leases is different to equipment leases. Real estate leases are not financings (which are typically for depreciating assets) and do not result in ownership of the property asset. The accounting treatment should differ based on whether a lessee is expected to consume more than an insignificant portion of the benefits of the property.

We therefore support the position in the revised ED that tenants should recognise a straight-line expense in profit or loss.

This approach reflects the economic substance of these leases and is consistent with the manner in which real estate lessors price such leases.

We commend the Board for conducting additional outreach to better understand the views of preparers and users about the economics of such leases and adapting the accounting treatment to reflect these views.

However, the adoption of the dual approach has highlighted that different leases have different economic substance and therefore that not all leases are necessarily financing in nature. Specifically, Type B real estate leases are not financing in nature.

In addition, recognising these real estate leases on balance sheet for lessees is inconsistent with the lessor treatment for Type B leases. The lease should be recognised on the balance sheet of the lessor because:

- the lessor retains the value of the asset and;

- investors rely on IAS 40 to assess the investment quality and performance of real estate companies which is key to their investment decisions.

We therefore recommend that the Board should reconsider whether it is appropriate to recognise Type B leases on balance sheet.

As a short-term solution, the Board should retain the recognition and measurement requirements of IAS 17 and include additional disclosures to provide the information required to satisfy the needs of users.

We also recommend that the Board hold public roundtables with users and preparers to understand the nature of the additional disclosures that are necessary, and then publish the results of this outreach.

Question 4: Classification of leases

Refer to response provided in question 4 above.

Question 5: Lease term

Refer to response provided question 5 above.

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?

The Property Council agrees with the option to apply a full retrospective or modified retrospective approach. If Type B leases are required to be recognised on balance sheet in the final Standard, an exception needs to be provided for leases previously classified as operating leases (if the lease term has ended before the effective date of the Standard).

We recommend that substantial lead time is required to:

- allow financial statement preparers adequate lead time for the adoption of the Standard; and
- educate shareholders and other interested stakeholders.

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?

The detail that would be required to present meaningful information for entities with large property portfolios will result this information being more difficult to understand.

We do not believe that providing reconciliations of the right-of-use asset or lease liability for Type B property leases provides useful information to users of the financial statements.