Government of **Western Australia**
Department of **Education**

Your ref :
Our ref D13/0436407
Enquiries :

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS ST WEST VIC 8007

Dear Mr Stevenson

I welcome the opportunity to provide comments to the Australian Accounting Standards Board (AASB) on ED 242 *Leases*. We acknowledge the tremendous amount of work that the AASB and IASB/FASB have invested in this project and the difficulties in meeting all stakeholders' needs.

Overall the Department of Education has concerns with the proposals, mainly from a business impact and cost versus benefit analysis. We also have some conceptual concerns as to whether the dual model best reflects the economic reality of some lease, hire etc arrangements.

- Overall we are opposed generally to the proposals.
- Costs versus benefits should be considered in any accounting proposals. In this case, there are little or no benefits to the Department but large costs, including potentially impacting front-line services.
- With large public sector agencies and especially those with decentralised environments such as the Department having approximately 800 schools in Western Australia (note that larger jurisdictions such as NSW have approximately 2,200 schools), the costs and business impact to obtain the information could be high.
- Transition to the new proposals seems to require all existing leases and potential lease contracts to be re-analysed. There would also be an ongoing need for increased monitoring of leases to comply with the reassessment requirements.
  - As both a lessee with large existing leasing portfolios as well as being a lessor of land and buildings – the system changes are likely to be significant.
- Financial accounting knowledge in these types of decentralised public sector environments is low. Also school registrars or administrative staff to do the analysis and implementation is limited in number and there could be some impact on front line services if they are to do some work.
- If the proposals proceed:
  - Prefer the application date be deferred as long as possible beyond 2017 - 18.
  - Public sector agencies will need the funding for resources to implement. In the current fiscal environment, this will not be provided by most jurisdictions' Treasury agencies. This could impact front line services, particularly if data capture is required at schools. It will cost resources; however Treasuries are highly unlikely to provide agencies with extra resources.
  - There are an extensive number of assets and different types of assets that we will need to consider and where data lies. The Department operates on a devolved or decentralised basis where schools are given

increasing flexibility and there could be arrangements that are captured by the proposals for which central office finance staff are currently unaware.

- If schools have to capture data, we would need a new system that would impact on workload which would go against the *Classrooms First Policy* in our devolved environment. If any new work is required, this has the potential to create industrial issues.
- There are unknown impacts from areas such as the need to examine all contracts for potential leases, i.e. assess whether they:
  - contain a lease agreement
  - are essentially service contracts with embedded lease components, or
  - are primarily lease contracts with attached services, such as maintenance services.
- Training will be extensively required.
- System implementation could involve significant costs.
- Collectively from the above points, applying the ED for the first time on transition would be a time consuming and costly process for which the Department could not currently resource.

Given this, the Department does not support the proposals in ED 242 *Leases*.

If you have any queries regarding the submission, please contact John Stanley on 08 9264 4162.

Yours sincerely

J Stanley

JOHN STANLEY
MANAGER FINANCIAL POLICY

Att.

Attachment 1

Initial Impact Assessment for WA Department of Education

The Department has a significant portfolio of leased assets including property leases currently held under operating leases across central office and 800 schools. Complying with the requirements of the new lease proposals, would place a huge administrative burden and strain on existing resources both on transition and on an on-going basis. It is thought that implementing the new lease proposals for a Government Agency such as ours, would outweigh any benefits they might provide.

The following outlines the extent of work for Department of Education relating to the new lease proposals:

1. All existing leases to be identified and re-analysed and then classified into Type A or Type B classification under the proposals

2. For both Type A and Type B leases determine the present value of the lease discounted using an appropriate discount rate. For each lease this involves:
   - Determining the lease term
   - Determining the number and amount of lease payments required during the lease term
   - Discounting the amount of the lease payments to their present value and determining their weighted average

3. Examine all contracts/agreements for potential leases, i.e. assess whether they:
   - contain a lease agreement
   - are essentially service contracts with embedded lease components or
   - are primarily lease contracts with attached services, such as maintenance services.
   - convey in the contract the 'right to control' the use of the 'identified asset'. *(Potential implications are some current leases would no longer be leases, and vice versa (e.g. consider lessor ability to substitute leased asset without requiring lessee's consent))*
   - have variable lease payments (depend on index or a rate are included, others linked to sales or use are still excluded), *(impact: increase asset & liability)*
   - have term options (included if there is a significant economic incentive to exercise them (rather than if it is reasonably certain at inception they will be exercised). *(impact: different?)*
   - have expected, rather than total, residual value guarantees (which are included) *(impact: decrease)*
   - have lease payments which are reassessed for changed circumstances, rather than only changes in contract terms *(impact: fluctuate more over lease term)*

   Look at all possible assets and arrangements including:
   - Some concern is possible arrangements outside of Common Use Arrangements (CUA's). There are no broad exemptions for Independent Public Schools (IPS) from using CUA's. Exemption must be sought from Department of Finance (as the CUA owner)
   - Photocopiers (schools, also central office)
   - Mobile phones, devices (schools, also central office) (not currently captured, but would all be under asset capitalisation threshold so no impact)
   - ICT equipment e.g. servers, Notebooks for teachers (held by ICT area centrally)
   - Agricultural equipment (held centrally)
   - Vehicles, approx 1000 (schools, also central office)
   - Buses (on central office system)

- Lessor of lands and buildings – The department is lessor for some assets and will need to look at various deeds.
- Lessor/hire of equipment such as planes, boats (not currently captured, thought that only schools hold these arrangements, possible 'lessor' implications.)

Once assessed, separate out lease components and non-lease components of a contract as under the proposals there are differences in accounting for services and leases

4. Based on all the above (1-3):
   - extract key data
   - separate the lease and non-lease components and allocate consideration
   - make new estimates and judgements
   - perform new calculations
   - consider impact on business practices and processes

5. For purposes of <u>initial budget estimation</u> (in the year before proposed transition):
   - make an inventory of all leases under the new proposal
   - carry out an evaluation of all leases as per points 1, 2 and 3 above
   - make an estimation of lease assets, liabilities, expenses and amortisation for initial budget estimates.

6. At <u>transition</u>, depending on whether modified or full retrospective approach is to be applied, gather all existing leases as per points 1, 2 and 3 above and work out:
   - Lease liability – equal to the present value of remaining lease payments, using discount rate as of date of transition
     - PV of lease payments includes expectations about various possible cash flows i.e. variable lease payments that depend on an index or rate (e.g. CPI), purchase options, RV guarantees, term option penalties as well as lease term.
   - ROU (Type A) Asset – recognise proportion to remaining lease term relative to initial lease term
   - ROU (Type B) Asset – recognise equal to the related lease liability, adjusted for uneven lease payments
   - Make necessary cumulative adjustments in opening retained earnings

7. Examine <u>other lease issues</u>:
   - Potential lessor of leases e.g. boats, planes
   - Multiple component leases

8. Ensure there is a <u>systems</u> in place or adapt current system to be able to:
   - manage and track leases under the proposals
     - note lease classification tests also need to be applied following a lease modification
   - determine present value of the lease using appropriate discount rate
   - provide note disclosures required under the proposals
   - provide any other information required by proposals
   - any other issues (arising from refer section on 'examine all contracts for potential leases')

9. Prepare impairment testing plan for ROU Assets.

Also, educate financial statement users as it may be confusing to understand how the new requirements would apply, and any impacts on the Departments business and processes.

Attachment 2

AASB Specific Matters for Comment

Issues 3 and 4, refer to comments in letter as well as comments below under 'what alternative approach would you propose and why' (context of lessee accounting).

IASB Questions for respondents

Scope

Question 1: Identifying a lease

No comment.

Lessee Accounting

Question 2:

Land and Buildings should be Type B

There appears to be a significant drafting flaw or conceptual flaw in the classification of leases that would have a significant adverse effect on the proposals in relation to land and buildings.

Para 35 in conjunction with para 52 appears to require land and buildings leases be classified as Type A whereas the policy intention must surely be that they are Type B unless there are exceptional circumstances. This would have significant illogical accounting treatment for public sector agencies where land and buildings are commonly held at fair value (as mandated by each jurisdictions' Treasury agency).

- Para 35: "a lessee shall not classify a lease as a Type A or a Type B lease if it chooses to measure the right-of-use asset in accordance with paragraph 52 or Paragraph 53. Such a lease shall be treated as a Type A lease when applying the applicable presentation and disclosure requirements."
- Para 53 allows lessee to measure right-of-use assets relating to a class of PPE assets at revalued amount.

ROU asset in a Type B lease as an asset and the straight-line expense recognition

If the proposals are to proceed, and an ROU asset is to be recognised for Type B leases notably land and buildings, we support the alternative measurement bases i.e. paragraph 53 in paragraphs 47-53.

In Australian jurisdictions, public sector agencies land and buildings are commonly mandated to be at fair value as is arguably best practise and consistent with GAAP/GFS Harmonisation. So the alternative measurement bases of fair value of the ROU asset under AASB 116 (paragraph 53) would be used. There are conceptually then two expenses to consider:

1. Lease expense – we support preserving straight-line expense recognition for most leases of property, similar to operating leases under the current AASB 117.
2. Amortisation of the ROU asset – some accounting commentator's have referred to this ROU asset subsequently being measured each period as a 'plug' or balancing figure, calculated by deducting the difference between straight-line lease expense, less interest on the lease liability each period,

from the initial ROU asset balance. This is apparent from reading paragraph 50. What is not clear is how paragraph 50 and 53 interrelate with each other particularly for leased buildings that are at fair value and revalued annually as our agency does. Our preferred accounting treatment is that these are amortised also on a straight-line basis. However, reading paragraph 50 does not seem to produce this outcome. This may be an unintended drafting error as the potential effects of revaluations should be considered by the standard setters and to avoid:

   a. Complicated accounting (straight-line amortisation is simple and arguably best reflects the consumption of economic benefits)
   b. Increased volatility in the Statement of Comprehensive Income
   c. Increased volatility in the Statement of Financial Position

3. The comments/concerns in 1 and 2 above can be ignored if the only expense recognised is a 'single lease cost' termed "Lease expense" and this is straight-line expense recognition. We support this accounting expense recognition pattern.

Lack of clarity if ROU asset is a tangible or intangible asset

It appears as though the ROU asset is an intangible asset. In the case of land and buildings owned and leased by the lessor it makes sense that under the proposals the lessor would recognise the tangible asset and the lessee would recognise the intangible asset – otherwise it would be double counting of the same tangible asset which would be physically, legally and conceptually impossible.

On the assumption the ROU asset is proposed to be an intangible asset, it is amortised in the proposals which supports it being intangible (rather than 'depreciated'). Technical confusion emerges in that the ROU intangible asset is then revalued in accordance with AASB 116 rather than AASB 138 which technically would be that fair value be determined with reference to an active market. We suggest that if the proposals proceed, the standard setters resolve this technical confusion by consequential amendments to the amended AASB 117, AASB 116 and AASB 138 by giving clarity to what the ROU asset actually is and treated by each of these standards.

- Presentation – paragraph 54 (a) broadly describes ROU assets as presented in Statement of Financial Position or disclosed in the notes as "ROU assets separately from other assets". Yet some accounting commentators are stating to "Present ROU assets within PP&E separately from other assets that the lessee owns". There could be interpretation issues from this lack of clarity.

Asymmetry for Type B lessor and lessee accounting within the consolidated entity

Adding to the comments immediately above, there are conceptual arguments against and practical issues with the apparent 'double recognition' of assets. For example, tow agencies recognise an asset in respect of land and buildings leased within government, the lessor the physical PP&E and the lessee the ROU asset. There is double counting and this will require consolidation elimination adjustments for Government's financial statements.

Even in the private sector, what seems to be the same asset will be represented on two entities balance sheets. This may present curious outcomes for a financial institution that is lending to both entities as it would seem to need to strip out an 'asset' of one of the entities Statement of Financial Position i.e. to adjust it to the correct financial position that there is only one asset.

What alternative approach would you propose and why?

The above issues we have raised and also expected to be raised by other accounting commentators in Australia, highlight concerns with the proposals both conceptually and practically. In addition, the proposals would entail a lot of costs and work for not a lot of benefits (as detailed in covering letter). Rather, the benefits to public sector agencies such as ours are not demonstrated.

For these reasons, we would prefer that the existing Standard be maintained i.e. Operating Leases (off balance sheet) and Finance Leases and the boards focus on making improvements to eliminate or minimise the concerns with existing practices. For example, consider how the accounting structuring in practice of transactions that may in substance be a financing arrangement and 'should' be on balance sheet – could be tightened. This 'off-balance sheet' financing seems to be the predominant reason for the proposals.

We note there may be similar 'accounting structuring' under the proposals too. Considering the requirements for a leasing transaction that involves multiple component arrangements, variable lease payments with non-lease (e.g. service component) and for which there may not be observable stand-alone prices. In these sorts of circumstances, off-balance sheet structuring opportunities may still exist.

Question 4: classification of leases

The ED does not provide 'bright-line' quantitative guidance on what constitutes an 'insignificant' part of the total economic life or an 'insignificant' amount of the fair value of an underlying asset. Some users may interpret this to be less than 5% (or arguably less than 10%) i.e. 'immaterial' in accordance with the analogy of materiality under accounting standards, but this is not clear.

Question 8: Disclosure

The Boards propose to implement a fundamental change in the lessee accounting model and increase the disclosure burden at the same time. As per comments in question 2, the proposals would entail a lot of costs and work for benefits that are not apparent to us. Does the failure to reduce lessee disclosures demonstrate a lack of confidence from the Boards in the recognition and measurement proposals?