

21 August 2013

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
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Via email: standard@asb.gov.au

Dear Kevin

ED 242 Leases

Thank you for the opportunity to comment on ED 242 (the ED). CPA Australia and the Institute of Chartered Accountants in Australia (the Institute) have considered the ED and our comments are set out below.

CPA Australia and the Institute represent over 200,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

As stated in our submission on the 2010 ED, we commend the IASB for tackling accounting for leases and support the decision to develop a model to replace the existing requirements. We agree the current standard AASB 117 *Leases* is inadequate in providing information sufficient to meet the needs of financial statement users. We have evaluated the current ED in terms of whether its proposals are an improvement on the current standard given its shortcomings.

It is our view that the proposals do not reflect a principles based approach, but rather a pragmatic, rules based approach that seeks to address some significant shortcomings of the existing lease accounting model. As a pragmatic solution to these shortcomings, we support the objective of the ED to bring the majority of all leases on balance sheet. However, we consider that the IASB needs to do more work in order to address the issues we identify in this submission, before proceeding with the current proposal. Until the outcomes of further work are reviewed, we consider the original ED proposals (i.e. the financing transaction model) to remain a viable alternative for a new leasing model.

The IASB Snapshot document describes the project objectives as follows: 'To improve the quality and comparability of financial reporting by providing greater transparency about leverage, the assets an entity uses in its operations, and the risks to which it is exposed from entering into lease transactions'.

The document goes on to criticise the existing model, stating that the difference in accounting for finance and operating leases has created incentives to structure some transactions as operating leases to achieve off-balance sheet accounting. In addition, the existing model has resulted in an operating lessee's balance sheet providing an incomplete picture about leverage and assets that the lessee uses in its operations. We agree that these two shortcomings reflect the core issues with the current standard and we believe it is essential that the proposals in this ED address them. Therefore, we have used these two shortcomings to evaluate the proposals.

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The outcomes of our evaluation are mixed. At one level, applying the ED proposals would result in greater transparency by bringing all leases on balance sheet, thereby providing more information about an entity's leverage and the assets it uses in its operations. However, the proposal to introduce a dual model for determining the profile of income and expenses has the potential to significantly undermine that improvement in transparency, as the dual model creates an environment for new structuring opportunities, as well as many flow-on costs, complexities and inconsistencies for users and preparers.

Given an important shortcoming of the existing model was the possibility to structure some transactions as off-balance sheet, we are not convinced that the proposals adequately address this risk. Existing structuring opportunities would be replaced by new structuring opportunities. These new opportunities appear to involve taking a transaction outside the definition of a lease entirely or creating a Type B lease to enable the accounting outcome favoured by the lessee.

As set out above, implementation of the proposals will give rise to significant costs, although it is not clear that the additional information will benefit users. In particular, we note the excessive disclosures in the proposals and consider that they have the potential to increase the cost and complexity of the financial statements. Due to cost/benefit and effectiveness considerations, we suggest that the proposed disclosures are subject to field testing with preparers and users before the standard is finalised.

Our detailed responses to the questions posed in the ED are contained in the attached appendices. If you have any questions regarding this submission, please do not hesitate to contact either Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au or Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au

Yours sincerely



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Appendix 1 – IASB questions

Question 1 Identifying a lease

The 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 the 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 patters, 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.

We agree with the revised definition of a lease as noted above. However, we would like to see this addressed further in light of the issue of DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting*. We think it is vital that the decisions about leases are not inconsistent with the decisions about elements in the IASB Conceptual Framework for Financial Reporting and we encourage you to consider them in finalising the leases standard.

We believe more guidance is necessary to establish whether an arrangement contains a lease versus a service contract. We do appreciate that several examples have been provided to assist in this process. However, we believe that guidance on the assessment of control and what constitutes an identified asset would also be of assistance. We note that contracts involving the capacity portion of an asset will not meet the definition of an ‘identified asset’, and hence will fall out of the scope of the proposals. We consider such contracts should be within the scope of the definition of a lease, and therefore would like to see ‘identified assets’ being expanded to include this.

We agree with the requirement to identify and account separately for lease and non-lease components, as it is consistent with principles established in the right of use model and the revenue recognition proposals. One criterion to be met in considering separate lease components is that the ‘underlying asset is neither dependent on nor highly interrelated with the other underlying assets in the contract’. We consider that the phrase ‘highly interrelated’ is not clear and requires additional guidance.

Question 2 Lessee accounting

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

It is our view that the proposals do not reflect a principles based approach, but rather a practical, rules based approach that seeks to address some significant shortcomings with the existing lease accounting model. As a practical solution to these shortcomings, we support the objective of the ED to bring the majority of all leases on balance sheet. Nevertheless, we consider that both the dual lease model, and the single lease cost for type B leases, have shortcomings.

Dual lease model

We believe the proposal to include a dual model for determining the profile of income and expenses has the potential to significantly undermine the ED's objective to provide more information about an entity's leverage and the assets it uses in its operations. We are of the opinion that the proposed model creates an environment for new structuring opportunities, as well as many flow-on costs, complexities and inconsistencies for users and preparers.

We are not convinced that the proposals adequately address the important shortcoming of the existing model, which is the ability to structure some transactions as off-balance sheet. Existing structuring opportunities could be replaced by new structuring opportunities. These new opportunities could involve taking a transaction entirely outside the definition of a lease or creating a Type B lease to enable the accounting outcome favoured by the lessee.

We would consider that the IASB needs to do more work in order to make a compelling case to proceed with the current proposal. Until the outcomes of further work are reviewed, we consider the original ED proposals (i.e. the financing transaction model) to remain a viable alternative for a new leasing model.

Single lease cost for type B leases

We do not consider the single lease cost to be consistent with the right of use asset approach. The right of use asset approach treats a lease as a financing arrangement, however the single lease expense model does not reflect this (as it does not reflect financing costs) and neither will the presentation of cash flows.

We understand the approach has been developed in response to significant concerns raised in relation to the previous ED, and we appreciate the IASB being mindful of those concerns, and the attempt to develop a solution.

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?

In our previous submission we expressed support for a single lessor model. Given the feedback received during the IASB's consultation processes, we can accept the principle based on the extent to which the lessee is expected to 'consume more than an insignificant portion of the economic benefits embedded in the underlying asset'.

However, our biggest concern with the lessor accounting proposal is the lack of synchronisation with the lessee model. Synchronisation with the proposed lessee model would mean that all leases will have a lease receivable, unless the lessor measures the underlying asset at fair value. For this reason, we cannot support the lessor accounting proposals for Type B leases when the underlying asset is not an investment property measured at fair value.

While we might 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', the approach in the ED is not consistent with the corresponding balance sheet approach of the lessee.

If the lessee in a Type B lease is recognising a right-of-use asset, it is illogical for the lessor not to derecognise an asset or part of an asset. We would recommend that recognition in the lessee's books be accompanied by de-recognition in the lessor's books in Type B leases. The lessors should reflect a receivable as the right to receive lease payments as a financial asset in their financial statements.

This issue becomes more complex when applied to sub leases or back-to-back leases in respect of a Type B lease. Under the proposals, the lessee who subleases a Type B property will have a right-of-use asset while the sub lessee would also have a right-of-use asset. It is illogical for both parties to hold the same type of right-of-use over the same property. If the IASB proceeds with its proposals, we recommend an exception for back to back leases, when the main lease is a Type B lease. This exception could either be made to the lessee or the lessor accounting, to ensure synchronised accounting between the lessor and lessee.

We support the proposed treatment that a lessor of investment property should apply IAS 40 for Type B leases. Fair value is commonly applied in Australia for investment properties, as it enables a user to

understand the property performance based on value enhancement or destruction caused by managements' actions, changing market value for rents and valuation yield.

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 an underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We do not agree that the distinction in classification should be based on the nature of the underlying asset but we are of the opinion that it should be based on the principle of the expected level of consumption.

For example, it is not evident why a ship which is in substance a floating building be presumed to be a Type A asset, when a building or part of a building is assumed to be a Type B asset.

Therefore, we suggest keeping the classification principle (subject to the comments in response to Q2) but abandoning the assumption that property is a Type B asset. We do not consider it appropriate to establish a principle, which is then applied in such a manner that it does not always result in conclusions that are consistent with the principle (as set out in paragraph 51 of the Basis of Conclusions to the ED).

Explanation of this principle in paragraphs 29 and 30 uses words such as 'insignificant', 'substantially all' and 'major part'. We suggest including additional guidance about the meaning of these terms to minimise inconsistent interpretation and outcomes.

We also question why when classifying leases, the remaining useful life is used for property but the total economic life is used for plant and equipment other than property. We cannot understand the rationale for this distinction. We believe the lease term should be compared to the total economic life in all circumstances, including leases involving property.

We welcome the fact that the IASB has accepted the recommendation from the Australian Accounting bodies and other constituents to include an exemption for short-term leases for lessees. The cost of recognising these leases would outweigh the benefits. We do not envisage any significant structuring opportunities from providing this exemption, as it is likely they would be too costly to implement.

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?

We do not agree with the proposals relating to the lease term. Specifically, we do not agree with the test of whether a significant economic incentive exists to exercise an option. While, we did not agree with the 2010 ED which proposed the term be based on the longest term more likely than not to occur, we believe the current test of 'reasonably certain' under IAS 17/AASB 117 works relatively well and introducing a new test may cause unnecessary confusion amongst preparers. We note that in BC140 the IASB acknowledged that the proposed concept is expected to be similar to 'reasonably certain'. If the IASB decides to continue to use 'significant economic incentive', more guidance will need to be included to explain this notion.

We do have some concern regarding the costs of the reassessment proposals. The factors to be considered in the assessment of 'significant economic incentive' are very broad, which will make reassessment across a large portfolio of real estate very onerous. However, we are supportive that changes in market based factors after lease commencement should not in isolation trigger reassessment of the lease term because of the potential for frequent changes to the lease terms as market prices increase or decrease.

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?

We agree that usage and performance based variable lease payments should be excluded from the measurement of the lease liability.

We also support the departure from the 2010 ED, which proposed a probability weighted estimation approach where a lessee and lessor would include estimated variable lease payments in the measurement of lease assets and lease liabilities at the commencement dates.

In-substance fixed payments that are structured as variable lease payments, will need to be included in the measurement of assets and liabilities. We are concerned that the notion of 'in-substance fixed payments' has not been explained sufficiently in terms of the establishment of a principle. Whilst some examples are included, these could be interpreted differently without a clearly defined principle. We recommend that the IASB include a principle with further guidance around the notion of 'in-substance fixed payments'.

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?

We are supportive of the IASB proposals, which allow entities to choose the most convenient method for them to transition to the new standard.

We recommend a substantial lead time for application of the standard, similar to that discussed in the current revenue recognition project. Preparers will need sufficient time to adopt, as it is likely that new systems will need to be created. Further, users and other stakeholders will need time to be educated on the changes.

Question 8 Disclosure

Paragraphs 58-67 and 98-109 set out the disclosure requirements for a lessee and 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?

We consider the proposed disclosures excessive and are of the opinion that they would not be required of users of the financial statements, particularly reconciliations of amounts recognised in the statement of financial position.

However, we welcome the allowance in paragraphs 59 and 99 that an entity should consider the level of detail necessary to satisfy the disclosure objective.

Questions 9, 10 and 11

We have no comments on Questions 9, 10 and 11 as those questions relate only to the proposed FASB standard and therefore would not apply in Australia.

IAS 40 Investment Property

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?

To the extent that the IASB issues the final standard based on the right of use model in the revised ED, we agree that a right of use asset should be within the scope of IAS 40 if it meets the definition of investment property. The removal of the option results in greater consistency in accounting for investment properties.

Other issues identified

Impairment

While lessees would apply the existing impairment requirements in the same manner they currently use for assets held under the finance leases, the analysis would be new for current operating leases with terms greater than twelve months. For leases that are not currently on the balance sheet, the requirement to test right of use assets for impairment could accelerate expense recognition, if an impairment occurs. However, if the corresponding liability could also be taken into account, which is not normally done in the current impairment model, the impact would be minimised. We recommend some clarification is provided in this regard.

Appendix 2 – AASB Specific Matters

Question 1 GAAP/GFS harmonisation

In relation to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*:

- (a) are you aware of any implications for GAAP/GFS harmonisation of the proposed changes?
- (b) how do you think the implications for GAAP/GFS harmonisation of the proposed changes should be dealt with in the context of the principles in AASB 1049?

GFS currently distinguishes operating leases from finance leases. The proposals will change the basis for lease classification and change the recognition and measurement requirements for lessees and some lessors. These changes are likely to increase GAAP/GFS divergence. Potential issues are:

- differences in relation to transactions (as defined in AASB 1049) as lessees would recognise amortisation and interest expense under GAAP while having to report lease rental expenses under GFS
- differences in relation to other economic flows (as defined in AASB 1049) as lessees would recognise reassessments of right-of-use assets and lease liabilities and revaluations of right-of-use assets under GAAP but not under GFS
- the value of various key fiscal aggregates (as defined in AASB 1049) would change.

Question 2 Regulatory issues

Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

- (a) not-for-profit entities; and
- (b) public sector entities?

We are not aware of any issues arising from the ED specifically pertaining to not-for-profit entities. However, there are concerns that the restriction on the revaluation of residual assets will cause inconsistencies for entities, such as Australian public sector entities, that adopt the revaluation model for similar property, plant and equipment. We would recommend a lessor be permitted to apply the revaluation model to a residual asset if it applies that model to similar items of property plant and equipment.

Question 3 Usefulness to users

Overall, would the proposals result in financial statements that would be useful to users?

Yes, apart from where our comments above indicate otherwise – for example we do not perceive reconciliation disclosures as being particularly useful to users.

Question 4 The Australian economy

Are the proposals in the best interests of the Australian economy?

Yes, we believe the proposals are in the best interests of the Australian economy.

Question 5 Costs and benefits

Do you have any comments on the costs and benefits of the proposals relative to current requirements, whether quantitative (financial or non-financial) or qualitative?

As these changes are fundamental many lessors and lessees will need to change their systems to incorporate them adequately. We recommend that further cost/benefit analyses and field testing are undertaken, particularly in the area of disclosures, to ensure these extensive changes are necessary.