16 June 2009

Mr Bruce Porter
Acting Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

Via email: standard@aasb.gov.au

Dear Mr Porter

ITC 20: Request for Comment on IASB Discussion Paper DP/2009/1 *Leases – Preliminary Views*

Thank you for the opportunity to comment on the AASB discussion paper ITC 20: Request for Comment on IASB Discussion Paper DP/2009/1 *Leases – Preliminary Views*. CPA Australia, The Institute of Chartered Accountants (the Institute) and the National Institute of Accountants (the Joint Accounting Bodies) have jointly considered the above discussion paper (DP) and our comments follow.

The Joint Accounting Bodies represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

We support the proposals, as they remove the opportunity for structuring transactions to remove lease arrangements from the balance sheet. We concur with the conceptual justification for recognising an asset and a liability, but note that in some instances the calculation of these figures will be complex due to the underlying structure of the lease arrangements in different industry segments. In our view, it will be necessary for the IASB to devise a simplified version of the requirements for the purposes of the IFRS for SMEs.

We also note that the conceptual approach of recognising asset rights and performance obligations is consistent with the approach being taken for revenue recognition. However the presentation of these contracts entered into is quite different. We hope that these two debates will inform each other and result in a cohesive and conceptually sound pair of standards. Further it is imperative that this project establishes a clear link to the ongoing work on the conceptual framework as it relates to the definition and recognition of assets and liabilities.

However, we see two major flaws in the DP which must be addressed before proceeding to issue an exposure draft and then a standard.

1. FASB and IASB must reach consensus on the proposals at an early stage. Such a radical change to an area of accounting affords the opportunity to issue a standard that is common to both Boards and remove a whole area of difference. As we have seen with the recent deliberations on financial instruments, the existence of different accounting standards in major jurisdictions opens the door to arbitrage. National standard setters apply pressure to be allowed to use the accounting treatment that is most beneficial to their constituents.

2. The Boards cannot ignore the issue of lessor accounting as numerous entities act as both lessee and lessor using subleases. With the removal of operating leases, leases of property will come on balance sheet and this is the area where subleases are particularly common.

Our response to matters on which specific comment is requested is included in the attached Appendix. Also attached is our submission to the IASB which includes our responses to the specific IASB questions for comment.

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, Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au, or Tom Ravlic (NIA) at tom.ravlic@nia.org.au .

Yours sincerely

Geoff Rankin
Chief Executive Officer
CPA Australia Ltd

Graham Meyer
Chief Executive Officer
Institute of Chartered Accountants

Andrew Conway
Chief Executive Officer
National Institute of Accountants

The AASB would particularly value comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(i) not-for-profit entities; and
(ii) public sector entities.

The proposals if adopted should be extended to not-for-profit and public sector entities under the policy of transaction neutrality. We consider that simplified proposals should be adopted by the IASB for entities eligible to adopt IFRS for SMEs.

(b) overall, the proposals would result in financial statements that would be useful to users; and

Because of the history of manipulation of balance sheets using the structure of leases, eliminating the ability to do this will result in financial statements that are useful to users.

(c) the proposals are in the best interests of the Australian economy.

In an environment of increasing globalisation, it is in the best interests of the Australian economy for publicly accountable entities to be following the IASB's standards.

Yours sincerely

Geoff Rankin
Chief Executive Officer
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Andrew Conway
Chief Executive Officer
National Institute of Accountants

16 June 2009

Mr David Tweedie
Chairman
International Accounting Standards Board
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London EC4M 6XH
UNITED KINGDOM

Via iasb website: www.iasb.org

Dear David

IASB Discussion Paper DP/2009/1 *Leases – Preliminary Views*

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Chapter 2: Scope of lease accounting standard

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards.
Do you agree with this proposed approach?
If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

We agree that the Boards should base the scope of the proposed new standard on the scope of the existing standards, but we further suggest that the Boards should specify that it will be based on IAS 17 (subject to the Boards' decisions how [and whether] to incorporate the existing standard's scope exclusions) and not American literature (according to para 2.2 of the DP, SFAS 13 only applies to property, plant and equipment). We see no reason why the proposals should be limited to tangible assets.

We trust that any resulting standard will be comprehensive and remove the need for IFRIC Interpretation 4, *Determining whether an Arrangement Contains a Lease.* If IFRIC 4 remains, the impetus for structuring transactions will simply be moved from the decision as to finance or operating to a decision as to lease or contract for services.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.
Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

We see no reason why the standard would exclude leases of non-core assets or short-term assets. The only reason we can see for excluding a lease is where it is not material to the financial report.

Chapter 3: Approach to lessee accounting

Question 3

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Broadly we agree with the Boards' approach. However we disagree with their analysis of the obligation to return the asset at the end of the lease term. In many cases the lessee has an obligation to hand back the asset in an agreed condition (ie to make good) and that obligation should be provided for under IAS 37. Paragraphs 3.23 and 3.24 view the lessee at the end of the lease term as custodian – the lessee is holding the asset on behalf of the third party. Their only obligation is to return it. When there is a "make good" clause, the lessee has two obligations, to make good the item that was leased and to hold the asset on behalf of the third party. The DP paragraph 3.11 does not fully identify the lessee's obligations and so contains no discussion of making good. This oversight should be rectified in the ED (or at least the Basis for Conclusions). IAS 37 should provide the appropriate accounting.

We like the Boards' approach from the point of view of removing the ability to manipulate the financial report via the structure of leasing transactions, but we are not convinced that the Boards have satisfactorily distinguished leases from executory contracts. On a month to month tenancy, for example, the transaction looks more like an executory contract.

A similar question arises in the context of a lease signed for an asset that does not yet exist. Is it an executory contract that does not require recognition of an asset and a liability until the asset is handed over in a usable condition?

Question 4
The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)
(b) a liability for its obligation to pay rentals.
Appendix C describes some possible accounting approaches that were rejected by the boards.
Do you support the proposed approach?
If you support an alternative approach, please describe the approach and explain why you support it.

We support the proposed approach, but in our view Appendix C dispenses with the executory contract approach without much discussion.

We have heard that some of our members, particularly those with long-term operating leases of land and buildings who have made a business decision to rent rather than buy, are reluctant to acknowledge the existence of a right of use asset and a lease obligation. They consider the arrangements they have entered into as executory contracts, ie equally proportionately unperformed. However, the existence of a present obligation (and consequently a right of use asset) can be discerned when one considers the implications of breaking the lease.

Question 5
The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

We support this approach. Splitting a lease into its components would be complicated for preparers and make the information harder for users to understand.

We understand from our members that some leases contain a right to purchase the underlying asset. In our view, a lease with a purchase option, when it is probable that the purchase option will be exercised, could be considered in substance a clean sale, ie a sale and purchase transaction and not a lease transaction. In substance there is no difference between this and a sale of goods on credit, when the sale contains a retention of title clause that can be exercised in the case of non-payment by the debtor. Such a sale is accounted for as a sale.

Chapter 4: Initial measurement

Question 6
Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate? If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Our concern with Chapter 4 is that the reasoning starts with the liability and not the asset. The first decision an entity makes is to acquire an asset. It then goes on to consider how it is going to fund the acquisition, ie to look at the liability side. The valuation of the liability can be an input to the determination of the cost of the asset, but its role should be secondary.

Our constituents differ as to how easy it is to arrive at the interest rate implicit in the lease. In instances where the lessee can easily arrive at this rate, we consider the implicit rate should be used in preference to the incremental borrowing rate. We appreciate that this may be rare, particularly once options, etc enter the calculation, but do not believe that the implicit rate should be prohibited. We agree with the proposal to use the lessee's incremental borrowing rate where the implicit rate is not readily available.

Question 7
Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?

If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

We agree with this proposal.

Chapter 5: Subsequent measurement

Question 8
The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.
Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

We agree with these proposals.

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

In the interests of simplicity and consistency between entities, we support the requirement to show the obligation at amortized cost.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows?
Please explain your reasons.

We do not believe that the lessee should be required to revise its obligation to reflect changes in its incremental borrowing rate if the repayment terms of the lease are not changing. The lease rate reflects the circumstances that prevailed when the transaction was entered into. Recalculating with a new rate would introduce unnecessary complexity. However, at points when the lease conditions are being reset, for example when an option to renew is exercised, the rate should be revised.

We strongly suggest that FASB and IASB reach consensus on this matter before proceeding to an exposure draft.

Question 11
In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

We agree with the approach taken by the Boards. Financial instruments standards are currently being rewritten and the process of convergence will be better served by having one consistent approach for lease liabilities, rather than directing users to inconsistent accounting standards to determine how to account for their obligations. We hope that work being done here will feed into a more consistent approach to financial liabilities generally.

Question 12
Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.
Would you support this approach? If so, for which leases? Please explain your reasons.

In our view this approach would be misleading. The substance of the transaction is that the entity has funded an asset by acquiring a liability. Treating the related expenses as depreciation/amortisation and interest reflects this approach.

Chapter 6: Leases with options

Question 13
The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We do not support the approach preferred by the Board, identified in the DP as 'Approach (b)' whereby uncertainty about the lease term is addressed through recognition.

We prefer the alternative approach outlined in the DP, identified as approach (a), whereby the uncertainty is addressed through measurement as it is best able to deal with the uncertainties concerning the amount recognised. While we can see that the figure calculated under approach (a) may not line up with any actual possible outcome, because the liability is reassessed annually, this approach will give rise to less dramatic adjustments as the probabilities gradually mature and will therefore create less volatility.

Question 14
The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.
Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

We agree with this proposal. Because management's intention with regard to the lease is such a significant input into the valuation of the asset and liability, it is appropriate to revisit these assumptions each year.

Some of our constituents have concerns about the practicalities of continuous reassessment. We suggest the IASB further research this area, perhaps through the implementation of field testing, to ensure these requirements are not unnecessarily burdensome.

Question 15
The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.
Do you agree with the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Refer to response in Question 5.

Chapter 7: Contingent rentals and residual value guarantees

Contingent rentals

Question 16
The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.
Do you support the proposed approach?
If you disagree with the proposed approach, what alternative approach would you recommend and why?

Conceptually, we agree with this proposal, but we suspect it may cause difficulties in practice, because it requires predicting future events. Such predictions may be more or less reliable, depending on the nature of the asset being leased. The Board may need to add something about not recognising where the contingent rentals cannot be reliably measured. One of our members cited the example of a stadium where the rent is based on future ticket sales.

Question 17
The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.
Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

We support the IASB's approach as it is in line with the approach taken by IAS 37. In addition, as we stated in our answer to Question 13, while this approach may not reflect any actual possible outcome, as the probabilities mature, it comes closer to what the actual outcome will be and will result in less volatility than radical changes of assumption as to the most likely outcome.

It seems inconsistent that the IASB chose to adopt the probability-weighted approach here, but did not in Chapter 6 (Question 13 above). In our view, the issues in both chapters are similar and should be treated in a similar fashion.

Question 18
The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.
Do you support the proposed approach? Please explain your reasons.

We agree with this proposal. As implied in para 7.21, a change in an underlying index is more of a reflection of the fair value of the liability, and not of the service potential of the right-of-use asset.

Question 19
The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.
Do you support the proposed approach? If not, please explain why.

We agree with this proposal.

Question 20
The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons.
If you support neither approach, please describe any alternative approach you would prefer and why.

We support the proposal to adjust the right-of-use asset. The contingent rentals reflect the service potential inherent within the asset. If the entity expects to gain more service potential and incur contingent rentals, it has acquired a greater right-of-use asset than it originally anticipated.

Residual value guarantees

Question 21
The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

We agree with these proposals and in particular support the options endorsed by the IASB.

Chapter 8: Presentation

Question 22
Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.
What additional information would separate presentation provide?

We agree that the lessee's obligation to pay is a financial liability. However, we support the FASB view that these obligations constitute a separate class of financial liability, because they are measured differently. In some ways they have more in common with provisions, because their measurement involves placing a value on uncertainties.

Question 23
This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.
How should the right-of-use asset be presented in the statement of financial position?
Please explain your reasons.
What additional disclosures (if any) do you think are necessary under each of the approaches?

In our view the right of use assets should be presented according to the nature of the underlying asset. There is little difference between the service potential to the business inherent in a leased motor vehicle compared with that inherent in an owned motor vehicle.

However, there needs to be additional disclosure to reflect the fact that a right to use an asset is not the same as ownership, perhaps by splitting leased and owned assets in the note disclosures.

Chapter 9: Other lessee issues

Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

In our view the lessee side of the transaction has been comprehensively covered.

However, the examples included in the document appear overly simplified. Many of our members have commented on the potential complexity of the calculations and we suggest that in the Exposure Draft, the IASB should include as an Appendix a comprehensive worked example highlighting the difficult areas, perhaps of a lease of a retail property, incorporating CPI increases, options to renew and contingent rentals based on shop takings. A further example could look at a lease of a property containing a small monthly fixed component and a larger monthly variable component based on turnover.

Chapter 10: Lessor accounting

Question 25
Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

We agree that the right to receive rentals under a lease meets the definition of an asset.

Question 26
This chapter describes two possible approaches to lessor accounting under a right-of-use model:
(a) derecognition of the leased item by the lessor or
(b) recognition of a performance obligation by the lessor.
Which of these two approaches do you support? Please explain your reasons.

Option (b) is in line with the revenue recognition proposals, but requires more analysis before one can determine its merits. As it stands, it unnecessarily inflates the balance sheet and double-counts the asset, by showing both the service potential inherent in the asset and the income stream receivable. Option (a) by contrast reduces the value of the asset to show the extent to which the entity has lost control of it for the duration of the lease.

For option (b) to be acceptable and reflect the substance of the transaction, some form of impairment needs to be included to recognise that the full service potential of the underlying asset is no longer available to the lessor. Once the asset has been leased out, it cannot be used by the lessor for anything else until it is returned or vacated.

Following the revenue recognition proposals strictly, the lease receivable and performance obligation would be netted off showing a zero net contract position. In some cases, for example where a bank is acting as lessor and the lease receivable is in substance a bank loan, this presentation would not reflect the substance of the transaction.

For these reasons and given limited analysis to date, we prefer approach (a) as it results in financial information that is more relevant and understandable for users of the financial statements. The portion of the asset that is retained reflects the extent to which the lessor has retained control of the asset and can be moulded to reflect any type of lease from hire purchase where the purchaser gains title to the asset through to short-term leases where the lessor retains substantial control of the asset, expects to have it returned in good condition and will hire it to someone else. The left hand column in Example 11 shows that the underlying asset has been derecognised and replaced with an income stream, the lease receivable.

However, if option (a) is adopted, it must be done in such a way that it is consistent with the IASB's proposals with regards to revenue recognition and derecognition.

Question 27
Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

This issue would be better dealt with as part of the revenue recognition project and the derecognition project, as it is a question of when revenue should be recognised and whether an item has been in substance sold. The leasing project should concentrate on the treatment of the lease receivable.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

The accounting for investment property cannot be ignored. Under IAS 40, the fair value of the investment property is related to the expected cash flows from the asset. However, the lease receivable is based on the same cash flows and so effectively these cash flows are double-counted. A lessor accounting for an investment property under IAS 40 would therefore have to derecognise a portion of the investment property when recognising a lease receivable.

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

We are not aware of any such issues.