COMMERCIAL IN CONFIDENCE

Defence Housing
AUSTRALIA

17 June 2009

The Chairman
Australian Accounting Standards Board
Level 7, 600 Bourke Street
MELBOURNE VIC 3000

Dear Sir

This letter provides the Australian Accounting Standards Board (AASB) with comments on:

(a) The proposed approach covered in the International Accounting Standards Board (IASB) Discussion Paper DP/2009/1;
(b) IASB's concerns with the current lease standard; and,
(c) Other issues related to the paper.

Background

Defence Housing Australia (DHA) is a government business enterprise that relies upon the sale and leaseback of properties for the majority of its funding. The Sale and Leaseback Program is an integral part of DHA's business model. DHA has over 11,000 current operating leases with individual and institutional investors that represent over $1.7 billion in net present value terms. DHA has a concomitant agreement to lease properties to the Department of Defence. Therefore it is reasonable to suggest that DHA has a significant stake in the outcomes of the discussion paper and is well placed to provide valuable feedback to the AASB and the IASB.

General Concerns with the Proposed Approach

When reviewing the proposed lease changes and applying them to DHA a number of significant issues were identified. These issues are practical in nature and reveal concerning impacts to financial information provided to users and are as follows:

<u>Changing the Nature of Expenditure when the Expenditure is Nothing More than a Payment to Use an Asset</u>: The paper does not adequately address why a financing and amortisation component is necessary and why this treatment more appropriately reflects the economics of the transaction. Our view is the paper artificially creates different types of expenditure which are completely different from the transactions commercial substance or practical meaning. The impacts on common performance measures such as Earnings Before Interest and Tax (EBIT) and Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) are significantly affected by a reclassification.

<u>Matching of Revenue and Expenditure Streams for Entities which Sublet</u>: The treatment of leases which are sublet will result in a mismatch in revenue and expenditure streams if lessor and lessee accounting treatments are not consistent. Users will not obtain a true and fair view of profit/loss margins generated by subletting leases.

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Matching of Receivable and Payable Commitments for Entities which Sublet: If a liability is recognised for future obligations, a user would be provided incomplete information if a receivable is not also recognised for future income generated as a result of subletting.

Other Scheduled Commitments: The paper has not addressed the implications on other scheduled commitments. Is there a fundamental or economic difference when comparing operating leases with contracted service and building commitments?

Entities with Large Operating Lease Commitments: The ramifications for entities with large operating lease commitments can result in ambiguous information to users. Refer below for the estimated impact the proposed changes have on DHA's Balance Sheet.

Approach	**Assets ($000)**	**Liabilities ($000)**
Current position	1,700,000	600,000
Adopt Lessee Proposals	3,200,000	2,100,000
Change	1,500,000	1,500,000

The Balance Sheet effectively doubles in size and results in lessee commitments becoming the dominant focus on the Balance Sheet. DHA has grave concerns regarding the shift in focus and how users would view information on non-lease related balances and movements as a result of the proposed change.

Balance Sheet Swings: The lessee proposals as presented, would result in a substantial increase in the size of the Balance Sheet, therefore any movements in the present value calculations on lease commitments will also have a significant impact. Lease renewals, rent revaluations and other rental contingencies have the potential for significant movement. The magnitude of lease commitments means the Balance Sheet will be dominated and determined by lessee obligations.

Cyclical or Seasonal Lease Commencements: The recognition of amortisation and interest expense in the Profit and Loss will result in higher expenditure in the early years of a lease. That is, interest expense will be higher when there is a larger principal. DHA is concerned about the impacts on profitability when lease commencements are cyclical or seasonal in nature. An entity with a large number of operating leases may show unusual profit or loss patterns providing misleading information to users. See "subsequent measurement section" for a simple worked example.

Forecasting: The number of variables involved (rental contingencies and renewals) in calculating the present value of lease payments makes it extremely difficult to reliably forecast results. Financial statements look at a single point in time however users need reliable information when making informed decisions. DHA is uncertain whether the information supplied would be reliable to users. The increased volatility and uncertainty created by the proposal is likely to be significant.

Key Performance Indicators: Impacts to key performance indicators (KPI's) are catastrophic for entities holding a large number of operating leases. Below is a table illustrating the potential impacts to a number of KPI's for DHA.

Key Performance Indicators	Current Budget	Adopt Proposed Lessee Requirements
Return on Capital Employed	7.7%	5.1%
Gearing	36.1%	65.9%
Debt/Equity	57.0%	126.2%
Economic Value Added	0.7M	(102.8M)

Complexity: The complexity of the arrangements would result in extremely high compliance costs. DHA manages approximately 11,000 leases (as lessee) which require rent revaluations annually in December. DHA has approximately 1,500 renewal options and 1,000 lease replacements each financial year. Under the current arrangements we undertake annual reviews of all leases. The proposed treatment would necessitate more frequent and more complex recalculations.

IASB Concerns with the Existing Lease Accounting Standard

We have identified a number of points mentioned in the discussion paper driving the necessity to change the current leasing standard. We have made brief comments in regard to these points which we will feel were not adequately discussed in the paper.

IASB: *Leasing is an important source of finance to business.*

Comments: DHA agrees generally with the comment, however the nature of an operating lease is different in the nature from other forms of financing. In a typical finance arrangement, failure to pay means action against the company with possible bankruptcy action, however operating lease defaults are generally limited to the leased asset. The consequences are therefore very different.

IASB: *It is important that lease accounting provides users of financial statements with a complete and understandable picture of an entity's activities.*

Comments: This can be achieved through mandated disclosures. A schedule of receivable and payable commitments for operating leases would provide users with the same information. Furthermore, disclosures do not introduce additional complexity and uncertainty onto the Balance Sheet and Income Statement. The creation of artificial assets and expenses are not necessary.

For example, Standard & Poors (S&Ps) take operating lease obligations into account in the calculation of gearing levels. They do not need this information to be measured and reported on the balance sheet to achieve their measurement and reporting objectives. They achieve this effectively through appropriate levels of disclosures by the subject entity.

IASB: *The existence of two very different accounting models for leases (the finance lease model and the operating lease model) means that similar transactions can be accounted for very differently. This reduces comparability for users.*

Comments: The fundamentals of a finance lease compared with an operating leases are materially different and this drives the different accounting treatments. The question has to be asked why comparability of two fundamentally different models is required. We understand the need for users to view future operating lease obligations, however, this is quite different to finance lease obligations.

IASB: *The existing standards provide opportunities to structure transactions so as to achieve a particular lease classification. If the lease is classified as an operating lease, the lessee obtains a source of unrecognised financing that can be difficult for users to understand.*

Comments: The solution to this problem is to provide more guidance and illustrative examples so the distinction is made clear. There is also a role and responsibility for preparers and auditors, to interpret and make the right judgement given a certain set of circumstances. Furthermore, most users and preparers clearly understand the distinction between operating and finance leases - this is a strength, not a weakness of the current approach. Moreover, should there be uncertainty then mandate the 'conservatism' principle, which means border-line transactions are classified as finance leases.

IASB: *Preparers and auditors have criticised the existing model for its complexity. In particular, it has proved difficult to define the dividing line between finance leases and operating leases in a principled way.*

Comments: Our experience is quite the opposite. Defining finance leases and operating leases may in some instances be difficult to determine, however we believe the majority of leases can be clearly defined into the two categories. DHA believes the "all in" principal would create more complexity and confusion than the current practice.

IASB: *There are significant and growing differences between the accounting model for leases and other contractual arrangements. This has led to inconsistent accounting for arrangements that meet the definition of a lease and similar arrangements that do not.*

Comments: The substance of the arrangement drives the nature of accounting for the transaction. Differences will continue to grow as commerce and economies evolve. The desire to have a 'unitary' treatment for contracts is considered unnecessary.

Other Issues

Lessor and Lessee Accounting

IASB: *When the boards added lease accounting to their agendas, they agreed that the project would consider both lessee accounting and lessor accounting. However, in July 2008 the boards tentatively decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model. Consequently, most of this discussion paper focuses on lessee accounting.*

Comments: The issue of lessor accounting should be addressed concomitantly. The very significant reasons for this are very clearly articulated by the board in section 1.22(a), (b) and (c) and do not seem to be weighted appropriately in the discussion paper.

Subsequent Measurement

DHA has modelled the initial and subsequent measurement of an operating lease using the proposed approach. Although the worked example is quite simple it does illustrates the balance sheet and profit and loss swings that could occur as a result cyclical or seasonal lease commencements.

A worked example of the proposal is illustrated below. In this example the rental payment grows at 5% per annum over 10 years and a discount rate of 8% is used. The table shows the accounting treatment in each of the ten years. It shows the closing balance of the asset and liability and the impact on financial performance.

The starting value is based on the NPV of the current rental amount over 10 years at 8%. At the end of the first period the payment would be adjusted for the 5% increase and a new NPV would be done at that point taking into account the reduced remaining life. This would result in an adjustment to the liability and a matching adjustment to the asset. The interest and principle repayment on the liability and the amortisation of the asset would then be recalculated.

WORKED EXAMPLE OF OPERATING LEASE BEING RECOGNISED ON THE BALANCE SHEET

Starting Rent	250
Rental Increase	5.0%
Discount Rate	8.0%
Years	10

	1	2	3	4	5	6	7	8	9	10
Rental Expense	**250**	**263**	**276**	**289**	**304**	**319**	**335**	**352**	**369**	**388**
Payment Breakdown										
Interest Payment	$ 134	$ 131	$ 127	$ 121	$ 112	$ 102	$ 89	$ 73	$ 53	$ 29
Principle Payment	$ 116	$ 131	$ 149	$ 169	$ 191	$ 217	$ 246	$ 279	$ 317	$ 359
Total Payment	**$ 250**	**$ 263**	**$ 276**	**$ 289**	**$ 304**	**$ 319**	**$ 335**	**$ 352**	**$ 369**	**$ 388**
Opening Balance	**$ 1,678**	**$ 1,640**	**$ 1,584**	**$ 1,507**	**$ 1,405**	**$ 1,274**	**$ 1,110**	**$ 907**	**$ 659**	**$ 359**
Principle Repayment	($116)	($131)	($149)	($169)	($191)	($217)	($246)	($279)	($317)	($359)
Interim Balance	**$ 1,562**	**$ 1,508**	**$ 1,435**	**$ 1,338**	**$ 1,213**	**$ 1,057**	**$ 863**	**$ 627**	**$ 342**	**$ -**
Adjustment for Rental Increase	$ 78	$ 75	$ 72	$ 67	$ 61	$ 53	$ 43	$ 31	$ 17	$ -
Closing Balance	**$ 1,640**	**$ 1,584**	**$ 1,507**	**$ 1,405**	**$ 1,274**	**$ 1,110**	**$ 907**	**$ 659**	**$ 359**	**$ -**
Asset Opening Balance	**$ 1,678**	**$ 1,588**	**$ 1,487**	**$ 1,373**	**$ 1,244**	**$ 1,097**	**$ 930**	**$ 741**	**$ 525**	**$ 280**
Asset Amortisation	($168)	($176)	($186)	($196)	($207)	($219)	($233)	($247)	($263)	($280)
Interim Asset Balance	**$ 1,510**	**$ 1,411**	**$ 1,301**	**$ 1,177**	**$ 1,036**	**$ 878**	**$ 698**	**$ 494**	**$ 263**	**$ -**
Adjustment for Rental Increase	$78	$75	$72	$67	$61	$53	$43	$31	$17	$0
Asset Closing Balance	**$ 1,588**	**$ 1,487**	**$ 1,373**	**$ 1,244**	**$ 1,097**	**$ 930**	**$ 741**	**$ 525**	**$ 280**	**$ -**
P&L Impact										
Interest Expense	($134)	($131)	($127)	($121)	($112)	($102)	($89)	($73)	($53)	($29)
Amortisation Expense	($168)	($176)	($186)	($196)	($207)	($219)	($233)	($247)	($263)	($280)
Total Expense	**($302)**	**($308)**	**($313)**	**($317)**	**($320)**	**($321)**	**($321)**	**($320)**	**($315)**	**($308)**
Total Vs Rental	**($52)**	**($45)**	**($37)**	**($27)**	**($16)**	**($2)**	**$14**	**$32**	**$54**	**$79**

The effect of this treatment is that the total expense of the business is increased at the start of the lease, and decreases towards the end (due to interest plus amortisation not equalling the rental expense they are replacing). Over the life of the lease, total expenses are the same but a timing disparity is created. As a result of the treatment of expenditure, Net Assets on the Balance Sheet are also negatively impacted throughout the lease term. DHA, with over 11,000 leases, may show a very poor position/performance or very strong position/performance. DHA's performance will be dependant on the lease term status for the majority of leases.

Recommended Approach

DHA believes that the current IASB proposal would create unnecessary complexities for preparers and has the potential to provide misleading information to financial report users. The use of artificial assets and expenditure provide complications for businesses and will surpass any benefits obtained by users from including operating lease obligations on the Balance Sheet. The use of a lease disclosure note (receivables and payables) will provide the same information to users without creating the balance sheet and income statement issues identified. This was not listed as an option in the discussion paper and deserves consideration.

Yours faithfully

Robert Groom
Chief Financial Officer