Australian Government

Department of Finance and Deregulation

Reference: 09/05739
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Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
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Dear Mr Stevenson

IASB Discussion Paper DP/2009/1 Leases - Preliminary Views

The Department of Finance and Deregulation (Finance) encloses for your information our comments provided to the International Accounting Standards Board (IASB) on Discussion Paper *2009/1 Leases – Preliminary Views*. Finance usually contributes to the Heads of Treasuries' Accounting and Reporting Advisory Committee (HoTARAC) comments on proposals. However, as the issues set out in the discussion paper are of significance to Finance and that Finance's views diverge from those of the majority of HoTARAC, Finance has elected to submit its own comments.

Finance would encourage the AASB to consult more widely on the issues raised in the discussion paper and not solely rely on constituents responding in writing to the invitation to comment, due to the significant implications this paper could have on accounting for leases.

Finance acknowledges the desirability of simplifying accounting for leases and the reasons given by the IASB for issuing the paper. At a high level, the core proposal to abolish the current distinction between finance and operating leases is attractive. However, when subject to more detailed scrutiny, we do not believe that the proposals, in their current form, are acceptable. Our reasons for this view are both conceptual and practical.

In addition to the comments attached, Finance notes that Government Finance Statistics currently retains the distinction between operating and finance leases and the IASB proposals will result in a divergence which has implications for AASB 1049 *Whole of Government and General Government Sector Financial Reporting* in the Australian public sector content.

In our view, the issues raised by the IASB would be better resolved by either of the following strategies:

- Greater disclosure (the approach taken with financial instruments); and/or
- A clearer principle for distinguishing between finance and operating leases, perhaps considering the control principle and/or the ability to cancel the lease.

Finance's detailed comments on the proposals are set out in the Attachment.

Please contact Mr Peter Gibson on 02 6215 3551 if you require an additional information or explanations.

Yours sincerely

Tim Youngberry
A/g Deputy Secretary
General Manager, Financial Management Group
13 July 2009

The Department of Finance and Deregulation's Response to DP/2009/1 Leases – Preliminary Views.

General Comments

For the following reasons, the Department of Finance and Deregulation (Finance) is not convinced the benefits of a standard based on the preliminary views set out in the discussion paper exceed the costs.

Conceptual Issues

1. There are conceptual difficulties with the conclusion that rights and obligations under all lease agreements do actually constitute assets and liabilities, particularly when compared with the approach to recognising assets and liabilities in other accounting standards, and when considering the issue of control.

2. "Future" rights and obligations under lease agreements can give rise to executory contracts in many cases, particularly in the case of leases that can be cancelled.

3. The preliminary views on the determination of the lease term and the measurement of the assets and liabilities involve a high degree of management judgement. The reliability and objectivity of the assets and liabilities determined using the approaches set out in the preliminary views could be dubious, resulting in the need for increased disclosure of information to allow users to assess the suitability of the judgement and the impact on the entity's bottom line.

4. The inherent assumption in the paper is that all leases are a means of financing an acquisition. However, Finance does not agree with this assumption as not all lessees want to acquire the asset they just want to use it for a period.

5. The proposals made in the paper result in measurement of assets and liabilities on a hybrid basis, and may not represent either cost or fair value.

Practical Issues

1. Finance is of the view that a lease accounting standard based on the preliminary views set out in the paper will not be superior to the current standard. While a new accounting standard may address the criticisms noted by the IASB in the paper, a range of new issues will arise due to the high level of subjectivity and management judgment in measurement. Finance is of the view that the IASB could address a number of the issues through improved disclosure rather than discarding the current standard.

2. While we note that the paper specifies that there will only be a single asset and liability disclosed rather than "componentised" items, we believe that the inherent subjectivity and management expectation in many of the proposals set out in the document will result in future calls for greater disclosure of the "components", particularly of the liability, and potentially of much greater detail. Finance notes some analysts have already suggested the components approach, which is the direction that disclosure surrounding financial instruments has evolved.

3. The nature of the proposed requirements is such that a much greater amount of work will be required to implement and maintain the standards. The cost of this will exceed the benefits to be obtained from improved disclosure.

While Finance does not support the principles in the paper, it has outlined below its views on the individual questions asked by the IASB.

Specific Questions

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.

   Agree, in part. The narrower scope of SFAS 13 that limits the scope to property, plant and equipment (land and/or depreciable assets) could result in leases involving intangible assets being treated differently with no adequate justification.

   The IASB needs to clearly state if leases that can be cancelled are included in the scope of the standard. The assumption is that they are, and this is a key factor in our comments.

   We note, however, that the scope needs to include accounting by lessors to ensure no mismatching of assets and liabilities.

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.

   No.

   Finance is of the view that conceptually both non-core assets and short-term leases should be included in the scope of the standard if it can be demonstrated that they contain financing elements and that the rights and obligations constitute assets and liabilities. Whilst Finance recognises that these leases have unique characteristics they are no different in substance to other leases.

   However, for practical reasons very short term cancellable leases should not be included as the cost would exceed the benefit.

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.

   Finance agrees that rights and obligations arise in simple lease contracts but they do not inevitably always give rise to the recognition of assets and liabilities.

   Assets can only be recognised where the entity has control, modified in the leasing standard to encompass risks and rewards incidental to ownership. This subject was not adequately explored in the paper.

   Finance is of the view that the IASB needs to review and compare the way other non-derivative commitments/obligations are recognised as liabilities under the accounting standards. Finance does not see any difference between lease agreements and executive service contracts, social benefit commitments and capital commitments. These obligations currently do not require the recognition of a liability under the standards, usually on the basis that the future rights and obligations are executory.

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

   Do you support the proposed approach?

   If you support an alternative approach, please describe the approach and explain why you support it.

   No.

   Further to question 3, consideration should be given to the treatment of executory contracts.

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?

   No.

   Finance is of the view that economic effects and the substance of the separate components should determine how the transaction is recorded and there should not be an absolute rule/requirement in the accounting standards.

   Whilst recognising a single asset and liability maybe straightforward and uncomplicated, Finance is of the view that in the longer term this approach is unsustainable. We believe that users will request greater information on the composition of, and the assumptions behind, the asset and liability due to the high level of subjectivity involved in measurement. This has been the case with financial instruments. For this reason an approach based on greater disclosure could be a better alternative solution to the issues raised by the IASB.

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.

   Disagree.

   Finance is of the view that the rate implicit in the lease should be used to discount the lease payments as this reflects the risks associated with the leased item and will ensure that the discounting of lease payments is inline with discounting requirements in other standards.

   Finance notes, however, that for practical reasons the incremental borrowing rate could be applied to all leases, since many operating leases do not incorporate an implicit rate as they are not financing arrangements.

   The determining of the lessee's incremental borrowing rate over the life of the lease at inception may be difficult and involve significant judgment particularly when the entity does not otherwise borrow and does not neatly fit the profile of existing borrowers. The costs of determining this rate will outweigh the perceived benefits.

   If the IASB does implement this measurement method Finance would strongly recommend that the IASB include guidance in the standard about determining a lessee's incremental borrowing rate for long term leases.

   Finally, Finance notes that the preliminary view does not consider the fair value of the underlying asset at the inception of the lease, as is the case under the present standard. Removal of this requirement, and basing initial measurement solely on discounting cash flows could in many cases result in initial measurement that has no relationship with either the cost or fair value of the underlying asset.

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.

   Agree in part.

   We agree with the concept of measurement at cost, but disagree with the method used to calculate it (refer to the answer to Question 6).

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.

   Agree.

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.*

   No.

   The amortised cost method best reflects the value of the obligation to pay and is considered to be consistent with the initial measurement basis.

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.

    No.

    The incremental borrowing rate should be considered each year but the liability should only be adjusted when the changes are material.

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.

    Agree, noting the answer to question 8 – 10 above.

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.

Yes. Rent is the term currently used, and a change may confuse users of financial statements, particularly for short term leases, but note that this is a consequence of the conceptual flaws in the model.

13. *The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. 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.

Disagree.

Finance believes this approach is too subjective especially for long term leases and would prefer the obligation to pay to be based on the minimum lease term, unless an extension of the term is reasonably certain, with additional information disclosed via the notes.

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

Finance would only support the reassessment of the lease term where the impact is material.

Finance does not consider it appropriate to adjust the carrying amount of the right-of-use asset for changes in the obligation to pay rentals as a result of a change in the lease term as the asset's carrying value will be a hybrid valuation rather than cost or fair value.

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.

Finance disagrees that this should be on the basis of "most likely" outcome.

Finance believes this approach is too subjective especially for long term leases. The "reasonable certainty" approach should be adopted (see question 13)

Under the proposed approach if a purchase option is accounted for and the asset is not subsequently purchased it has been overvalued in the earlier years.

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 note that this is an acceptable approach. However, we do not agree with the preliminary view. As the name implies these rentals are dependent on other factors which will not be known until a future date.

Once again this requirement is too subjective and could allow for the financial positions of entities to be manipulated. For example, an entity could initially recognise the contingent rentals in line with the preliminary view. However, in future periods if the financial position of the entity is under pressure there would be incentives to manipulate remeasurement of the contingent rentals with the objective of reducing the liability.

In respect to very long term leases particularly, it may even be impossible for management to reliably estimate future contingent rentals e.g. rentals on premises that are contingent on price indices, market reviews or rental turnover figures. Rules could be specified as to how these are to be treated, but they will remain subjective and difficult to provide assurance on.

Finance supports the expensing of the contingent rentals as they are incurred.

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.

    A probability-weighted estimate is conceptually superior.

    However, Finance believes both methods are subjective and would rely too much on management judgement. Neither option of measurement is unacceptable as it is impractical to measure without subjectivity (refer to question 16 above). However of the two methods the probability-weighted estimate is preferable as it is consistent with the way other liabilities are determined and best reflects uncertainty.

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.

    No. Finance sees this simply as a rule to overcome the otherwise critical subjectivity in measurement of contingent rentals.

    Finance does not support the inclusion of contingent rentals at the beginning of the lease term. Contingent rentals should be expensed as they are incurred.

    Refer to question 16 regarding subjectivity.

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.

    If the Board requires contingent rentals to be included at inception, the remeasurement of the obligation should only occur when a change is material.

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.

    Finance would prefer any changes in the liability to be recognised in the profit and loss as this approach is similar to financial liabilities.

    If the changes are adjusted against the carrying amount of the right-of-use asset the measurement of this asset will become a balancing item rather than reflecting the fair value or the cost of the asset.

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?

    Finance agrees with the aligning of the accounting treatment. However, we do not agree with the accounting for contingent rentals and residual value guarantees refer to our responses to questions 16 – 19.

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?

    Agree.

    This project is being undertaken by the IASB to improve the understandability of leases by users.

    Due to the significant level of management judgment in measuring the liability it needs to be clearly identifiable in the financial statements.

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?

Finance is of the view that the right-of-use asset should be presented with similar assets but clearly identified as leased assets. If recognised as an intangible asset it effectively undermines the IASB argument that all leases constitute financing the acquisition of an asset.

However, Finance appreciates that this creates an additional conceptual problem since the right-of-use asset is recorded at neither cost nor fair value unlike property, plant and equipment or intangibles.

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

Refer to question 3 and the additional information at the end of this attachment.

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.*

Yes.

Finance is of the view that when the asset recognition test set out in the Framework is met and the contract is not executory, the lessor has the right to recognise an asset.

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.

Finance believes the approach is dependent on the level of control that is transferred to the lessee. If all the future economic flows are transferred to the lessee then the leased item should be derecognised, but if only some of the future economic flows are transferred then a performance obligation should be recognised.

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.

Yes, in the broader context of the revenue recognition projects.

28. *Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting?*

Please explain your reasons.

Yes.

Finance does not believe that this topic can be ignored as most investment properties are leased. Even if a separate standard is retained for investment properties its provisions need to be consistent with the leasing standard.

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

All lessor accounting issues in the paper need to be explored more thoroughly by the IASB.

Additional Information

Finance is of the opinion that the IASB needs to consider the following additional issues prior to issuing an exposure draft for a new leasing accounting standard:

1. Relationship with relevant interpretations including IFRIC 4 *Determining whether an Arrangement contains a Lease*, IFRIC 5 *Rights to Interest arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*, IFRIC 12 *Service Concession Arrangements*, SIC-15 *Operating Leases – Incentives*, SIC -27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, and SIC-29 *Service Concession Arrangements: Disclosures*.

2. Treatment of perpetual leases;

3. Measurement of "peppercorn rentals" or nominal dollar value leases;

4. Arrangements that involve the construction of the leased assets; and

5. Treatment of sub leases when the entity is the lessee and lessor.