



Sir David Tweedie
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cc Mr Kevin Stevenson
Chairman and CEO of Australian Accounting Standards Board

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Dear Sir David

Finance & Treasury Association (FTA) response to ED/2010/9 Leases

The FTA welcomes the opportunity to make comment on the IASB's proposals to amend accounting for leases as set out in Exposure Draft ED/2010/9 Leases.

The FTA is the peak professional body in Australia for corporate treasurers and senior financial risk managers with around 850 members primarily from Australia's top 300 listed corporations. The FTA has been operating for over 25 years in different forms and has established its reputation as a premier provider of continuing professional development (CPD) for finance and treasury forums in Australia.

This is a significant issue for Corporations in Australia and particularly for Corporate Treasurers who use leasing as an alternative form of financing.

Based on the FTA's membership profile outlined above, the FTA has a particular interest in Lease accounting and we have consulted widely with our corporate membership base. The following document details the FTA's responses to the specific questions outlined in ED/2010/9.

The FTA would welcome the opportunity to discuss the information contained in this submission and I can be contacted for further explanation on +613 9653 9532.

Yours faithfully

Mike Dontschuk, FFTP
President



Question 1: Lessees (a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

The FTA would like to express two views. The view of the majority of those that provided their input to inform the preparation of this submission is that a leased asset and liability to make lease payments should only be recognised as an asset and liability if the lease is classified as a *finance lease* by applying the existing requirements in IAS 17 Leases. The definition of a finance lease recognises that certain lease arrangements are in substance the financing and purchase of an asset. We do not believe that a lessee should recognise rights and obligations under executory contracts such as operating leases which are effectively contractual arrangements to use someone else's assets for a period of time. We do not believe that rights and obligations under any executory contracts should be recognised as assets and liabilities and do not believe that there is a strong enough conceptual argument that operating leases are somehow different to any other executory contract. We do not believe there is a strong conceptual basis to recognising assets and liabilities whose existence is contingent upon the continued performance of both parties to a contract.

The view of a minority that provided input is that operating leases of core assets which are plant and equipment and are used to generate income should be recognised as leased assets and lease liabilities, however that the accounting model proposed in the exposure draft is overly complex, subjective and flawed. For example, it results in contractual rights (such as term extension options) being recognised as liabilities.

The definition of core assets at a minimum should exclude leases of property (unless they are finance leases). The definition of property can be drawn from the existing definition of investment property in IAS 40.

The other point we would like to make is that it is not clear from the ED whether the board is more concerned with the measurement of the lease liability or with the right of use asset. In the FTA's view the key point of contention with lease accounting is the non-recognition of liabilities, therefore any lease accounting model should be primarily focused on the recognition and measurement of the liability, not the asset.

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We believe the requirement to amortise finance lease assets under IAS 17 and recognise interest expense on the finance lease liability should be maintained. If operating leases of core assets are recognised as assets and liabilities the leased asset should be amortised and interest expense recognised on the lease liability. Also, these amounts should be clearly labelled as relating to operating leases of core assets so that a user can make the necessary adjustments to reported information, for example, to adjust financial measures such as EBITDA or interest cover ratios. These amounts should also be clearly labelled in the cash flow statement.

Question 2: Lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

The lessor accounting model proposed is based heavily on concepts that already exist in IAS 17. That is, the performance obligation approach aligns closely with the existing operating lease concept, and the derecognition approach aligns with the finance lease concept. We agree that the concepts of operating lease and finance lease for lessors should be maintained, however, we do not agree with the accounting models proposed. They would be costly to implement and do not result in any improvement in financial reporting of leases by lessors.

We do not believe that lessor accounting should be changed from the model that exists under IAS 17. As noted earlier in our submission the key issue in relation to lease accounting is the non-recognition of lease liabilities which relates solely to lessee accounting. The current IAS 17 accounting model for lessors is conceptually sound and results in information that is useful and understandable for decision making purposes.

The performance obligation approach does not improve financial reporting as it results in the recognition of an asset and liability for an executory contract. We do not believe there is a strong conceptual basis in recognising assets and liabilities whose existence is contingent upon the continued performance of both parties to a contract.

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

We do not agree with the boards proposals for the same reasons as set out in 2(a).

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65). (See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We do not support the above proposals. It is unlikely that the measurement of leases with a term of shorter than 12 months would be materially different whether discounted or undiscounted; therefore the application of materiality would achieve a similar result to the above proposals in most cases. In addition, even if it were material, performing a present value calculation for a lease of shorter than 12 months duration would not be particularly onerous.

Question 4

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

We agree that the definition of a lease is appropriate.

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

We believe that the current definition of finance lease adequately captures lease agreements that are “in-substance purchases or sales” of assets. Therefore we do not believe that a separate definition is necessary.

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

We agree that the guidance is sufficient.

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46). Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

We agree with the proposed scope, except in relation to intangible assets. We consider the lack of clarity around the accounting for leases of intangible assets to be unsatisfactory, particularly in relation to the acquisition of software. Companies that are about to make significant capital investment in information technology and are deciding on whether to ‘own’ the software and hardware or have a complete outsourced model (software-as-a-service) are unclear as to what the accounting implications would be. Therefore we urge the board to clarify the accounting for leases of intangible assets.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54).

If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

(i) a lessee should apply the lease accounting requirements to the combined contract.

(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We do not agree that material amounts for non-distinct services in lease payments should be included in the calculation of the lease liability. The standard should allow preparers to separate amounts that are payments for material non-distinct services on the basis of the preparer's best estimate. For example, if a preparer can reliably estimate that payments for the leased asset without the non-distinct service component would approximate 20% of the lease payment, the remaining 80% should be excluded from the calculation of the lease liability.

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

The FTA agrees with the proposal to account for purchase options only upon exercise. The IASB should provide clear guidance as to when the underlying asset should be recognised, as there may be a significant time delay between notifying the lessor of exercise of the option and actually taking control and ownership of the underlying asset.

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not agree with the proposals. A lessee only has a contractual obligation to make minimum contractually required lease payments. Accounting for a lessee's contractual right to extend the term of a lease as a contractual obligation has no conceptual merit. We acknowledge that in certain circumstances term extension options are almost always exercised depending on the facts and circumstances, therefore we would recommend that term extension options are only included in the calculation of the lease liability if they are reasonably certain of exercise (e.g. more than 90% chance of exercise).

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why? Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

The FTA does not agree with the proposal, as the amount recognised in the financial statements may represent an outcome that will never occur given that it will be a probability weighted average of all possible outcomes. In addition, contingencies that are influenced or controlled by the actions of the lessee (sales, usage or other performance measures) are not contractual obligations of the lessee and can be avoided, therefore should not be included in the measure. Lease agreements where the payments are 100% contingent upon the performance of the lessee would result in no recognition of a leased asset or lease liability.

However we do agree that rental payments that are linked to indices or rates that are independent from and not influenced by the lessee or lessor (such as CPI or interest rates) should be remeasured on the basis of the prevailing rate or index.

We believe that disclosures should be required around the nature and potential magnitude of uncertain payments under lease arrangements to provide users with sufficient information into amounts that could become payable in future.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Re-assessment is necessary to ensure that the measurement of the liability at each reporting date reflects the obligations of the company. However, without amending the proposals relating to lease term and contingent rentals to reflect contractual obligations or amounts which are highly probable of payment, the measurement of the lease liability will be highly subjective and volatile from period to period.

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

The sale and leaseback criteria are appropriate in the context of the IASB's proposals.

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

The FTA agrees with the proposals, however, by no longer distinguishing between operating leases and finance leases important information for decision making will be lost. Credit analysts and financiers treat finance leases as indebtedness and do not necessarily include all operating leases as debt of the company. Similarly, finance leased assets are treated as tangible assets, whereas a right-of-use asset in what is essentially a hiring arrangement would normally be treated as an intangible and therefore be excluded from a net tangible asset calculation.

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

We do not agree with the lessor accounting proposals, therefore do not agree with the proposals for presenting rights and obligations of lessors in the statement of financial position.

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

We do not agree with the lessor accounting proposals; therefore do not agree with the proposals for presenting rights and obligations of lessors in the statement of financial position.

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Yes.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Yes.

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Yes.

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from leases; and***
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?***

In the context of the IASB's proposals the objectives of the disclosures are appropriate. However, the FTA believes that the current disclosures in IAS 17 are adequate, and would recommend certain improvements such as mandating that lease commitments are disclosed by class of leased asset to align with the requirements to categorise property, plant & equipment by class.

Question 16

(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

These proposals are not appropriate. Full retrospective application should be allowed as it will result in the recognition and measurement of the lease liability based on the economics (e.g. incremental borrowing rate) that existed at the inception of the lease, rather than on the date of adoption of the standard, unless it is not practicable (meaning that the preparer simply does not have access to the information in order to apply the requirements retrospectively). In addition this will reflect that the leased asset has been amortised for part of its useful life up until the transition date, and that the higher interest charges relating to the earlier period of a lease (which has the characteristics of an amortising loan) have already been expensed in retained earnings.

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

Yes, see response above to question 16(a).

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

No

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

The FTA believes that the costs of implementing the proposals will significantly outweigh the benefits. The financial impact of leases is currently well understood by preparers and users. Users have sufficient information in the disclosures in order to assess the financial commitments of a company therefore we do not see the benefit in changing the way in which leases are reported. The costs of implementation and maintenance of lease accounting going forward will be significant and will have significant knock-on effects to contractual arrangements, regulatory compliance, debt covenants etc. The impact to corporations and financial institutions in renegotiating lending agreements and debt covenants as a result of this accounting change should not be underestimated.

We note the IASB use the argument that because analysts often notionally bring operating leases back on balance sheet that somehow the accounting model is wrong or broken. This ignores the fact that the analyst may simply want to restate the balance sheet on the basis that the company had elected to fund and purchase an asset as opposed to leasing it. It is not necessarily evident that users of financial statements disagree with or are challenging the accounting applied by the company. In any case, the fact the user is able to perform this analysis suggests that the current model is more than adequate to meet the needs of users and that there is no significant benefit to amending lease accounting.

Furthermore, the accounting model being proposed is highly subjective and will result in volatility in reported balance sheets and income statements as well as a lack of comparability between companies. We don’t see how this improves the decision usefulness of financial reports.

Summary

Unlike financial instruments accounting which was in major need of an overhaul, we don’t see the need to significantly change lease accounting. In short our message to the IASB would be “if it ain’t broke, don’t fix it”. Lease accounting is already well understood, and any judgment applied by management in differentiating between finance and operating leases can easily be supplanted by users by referring to the operating lease commitments note.