



AUSTRALIAN BANKERS' ASSOCIATION INC.

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH
UNITED KINGDOM

Dear Sir David,

ED/2010/9 Leases

Thank you for the opportunity to comment on the Leases Exposure Draft.

The Australian Bankers' Association (ABA) works with its members to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services. The ABA works to ensure the banking system can continue to deliver the benefits of competition to Australian banking customers and that industry views are put forward when governments and regulatory bodies or boards determine policy or legislation.

Please find attached the ABA's comments.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Tony Burke', written over a horizontal line.

Tony Burke

APPENDIX – RESPONSE TO SPECIFIC QUESTIONS

The Accounting Model

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?
- 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?

There are differing views amongst our members, with some agreeing with the proposed model. Those that do not agree that a lessee should recognise a right-of-use asset and a liability to make lease payments have the following reasons:

- The recognition of a right-of-use asset, if deemed to be an intangible asset by the regulatory bodies, would lead to a significant reduction in Tier 1 capital for banks worldwide. We note that the reduction for one of our members would be in excess of 90 basis points.
- The implication of grossing up the balance sheet will lead to shorter lease terms. As financial institutions, we cannot lend against non-contractual cash flows. Businesses that rely on the certainty of cash flows associated with contractual lease terms to finance their operations will be crippled by this implication.
- A treatment such as the current treatment whereby operating lease expense is recognised as incurred by lessees who do not hold substantially all the risks and rewards of the underlying asset, is well understood by analysts, shareholders and preparers. Should the IASB be tied to recognising items in the balance sheet of the lessee it is worth considering disclosure alternatives/set-offs.

In addition, some members do not agree that the lessee should recognise amortisation of the right to use asset and interest on the liability to make lease payments for the following reasons:

- The commerciality of a lease is not negotiated based on paying a yield-related expense per month but rather a usage rental that is more akin to the profile of the benefits the entity derives. Hence the proposed treatment does not mirror the economics of the lease and leads to key performance ratios being misleading.
- Under certain jurisdictions, the amortisation of the right of use asset will be non-deductible, and hence this will create tax effect accounting implications and further operational risk around accurate reporting under the new standard.

- The proposed lessee model may lead to existing hedges being rendered ineffective due to a mismatch in the cash flow profile and expense recognition of a lease thus creating additional volatility.

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?
- 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?

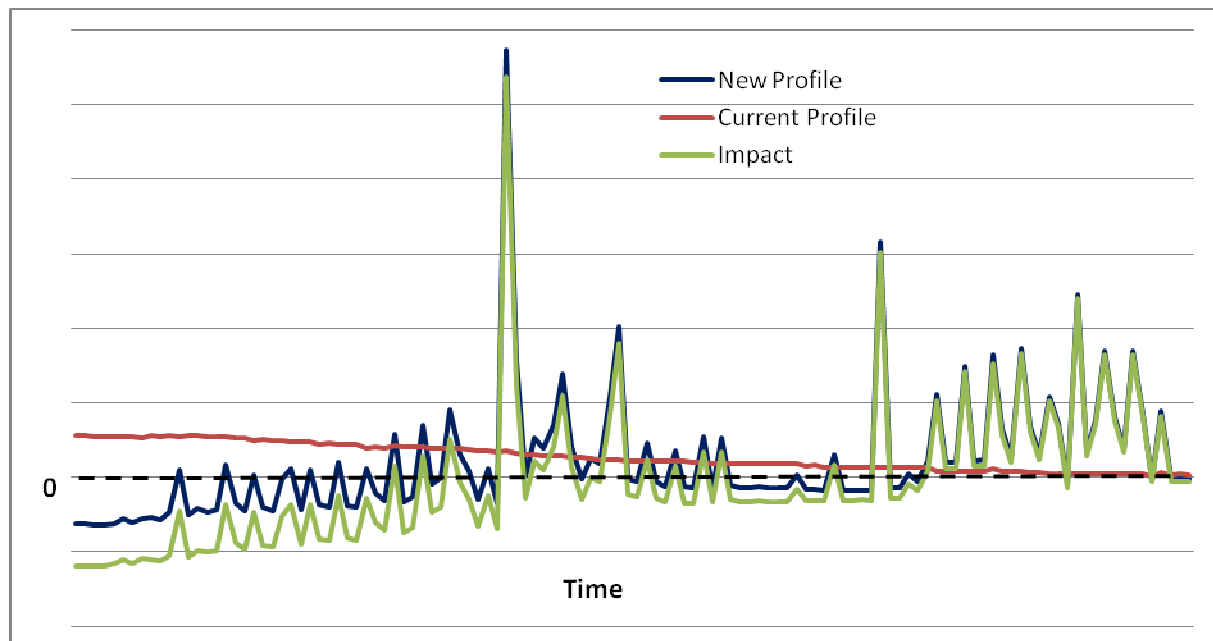
We believe that the derecognition model with small modifications, should be applied to all leases issued by lessors, rather than applying the performance obligation approach. The rationale is as follows:

- The performance obligation approach is inconsistent with the lessee 'right of use' model being proposed. With the lessee recognising its right to use the asset, the lessor does not have an obligation to provide the asset to the lessee anymore, hence the model is contradictory. In addition, there may be three assets and two liabilities recognised between the lessee and lessor as a result of one lease contract.
- The use of one approach will eliminate the subjectivity involved in applying both models and lead to increased consistency and comparability of entities for users of financial reports.
- Based on the two models proposed, the derecognition approach is preferable but flawed. To repair this model, it should incorporate the unwind of the present value adjustment to the residual value asset through interest income over time. Without the adjustment to the residual asset, lessors are left with the deferral of income until the end of the lease which will lead to leases becoming uneconomic in the latter part of the lease and the recognition of a large one-off spike in their profit at the end of the lease. An example of the potential impact from the derecognition approach on the Statement of Comprehensive Income, applied to a portion of a member's leasing book only, is shown in the graph below.
- The performance obligation approach also gives rise to finance income and income arising from the amortisation of the lease obligation, which is inconsistent with the nature of the lease arrangement, where income is earned via the use of the asset. The proposed income and expense treatment under this approach leads to key performance indicators becoming misleading as a lessor will

be earning interest income and "amortisation income" on an asset disclosed as a core asset which it leases out.

Hence we recommend that the Board adopt the derecognition model for lessors, with an adjustment to the model which allows for the interest income from the present valuing of the residual value asset to be unwound over time, to ensure that the commerciality of leasing is retained.

Lessor margin income



Question 3: Short-term leases

The ED 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 (para 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, or 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 (para 65). (See also paras BC41-BC46).

Do you agree that a lessee or a lessor should account for short-term leases on a lease-by-lease basis on the basis of undiscounted cash payments plus initial direct costs? Why or why not? If not, what alternative approach would you propose and why?

We agree that lessors should have the option to account for short-term leases on the basis of undiscounted cash payments plus initial direct costs. However, we do not believe that the short-term lease proposals for a lessee provide an adequate simplification. Lessees are still required to recognise the liability to make lease payments and a right of use asset which will require changes to processes and systems, and a consideration of each lease separately in line with the proposals will be extremely time-consuming for a lease that is short term.

The current proposals will not provide relief to low value leases such as office equipment and communications equipment, whose lease terms are generally greater than 12 months, and will pose a significant administrative and resource constraining burden. Hence, we recommend that the lessees need not recognise a liability to make lease payments and a right of use asset if the lease is deemed to be a short term lease but rather be allowed to apply the current lease accounting model. In addition, our members recommend that the Board extends the maximum possible term of the lease to a range between 24 - 36 months, which will capture a number of low value items which affect businesses of all sizes, and assist with the service contract / lease classification distinction for such items.

Question 4: Definition of a lease

- a) Do you agree that a lease defined as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- b) Do you agree with the criteria in paras 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?
- c) Do you think that the guidance in paras B1-B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary why?

We do not agree that the definition of a lease has been defined appropriately as the definition infers that each lease, being a specified asset, must be accounted for separately. This will lead to an administrative and resource constraining burden on all entities as entities will not be allowed to pool similar assets, as is allowed under other existing standards such as IASB 139.

Furthermore, based on the proposed definition, it will be difficult to distinguish and separate all the service contracts that exist within standard lease documents. Considering the new focus placed on this distinction we recommend that the Board revise the need to distinguish service contracts and provide additional clarity around the practicalities of doing so on for instance large property wet leases.

Scope

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 (paragraph 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 do not agree with the proposed scope in the exposure draft. The proposed scope excludes leases on intangible assets, which would preclude software from being captured within the proposed leasing standard. This implies that contracts which have a software and hardware component, such as leasing automatic teller machines, merchant facility terminals, computers with software installed, communications equipment and so forth, will need to be separately accounted for. This will be operationally difficult to separate, keep track of and account for, and will require even more resources to be allocated to processing the proposals. We therefore propose that if there is a software and hardware component within a lease, the software component is also captured within the proposals unless the software makes up the major part of the asset.

In addition, we request that leases linked to employee benefits are excluded from the scope of the proposed standard. For example, under novated lease agreements such as the provision of a motor vehicle to an employee, employers will be required to report a right-of-use asset and a liability on their balance sheet. Due to the implications of grossing up an entity's balance sheet, this requirement may lead employers to no longer offer this form of salary package arrangement to their employees, and a large number of businesses providing this service will ultimately cease trading.

Furthermore, we believe that subleases should be excluded from the scope of the proposals. The current proposals appear to lead to the recognition as a lessee of a right of use asset and a lease liability and as a sub-lessor, a lease receivable, performance obligation liability and the un-owned underlying asset. If a sub-lease arrangement is undertaken, we recommend that the Board allows netting of the arrangements and accounting for the leases in contemplation of one another.

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 the IASB or the FASB 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?

Whilst there will be practical issues in separating the components, we agree with the proposals that distinct service and lease components should be accounted for separately if possible. If the components are not distinct, we agree with the FASB approach in that the lessee and lessor should apply the lease accounting requirements to the combined contract. This will be much simpler for preparers if a combined approach is applied where components are not distinct due to difficulties in identifying and separating the combined contract.

Q7: 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?

We agree that purchase options, subject to them being bargain in nature, should only be accounted for when they are exercised as there is certainty at that point in time. This is consistent with our view that contingent rent and renewal options should not be taken into account unless there is reasonable certainty surrounding the options.

Measurement

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 proposed definition of the lease term being one based on a probability approach. The approach based on the most likely lease term contradicts the current definition of a liability as the lessee does not have an unconditional obligation at the beginning of the lease. This will lead the lease term to become judgemental and operationally difficult to implement. The assessment of the lease term contract by contract will involve substantial resources in non-productive work and involve significantly increased management time as lease renewals (e.g. over properties, stores, branches etc) are linked to subjective processes such as management strategy.

We believe that the lease term should be based on the contractual term of the lease unless there is a high degree of certainty that the option will be extended.

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?

We do not agree that contingent rentals should be included in the measurement of lease assets and liabilities. Contingent rentals, by their nature are conditional upon a number of factors and hence require judgement and estimation. This will lead to less relevant and reliable information provided to users as the information is based on subjective assumptions. For example, property rentals may have a market review clause within the contract – the estimation of how the property

market will behave is difficult at the best of times, and the majority of entities will have such a lease. We therefore believe that only known contractual rentals should be included in the measurement of lease assets and liabilities to ensure useability and comparability in the financial statements. We recommend that the Board request disclosures of estimation uncertainty relating to contingent rentals instead.

We would recommend that in order to remove judgement and subjectivity that comes from including contingent amounts payable under term option penalties and residual value guarantees these amounts should only be recognised once their payment becomes probable.

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?

As we do not agree that a probability weighted lease term and contingent payments should be taken into account as discussed in our response to questions 8 and 9, we also do not agree that these contingencies should be reassessed. Reassessment will lead to an increase in resourcing required, an increase in operational risk, further volatility recognised in the statement of financial position and statement of comprehensive income, further judgement being applied to an estimate, and pragmatic issues in developing reassessment processes for our member's numerous leases, both as lessee and lessor. We note that one of our members has approximately 250,000 lease contracts it is party to; hence we recommend that reassessment should only occur if there are changes in the contractual terms of the lease.

Question 11: Sale and leaseback

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?

Our members have differing views on the proposals, with some members agreeing with the proposals, whilst others do not agree. Those that do not agree site the fact that the exposure draft contemplates separately the definition of a sale and lease and therefore the specific provisions are not required. Furthermore, as discussed in question 2, members do not agree with the performance obligation approach to lessor accounting which is required under the sale and leaseback provisions.

Presentation**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 (paras 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?
- 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 (paras 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?
- 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 (paras 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?
- d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paras 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?

In response to part a), we believe that a lessee should present the liabilities to make lease payments separately from other financial liabilities in the notes. In addition, as the right of use asset is not a tangible asset, we ask that this be presented separate to the tangible assets. Comments made in question 1 regarding removing these amounts from the balance sheet entirely aside we would prefer the right of use asset and lease liability to be presented within the same category on the statement of financial position as the lease does not give rise to a real financial liability or a tangible asset.

In response to part b), we believe that a lessor applying the performance obligation approach should only present the net lease asset, with disclosure in the notes of the gross position. The gross up in the statement of financial position provides less clarity to users of the financial statements and could be misleading to users. Furthermore, the gross up in the statement of financial position will impact upon other legal requirements such as regulatory capital.

As banks regulated by the Australian Prudential Regulation Authority (APRA), we have a significant concern about the potential unintended effect of the proposals upon our regulatory capital levels. APRA's policy is to follow accounting treatment except in very limited circumstances. The proposals will increase the level of

assets that a lessee preparer who is a bank has on its balance sheet, require a risk weighting to be applied to them, and require regulatory capital to be held against them. This will increase the bank's costs which will then have to be passed onto customers. While we will attempt to seek relief from APRA in relation to such a regulatory capital outcome, our experience is that it will be difficult to obtain relief on such a technical issue quickly

In response to part c), some members agree that the right to receive lease payments should be presented separately from other financial assets. However, other members do not agree that a lessor's right to receive lease payments under the derecognition approach should be presented separately from other financial assets as the financial asset in substance, represents a yield earning loan, and believe that the split should be documented in the notes. In addition, lessors should be able to present the residual asset (noting our recommendation to present value this amount in question 2) within financial assets, which will be representative of the fact that they are income yielding assets, with separate disclosure in the notes.

In response to part d), we do not agree that a lessor should distinguish between assets and liabilities that arise under a sublease in the statement of financial position, rather the assets and liabilities should be netted on the face of the statement of financial position with the gross position disclosed in the notes.

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 (paras 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?

We believe that separate disclosure should be dependent upon the existing materiality requirements.

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 (paras 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?

We believe that separate disclosure should be dependent upon the existing materiality requirements.

Question 15: Disclosure

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

(paras 70-86 and BC168-BC183)? Why or why not? If not how would you amend the objectives and why?

In addition to having all disclosures subject to materiality on the entity reporting we believe that disclosure of measurement uncertainty should be considered under the existing provisions of IASB 101.125.

Question 16: Transition

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

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

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

We do not agree with the proposed simplified retrospective approach. This approach will lead to the recognition of significant leasing balances on transition even though the leases were entered into over a number of years. This will skew the statement of financial position and the results in the statement of comprehensive income. Any upfront profit or loss arising from the derecognition model will be recognised at the same time on transition, and all leases will have a similar profile that will not represent a potentially staggered leasing portfolio, in that there will be more finance income or expense recognised in the earlier years.

The skewed results will require the education of investors and analysts in the year of implementation and going forward as the transitional leases roll off. Hence, some of our members consider that full retrospective application should be provided as an option such that the volatility and impact on transition can be minimised for users and preparers. Alternatively some members did not support the full retrospective approach but asked that the IASB consider grandfathering be applied to existing leases.

We recommend that the Board also consider the following issues arising from transition:

- The proposed standard changes are extreme, leading to a significant change in the way leases are recognised. In addition, the proposals appear to require that each lease be accounted for separately, inclusive of contingent rentals and option renewal periods which require forecasting and estimation. Hence the time and resourcing required on transition will be significant and

onerous. We therefore recommend that the Board consider a long lead time for implementation;

- In addition, we recommend that the Board considers the number of International Accounting Standards to be implemented at the same time. This will place a significant operational and resource burden on organisations, which may also be dealing with other regulatory reforms such as capital.
- Systems will also need to be replaced and an adequate leasing system built, which will cater for the changes required in the standard. The ability to implement the standard will be dependent upon these leasing systems becoming available. Considerable changes would be required to existing systems, including the flow on effect to management and reporting systems, which are expected to cost in the millions of dollars.
- Furthermore, the impact to Risk and Treasury systems for the amortisation of the new balance sheet profiles may lead to large break costs associated with existing fixed rate hedging profiles.

Question 17: Benefits and costs

Paras BC200-BC205 set out the boards' assessment of the cost 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?

We do not agree with the Board's assessment that the benefits of the proposed requirements will outweigh the costs. It would appear the benefits identified centre around greater transparency and information for users. We see the inclusion of subjectivity around lease terms, contingent rents and the reassessment process to add confusion for users, and complicate preparers' tasks significantly. We would also ask which users the IASB has surveyed when identifying these benefits as ratings agencies and analysts have not listed the information provided in the standard as better but just something more to consider. Therefore, considering the costs and time involved in providing this information, this does not seem to be an outweighing benefit.

Question 18: Other comments

Do you have any other comments on the proposals?

We would ask that the exposure be contemplated in light of other standards that it will interact with significantly such as the hedging and revenue recognition exposure drafts, and the existing tax standard. Guidance on how these pronouncements interrelate would be extremely useful.