2013-270 Comment Letter No. 421



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Hans Hoogervorst
Chairman
International Accounting Standards Board
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Dear Mr Hoogervorst

Re: Invitation to Comment on Exposure Draft ED/2013/6 "Leases"

We welcome the opportunity to comment on the Exposure Draft ED/2013/6 *Leases* (the Exposure Draft) issued by the IASB in May 2013.

Whilst we agree that there is a need for clarification on lease accounting issues and we support the initiative to achieve proper recognition of assets and liabilities arising from leasing arrangements, we disagree with a number of the proposals in the Exposure Draft. Our main concerns are as follows:

Complexity

We do not believe the lease model proposed in the Exposure Draft has met the IASB's objective of reducing complexity. Whilst the ultimate objective of the Leases project of recognising all leases on balance sheet might be largely achieved, we do not agree with the retention of a two model approach which is on a different and far more complex basis to that currently employed. We do not agree with compromising fundamental IFRS principles by the inclusion of arbitrary rules and exceptions. We are also concerned that the proposed exception for short term leases will provide structuring opportunities to manipulate accounting outcomes. It would be far simpler and more robust to simply emphasise the role that materiality should take in the application of the proposed standard. Overall, the proposed standard creates an extremely complicated methodology for preparers as well as accounting outcomes which are difficult to comprehend by users. Given many aspects of the current model work well in practice, we encourage the IASB to construct a simpler solution for lease accounting that draws from proven principles.

Cost vs benefit

While we understand the objectives of the IASB in seeking to modify the accounting for leases by both lessees and lessors, we do not believe that the IASB has clearly demonstrated that the benefits expected to arise from its proposals justify the cost. The proposals contained in the Exposure Draft will impose significant cost on many entities, both in the initial analysis and implementation phases as well as in the ongoing accounting. We expect that most of the benefits anticipated by the IASB could be achieved through enhanced disclosure rather than the outcomes of the complex method of accounting proposed in this Exposure Draft. Given the significant costs of implementation, it is critical that a simpler (and single) model for both lessees and lessors be pursued to better demonstrate the cost / benefit equation.

Areas that are likely to create significant work and cost which should be considered by the IASB include:

- Determination of whether the right to use an asset which is embedded in a service contract is a Type A or Type B lease. Currently most assets embedded in service contracts in the mining and oil and gas sector are clearly operating leases and therefore the accounting outcome for the operating lease is currently the same irrespective of whether the total costs of the contract are expensed as incurred or the operating lease is separated from the contract. Having to measure and separately account for these leases will be a significant impost on the mining and oil and gas sector. Our view is that these contracts are essentially executory contracts and should continue to be accounted for as such. However, if a lease is to be separated from the host service contract, a single model of accounting for that separation would minimise the incremental cost of compliance.
- Determination of a stand-alone observable price when separating the service component from the lease component of a lease contract. Our interpretation of the proposals is that regardless of whether a separate price is quoted in a service contract for the service component and lease component, the lessee will be required to benchmark these prices against market rates. Depending on the availability of market prices for the comparable service and lease components (many of which may be unique or unusual in some industries) significant cost and effort will be incurred to separate and measure the value of each component.
- Reconfiguration of joint venture billing systems and rewriting joint venture contracts to allow depreciation and interest costs to be billable. In the oil and gas sector it is common for equipment to be leased by an operator of a joint arrangement as principal. The operator then charges out the cost of leasing the equipment based on the cash lease costs incurred by the lessee. As the methodology proposed in the Exposure Draft incorporates both depreciation and interest into the measurement of the lease expense, the lease expense incurred in a Type A lease will be disconnected from the income received on recoupment of the cost from the joint venture parties. It is probable that the re-charge arrangement might constitute a sub-lease, in which case the operator will need to apply both lessee and lessor accounting, together with a cash based cost recovery process. It is evident that a single lease model that is consistent for lessees and lessors will greatly reduce the cost of compliance with the proposed standard.
- Re-measurement of contingent rentals based on an index or market rate and changes in the
 discount rate. This will require extensive modifications to systems and processes to capture
 these changes. A far simpler and cheaper model would be to value variable payment
 arrangements at the outset of the lease and incorporate them into the initial measurement of the
 lease asset and liability. Thereafter, remeasurement should be required only in the event that a
 remeasurement is triggered, similar to the triggering of asset impairment assessments.
- Information systems and processes. For many entities operating outside the finance sector, and
 with large numbers of operating leases, the proposals in the Exposure Draft will require the
 design and implementation of new information systems and accounting processes. The cost of
 implementation of such systems will often be significant, but those costs can be mitigated with a
 single, simple and principles based accounting method.

Operating Leases embedded in a Service Contract

We consider the requirement to account for an entire contract as a lease if the lease component is not distinct to be extremely onerous. For some entities, this will result in a significant amount of otherwise normal executory contracts being brought onto the balance sheet. The implications of this are:

- The recognition of the service component of a lease as a liability and a "right of use" asset contrary to the definition of an asset and liability under the current IFRS Framework.
- Liabilities will be overstated for those entities which use service contracts (where the service component is not distinct) to operate their business compared to those companies which

perform those activities with their own employees, use normal executory contracts (which do not contain an element of leasing) or are able to separate the service component from the lease. Comparison between these different types of entities will be misleading and confusing to users.

 The resulting overstatement of liabilities will result in inflated and inaccurate gearing and other leverage ratios. This could lead to inadvertent breaches of banking covenants, potentially higher costs of finance as the leverage position is incorrectly stated and impact upon credit rating of entities by rating agencies.

A better solution for service contracts (with an embedded lease but a non-distinct service component) is to require management to estimate the fair value of the lease component to permit separate accounting of the lease asset and service components. Where management is unable to reliably estimate the fair value of the lease component, the entire contract should be accounted for as an executory service contract, supplemented with disclosure of the timing and present value of future payments to be made under the contract. This would provide the relevant information to the users of the financial statements without bringing assets and liabilities on to the balance sheet which do not meet the definition of an asset or liability under the IFRS framework.

Our responses to each of the questions raised in the Exposure Draft as well as additional comments on some of the proposals within the ED are outlined below.

Question 1: identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

- (a) fulfilment of the contract depends on the use of an identified asset; and
- (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Determination of an identified asset

We consider the way in which the Exposure Draft seeks to define an "identified asset" is likely to lead to problems in application in the following ways:

• The definition of a lease has determined that the underlying asset in a lease can be a physically distinct portion of a larger asset however cannot be a capacity portion of an asset that is not physically distinct. Examples of capacity portion arrangements include the rights to use a specified portion of a fibre-optic cable, gas pipeline, freight train route etc, that are less than substantially all of the capacity of the physical asset. In some circumstances, the assessment of whether the lessee is confined to a capacity portion of an asset would be difficult to determine as a customer would not necessarily know what portion they employed of the total capacity of an asset.

As an example, a freight contract could involve the use of the entire vessel or merely specify an amount of cargo to be delivered (and that portion may not represent the total capacity of the vessel). Where the charterer or customer has specified an amount of cargo to be delivered, when assessing whether the arrangement relates to a non-physically distinct portion of an asset

that represents substantially all of the capacity of that vessel, (and hence could be an identifiable asset) both the customer and the shipper would need to assess whether the volume of cargo contracted for delivery over the life of the contract represents substantially all of the vessel's capacity. Such an assessment may be a simple exercise for the shipper, who would have ready access to such information. However, the customer may need to obtain additional details from the shipper in order to make such an assessment.

• It is unclear as to how the identified asset test, with respect to a lease of a capacity portion comprising substantially all of the capacity of an asset, should be performed when there is a possibility that a third party could take a capacity portion of that asset.

For example, consider the situation where a customer is able to direct the use of a power plant (based on the power plant not being able to be substituted due to remote location and the customer making most decisions in relation to the day to day running of the power plant) and any power produced that was excess to the customer's needs was put back into the grid and sold to third parties. This would indicate that the customer is not taking all the output of the plant but still "controls" the use of the asset. If this customer is being charged on a per unit basis and they are therefore taking output from the power plant which may or may not be a capacity portion of the power plant, the test of an identified asset will depend on the interpretation of whether it is possible the customer's requirements will vary and the likelihood of a third party taking some of the output in the future.

• The illustrative example 5 in the Exposure Draft for a contract for power does not clearly illustrate the mechanics of determining if a contract is a lease or contains a lease. Example 5B explains the power plant is not a lease as the customer has no ability to direct the use of the plant that is used to make the power. However, there is no mention in this example as to whether the first lease assessment test prescribed by paragraph 7(a) has been met (i.e. is the customer taking a capacity portion of a larger asset) and therefore there is a question as to whether the power plant is an "identified asset" in the first place.

We believe that more clarity is required to understand the Boards intentions with respect to the application of the capacity portion criteria. However, a far simpler solution is to extend the application of lease accounting to capacity portion arrangements. We see no conceptual basis to the exclusion of such arrangements, particularly when the leased asset is characterised as a right of use of the underlying asset, not the physical underlying asset itself.

Determination of control based on influence over returns

We agree that it is appropriate that the definition of control be aligned with concepts of control applied in other IFRS requirements and projects (that is, the revenue recognition proposals and consolidation requirements). However, we believe that it may be difficult in practice to determine if one party in a supply arrangement has greater "control" over an asset than the other party. The control concept may be more difficult to apply for a single asset particularly when the way in which an asset is directed may be the result of a negotiated outcome between parties. Often it is not one single party that makes decisions about the operation of an asset in a lease contract. Decisions may be agreed upon upfront unanimously by both customer and supplier. Therefore in such a case it may be difficult to determine if the customer or supplier has "control" over the asset. This will further complicate the analysis of whether the right to use an asset is a lease at the time of transition for already existing negotiated service contracts.

As an example, a customer may stipulate a certain level of maintenance be undertaken by the supplier of the asset during the contract term. Because the supplier is maintaining the asset does this indicate the supplier has control over the maintenance of the asset or because the customer has stipulated the level of maintenance does this mean the customer has control over the maintenance of the asset?

Separation of Service Component from Service contract

In the Basis of Conclusions the Board has stated, in describing the difference between leases and service contracts (for the lessee) that the customer typically has an unconditional obligation to pay only for the services provided to date for a service contract. In addition, although fulfilment of a service contract may require the use of assets, fulfilment typically does not require the delivery of an identified asset. We disagree with this assertion as often fulfilment of services in the mining and oil and gas industry will require the delivery of an identified asset (as defined). An example of a service arrangement common in the mining industry involves mining contractors delivering both labour services and their own mobile equipment when providing mining services. Often the contract is priced on a per unit of output basis. The right to use the mining equipment typically satisfies the definition of a lease as the mining entity will be deemed to have control over the equipment as:

- The equipment is not easily substituted as mines are often located in remote areas
- The mining company will direct what material is to be mined and impose their own safety standards and operating procedures which dictate how the equipment is to be configured and used.

However, because of the pricing structure, it is difficult to separate the service component from the lease component. Often the mining equipment is built to specification and so would make the determination of an "observable stand-alone price" difficult. As the contract is priced on a per unit basis there is no benchmark in the contract itself to separate the service component from the lease component. Under the proposals in the Exposure Draft, as there are no observable stand-alone prices from the lessee's perspective, the mining entity would be required to bring the entire contract onto the balance sheet. However, the obligation to make payments under the contract does not meet the definition of a liability under the current IFRS framework as the mining company does not have an obligation to pay for services not yet received. As a result, companies with long standing contractual arrangements which are unable to be separated into a service component and a leased asset component will be disadvantaged at transition due to the recognition of additional liabilities.

We believe a better solution for service contracts (with an embedded lease but a non-distinct service component) is to require management to estimate the fair value of the lease component to permit separate accounting of the lease and service components. We understand that the Boards have gone some way to allowing management to estimate the embedded lease component however we would like the determination to be widened to allow an estimate of fair value rather than an observable stand-alone price.

Where management is unable to reliably estimate the fair value of the lease component, the entire contract should be evaluated to determine its principal purpose and substance and accounted for according to the conclusion reached. If the service is being delivered and paid for on a unit of output basis and the contract is cancellable, this would indicate a service is being provided on an executory basis, regardless of the entity's ability to direct how the embedded leased asset be used. Contracts written on this basis should be accounted for in the same way as other executory contracts, supplemented with disclosure of the timing and present value of future payments to be made under those contracts. This would provide relevant information to users of the financial statements enabling them to assess the impact of such contracts on the future cash flows of the entity, without bringing assets and liabilities onto the balance sheet which do not meet the definition of an asset or liability under the IFRS Framework.

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

No, we do not agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

It is clear to us that the proposed two model approach has not met the IASB's objective of reducing complexity. Rather, it appears to have created a more complex accounting solution that is not warranted.

We encourage the IASB to explore a simpler solution for lease accounting. We believe that it would be simpler and more appropriate to account for lease contracts using the existing principles already set out in other accounting standards. As such, any right to use the asset would either fall under IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets and the obligation to make payments would either be a financial liability under IAS 39 Financial Instruments: Recognition and Measurement or if the timing and amount of the liability are uncertain then it would be appropriate to account for the liability under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. However, if the contract was executory, no asset or liability would be recognised.

Therefore in principle we agree with most of the recognition, measurement and presentation requirements relating to Type A leases however we do not believe that a different method is warranted for Type B leases. The method of accounting for Type B leases is rule based and therefore contrary to other IFRS. That is, the amortisation of the right of use asset, under the proposed Type B methodology, is in effect a balancing figure to achieve a straight-line expense in profit and loss and combines a financing cost and amortisation of the right of use asset. Our view is that once the right of use asset is recognised it should be measured independently from the lease liability.

In removing the requirement to assess whether a significant or insignificant portion of the economic benefits embedded in the underlying asset are being used, the accounting requirements for leases will be simplified with fewer structuring opportunities. Our views regarding lease term are set out under Question 5 below.

Also we consider that it is a peculiar accounting outcome to change the way in which a leased asset is accounted for based on whether the asset is being used at the beginning of its useful life or the end. For example, a property asset might be accounted for as a Type B lease for most of its useful life and then towards the end of its useful life it may be re-leased under the same terms and conditions and therefore become a Type A lease.

Question 3: lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

No, we do not agree with the proposed two model approach as discussed in answer to question 2 above relating to lessee accounting.

Of the two models proposed in the Exposure Draft, we strongly prefer the Type A approach. We believe that a lease accounting model under which both parties to a lease apply consistent concepts in determining the accounting treatment is necessary.

We also consider that the accounting under a Type B lease is inconsistent. If the lessee is required to recognise an asset and liability for the right to use the asset then we do not understand why the reverse accounting should not be adopted for the lessor. If the Board believes that the lessee is making payments to use the asset during the lease term (rather than to acquire a portion of the underlying asset as in a Type A lease) then it is inconsistent for the lessee to be recognising a lease liability and the lessor to not be recognising a lease receivable.

Question 4: classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

No, we do not agree with the proposed two model approach as discussed in answer to question 2 above relating to lessee accounting.

The IASB set out to create a single lease accounting model and in presenting two models in this Exposure Draft they have not met their objective. We strongly encourage the IASB to not be swayed by individual lobby groups in their determination of accounting standards but to strive towards their initial objective. The proposal will mean very little change for the property sector however has added significant work to companies in many other industries.

We do not see the point of replacing the existing two model approach to lease accounting with another two model approach. Given a choice we would prefer to continue using the existing finance lease approach rather than change to a hybrid model which has been designed to appease certain industries rather than adhering to IFRS principles and the IASBs stated standard setting objectives.

Question 5: lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We do not agree that options should be taken into account when determining the lease term as an entity does not have a liability for the option term until the option is exercised. The Framework definition of a liability requires there to be a "present obligation". Until the option is exercised there is no present obligation for the lessee to make payments relating to the option term. Under a Type A lease proposed in the Exposure Draft, the inclusion of optional periods in the lease term will impact the size of the recognised asset and liability on the balance sheet and will result in overstated debt levels.

We believe that lease term should be determined with consideration of the period of time over which the lease is non-cancellable and with reference to the definition of assets and liabilities in the Conceptual Framework.

Question 6: variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We agree broadly with the Boards approach to the initial measurement of variable lease payments. We acknowledge that variable lease payments that depend on an index or rate in the measurement of the lease assets meet the definition of an asset (for the lessor) and liabilities (for the lessee) because they are unavoidable. As these payments are unavoidable payments, the uncertainty therefore relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability. However, we also believe that other variable lease payments, such as those which may vary based on the volume of use or the value of turnover, should also be included in the initial measurement of the lease asset and liability, as such amounts are obligations that cannot be avoided at the discretion of the entity.

We do agree that, consistent with the requirements of IFRIC 1 "Changes in Existing Decommissioning Restoration and Similar Liabilities" it is appropriate to re-measure the assets and liabilities under a lease when there is a change in the facts and circumstances which indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments. However, we are concerned that the re-measurement as proposed would create significant work to identify potentially large numbers of minor changes. Accordingly, we would prefer that the re-measurement mechanism operate in the same way that impairment trigger tests operate under IAS 36. That is, no re-measurement is required unless there is an event or change in circumstances which would indicate that a re-measurement is necessary.

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

We consider that in providing a choice, entities will feel obliged to measure the transition adjustments applying both methods to determine which gives them a preferred outcome. Given that leases vary in length and lease costs are usually greater in the earlier years, it would be impossible to determine the impact of the two proposed methods without doing both calculations. This will add considerable effort to the transition. We therefore propose that the Boards agree on one approach to transition.

Our preference is to mandate use of the modified retrospective approach whereby the liability of the lessee is measured at the present value of the remaining lease payments and the asset is measured based on the applicable proportion of the lease liability, adjusted for any previously recognised prepaid or accrued lease payments.

We would like to see some relief given to entities with operating leases embedded in service contracts. If the IASB proceeds with the proposal to bring the entire service contract onto the balance sheet where observable stand-alone prices are not available, we urge the Boards to reconsider the transition provisions and exclude pre-existing contracts which are essentially service contracts with an embedded operating lease. This relief is appropriate because the identification of the service component will be reliant upon information from the service provider which will often be problematic given its commercial sensitivity.

Significant work to review all lease contracts, and contracts with embedded leases, will be required prior to application of this proposed standard and therefore, we urge the IASB to consider a long lead time of at least three years to the effective date of this proposed standard.

Question 8: disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We do not consider that the benefits to be derived by analysts and other users of the financial statements, in providing the additional disclosures proposed in the Exposure Draft, justifies the cost to the preparers of financial statements, specifically in relation to lessees. Many users currently include the operating lease amounts currently disclosed in their assessment of a company's financial position, thereby achieving their primary objective very simply and with no additional work required of preparers.

We consider that the most important information relevant to users of the financial statements is the timing and present value of lease liabilities (in the lessee's financial statements) and the assumptions used to determine the amounts presented. The roll-forward disclosure from opening to closing balances of both the right of use asset and the lease liability is extensive and it will be costly to implement the processes and systems to collate this information. We therefore do not support the provision of this additional information.

Question 12 (IASB-only): Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Yes we do agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property as we are firmly of the opinion that it is simpler and more appropriate to account for lease contracts using the existing principles already set out in other accounting standards rather than adopting a different measurement method for what is essentially the same asset.

We would like to thank the IASB in providing the opportunity to comment on this important issue.

Yours sincerely,

Brett Rix

Vice President External Reporting and Governance