

15 December 2010

International Accounting Standards Board 30 Cannon Street, London EC4M 6XH, UK

Submitted via email to <a href="mailto:commentletters@ifrs.org">commentletters@ifrs.org</a>

RE: Exposure Draft ED/2010/9: Leases

Dear Chairman

We appreciate the opportunity to respond to the proposed Exposure Draft, ED/2010/9, *Leases* ("the ED" or "new Standard").

This letter represents a group response from the members of the Australian Constructors Association ("ACA").

ACA was formed in 1994 to advance the interests of major construction contractors ("we", "us", "our Industry" or "the Industry"). ACA has 20 members (see Appendix A) who have combined revenue of over A\$40 billion and employ over 86,000 people directly and hundreds of thousands more employed by subcontractors on member projects. Our members provide long-term construction related services to customers around the world. The services provided by ACA members are broad and can vary widely from one project to the next, and typically include some or all of the following: program management, planning, design, engineering, procurement (services and/or material procurement), fabrication, construction, construction management, logistics, start-up/commissioning, operations and maintenance, and decommissioning/closure services.

Our focus on the ED is from the point of view of the impact on the contracting industry. Our response reflects the collective perspective and view of the entities named at Appendix A.

Our response to the specific IASB questions is provided in Appendix B.

In summary, we believe that the current accounting and classification of leases as either operating or financing should be retained as it reflects the risks and rewards in leasing agreements and including all leases on balance sheet has the potential to mislead users (see response to Question 1).

In the event the Boards proceed with the approach outlined in the ED, we believe:

 The significant costs of accounting for short term leases under the ED, including the need for preparers to develop new systems, outweigh the limited benefits to users (see response to Question 3). Abigroup Contractors
Ptv Limited

Baulderstone Pty Ltd

▲
BGC Contracting Pty Ltd

Bovis Lend Lease
Pty Limited

▲
Brookfield Multiplex
Constructions Pty Ltd

▲
CH2M Hill Australia Pty Ltd

▲ Clough Limited

Downer EDI Limited

Fulton Hogan Pty Ltd

▲
Georgiou Group Pty Ltd

John Holland Group Pty Ltd

Laing O'Rourke Australia
Construction Pty Limited

Leighton Contractors
Pty Limited

▲
Leighton Holdings Limited

Macmahon Holdings Limited

McConnell Dowell
Corporation Limited

▲
Thiess Pty Ltd

▲ UGL Limited

▲
Valemus Australia Pty Limited

Watpac Limited



Additional guidance should be provided in relation to contracts containing service
and lease components to avoid any misinterpretation that could result in the wet
hire or subcontracting of construction services, or the provision of contract mining
services, being regarded as containing lease elements and therefore being
accounted for as leases (see response to Question 6).

ACA would welcome the opportunity to be involved in the further development of this standard and is more than willing to provide further submissions and/or presentations as required.

If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact the undersigned.

Yours sincerely,

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### Appendix A

### **MEMBER COMPANIES**

Abigroup Limited

Baulderstone Pty Ltd

**BGC Contracting Pty Ltd** 

Bovis Lend Lease Pty Ltd

Brookfield Multiplex Constructions Pty Ltd

CH2M Hill Australia Pty Ltd

Clough Limited

**Downer EDI Limited** 

Fulton Hogan Pty Ltd

Georgiou Group Pty Ltd

John Holland group Pty Ltd

Laing O'Rourke Australia Construction Pty Limited

Leighton Contractors Pty Limited

Leighton Holdings Limited

Macmahon Holdings Limited

McConnell Dowell Corporation Limited

Thiess Pty Ltd

**UGL Limited** 

Valemus Australia Pty Limited

Watpac Limited



Appendix B

# Response to specific questions in the Leases Exposure Draft

### **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?

We disagree with the proposal to remove the operating and financing lease distinction and record all leases on balance sheet.

The distinction between operating and finance leases in IAS17 was to reflect "the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee" [IAS17.7]

"A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership." [IAS17.8]

We agree with this distinction and believe it reflects the risks and rewards inherent in leasing arrangements.

It is important to note that leasing of assets is not just a pure financing decision. Leasing of assets is an important part of contractors risk management strategy. Operating leasing enables contractors to mitigate the risks of ownership of assets, including:

- Idle equipment risk use of leased assets provides flexibility on the type of equipment and size of the fleet via the ability to cancel the lease and return the equipment to the lessor on short notice. This is a key commercial consideration where contract mining agreements can be cancelled or are significantly shorter in term than the useful life of the required mining equipment;
- Political risk use of leased assets in countries with high political risk enables contractors to "walk away" in the event of conflict; and,
- Residual value risk use of leased assets enables the use of untested technology in new environments without the contractor bearing the risk of higher than expected wear and tear.

Leasing can also provide additional benefits, such as access to enhanced equipment servicing not otherwise available.

Including all leases on balance sheet has the potential to mislead users that contractors are exposed to risks in relation to leased assets that lessee's are not. It is the lessor who bears the risk of:

 the economic depreciation of the asset, including the assets ability to physically withstand wear and tear;



- obsolescence caused by technological advancement; and,
- the operation of secondary markets for the assets, including periods of prolonged equipment shortage or surplus.

The lessor is generally in a better position to assess, price and manage these risks than the lessee, particularly if they are the equipment manufacturer.

The risks borne by the lessor are already adequately reflected in the operating charge the lessee pays, currently recorded in the profit & loss. Lessee's commitments under lease agreements, either cancellable or non-cancellable, are also already adequately disclosed.

As a result we believe the Board's should retain the existing leasing framework rather than that proposed in the ED.

#### **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 do not agree with two separate approaches to lessor accounting. We believe the derecognition approach should be used as it better mirrors the lessee accounting.



#### **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 agree with the proposed treatment for short term leases (less than 12 months). The cost for lessees of recording short term leases as proposed outweighs the benefit to users of the proposed presentation. Short term rental and hire of plant & equipment is frequently used in construction and contract mining activities, for example the hire of lighting towers, or the rental of motor vehicles and hand tools. The feature of these arrangements is there is no fixed rental term, they can be for varying periods of time from less than one day to several months, and the items can be returned with little or no notice. Contractors enter into a high volume of these low value transactions annually.

The cost of accounting for short term leases under the proposals will be significant as currently we do not have systems designed to track the value or the expected period that rented or hired plant and equipment will be used in our construction and mining projects. The implementation of a system for this purpose is viewed as being impractical, cumbersome, expensive, and of no value for management purposes. In addition to new systems, additional accounting human resources would be required to account for short term leases as proposed.

We also question the benefit to the users of having the amount of equipment rented or hired for a short time (which can vary from a day to a number of months) on balance sheet at a reporting date. Short term leases are operating in nature rather than investing or financing. The amount recorded on balance sheet could vary significantly based on the number, nature, and stage of

completion of particular projects, and this would require additional explanation to users of the accounts. As a result we believe no amount should be recorded on the balance sheet where the lease is short term and accounting for short term leases should be consistent with current operating lease accounting.



It is not clear from the ED how the profit & loss charge for short term leases will be presented. If it is proposed to be split between amortisation and interest expense, consistent with long term leases, we believe this would be a misleading presentation. Amortisation implies the asset has a useful life greater than 12 months and interest implies a financing element. Short term rentals by their nature, such as hiring a hotel room for an evening, involve no financing element and are purely a charge for use of the asset for a short term. As a result we believe the profit & loss charge for short term leases should also be consistent with current operating lease accounting.

#### 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?
- (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?
- (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?
- (a) We agree with the definition of a lease but are concerned that the distinction between leases and service contracts is not clear, see (c) below and Question 6.
- (b) We agree with the criteria for distinguishing a lease from a contract that represents a purchase or sale.
- (c) We do not believe the guidance for distinguishing leases and service contracts is sufficient and we believe as drafted that the guidance is open to misinterpretation, particularly in relation to implicitly specified assets, see Question 6 below.

# **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?

No comment.



### 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?

The current drafting of the ED for "Contracts that contain service and lease components" could result in an interpretation that the following activities undertaken by contractors could be deemed as leases, impacting both contractors and their client's balance sheets:

- Subcontracting / wet hire where contractors use subcontractors to provide wet hire (hire of plant with an operator) on construction projects
- Contract mining customers use contractors to provide mining services using mining plant & equipment

The application guidance states for a contract to be classified as a lease, the fulfilment of the contract depends on providing a specified asset or assets and the contract conveys the right to control the use of a specified asset.

We believe in the examples above that contractors are either using or providing a "total" service, with the items of plant and equipment used not being specified by the contractor or the client. Under these agreements both the subcontractor and the contractor would be able to substitute equipment in order to provide the contracted service. ED.B3 states "if the supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfilment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease."

We note that some contract mining agreements are cancellable by the mine owner, such cancellation resulting in our vacating the site and removing our plant. The mine owner then would either self perform or engage another contractor to undertake the mining work. This situation supports the view that the plant is not "specified" as defined by the ED.

We believe that the other requirement of the ED, that the contract conveys the right to control the use of the specified asset is also not met in subcontracting or contract mining arrangements as control has not passed.



While we have reached this view, our discussions with other stakeholders indicate that the ED as drafted could leave these arrangements open to interpretation and we ask that additional guidance to that currently included (that is based on IFRIC 4) be provided in the new standard that requires the business purpose of the transaction and the nature of the service provided be considered, as opposed to the current focus on specified assets and control.

# Benefits of further guidance

We believe that a clear guidance that subcontracts and contract mining contracts do not contain elements that contain a lease would:

- Ensure the model reflects the nature of subcontracting and contract mining activity where the contractor controls the equipment
- Allow the continuation of existing accounting under revenue recognition proposals

# Risks of existing interpretation

Not clarifying guidance carries the risk of misinterpretation and resulting in:

- Subcontracting lessor accounting for subcontractors and lessee accounting for contractors
- Contract mining lessor accounting for contractors and lessee accounting for customers

This would significantly change the financial performance and position of both sides of subcontracting and contract mining arrangements and change the way contractors businesses are viewed.

This would also significantly impact the contracting industry, including:

- A need to hire and train staff to assess these agreements for lease components, including accounting for numerous subcontracts in large and complex construction and mining contracts.
- A need to develop new systems to record and track leases for financial reporting purposes that will overlay existing systems that need to remain focussed on measuring contract cost for monitoring management performance and remuneration.
- A major disconnect between financial and management reporting with substantial time and resources being used in reconciliation.
- A significant increase in additional reporting outside the primary financial statements to ensure users understand underlying performance.
- All additional costs would be passed on to customers.



# Implicitly specified assets

We also believe the drafting of the guidance in ED.B2 that an asset may be "implicitly 'specified' if it is (a) infeasible or impractical for a lessor to provide alternative assets in place of the underlying asset during the lease term or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice" is unhelpful to determining if a contract contains lease components. The wording of part (b) could potentially penalise contractors with construction or contract mining activities in remote locations (compared to less remote locations) who in practice prefer to repair equipment on site rather than substitute.

Also we would highlight that the example provided in ED.B2 of an aircraft that has been "extensively changed" for the customer is differentiated from the majority of mining equipment, where any modifications required for work on a clients site are generally minimal. It would be helpful if the new standard could also include an example of where an asset is not implicitly specified.

# Accounting for arrangements containing a lease

For any arrangement that did actually contain a lease, we do not agree that lease accounting requirements should be applied to the combined contract, as immaterial lease components in a contract could require the entire contract to be accounted for as a lease which would reduce the usefulness of the financial reporting. Where present, lease and service components should be accounted for separately.

### **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?

We agree with the proposal.

#### **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 disagree with the proposal. As drafted the longest possible term would be practically difficult to determine and would result in the inclusion of amounts in the lease liability that do not meet the definition of a liability as the lessee is not contractual



committed. We believe lease payments should only include what are present obligations of the lessee.

### **Question 9: Lease payments**

Do you agree that contingent rentals and expected payments under term option penalties and residual value quarantees 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 disagree with the proposal. As drafted the expected outcome technique would be practically difficult to determine and would require us to forecast multiple different events which would be complex and costly. We believe lease payments should only include what are present obligations of the lessee.

#### 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?

We agree that reassessment would be required under the proposals as drafted, however improvement in the calculations of lease term and lease payments outlined in our response to Question 8 & 9 above would make this reassessment easier.

### **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?

We do not agree with the inclusion of guidance on criteria for a sale in the leasing standard. The criteria for a sale should be covered in the standard on Revenue Recognition to ensure consistency.



### **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?
- (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?
- (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?
- (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?
- (a) We believe separate disclosure of lease liabilities and right of use assets should be made in the notes the accounts and not on the face of the balance sheet as it is a summary statement.
- (b) (d) No comment

### 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?

We believe separate disclosure of lease expense (amortisation and interest) should be made in the notes the accounts and not on the face of the profit & loss as it is a summary statement.

As discussed in our response to Question 3 above, we are unclear as to the proposed presentation of short term lease charges in the profit & loss.



#### **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?

We believe separate disclosure of cash flows arising from leases (principal and interest) should be made in the notes the accounts and not on the face of the cash flow as it is a summary statement.

#### **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?

We agree that disclosure consistent with that provided currently for finance leases would be appropriate.

### **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 whv?
- (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 agree with use of either the simplified retrospective approach or full retrospective application at our election.

# **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?

We disagree with Boards' assessment particularly for short term leases. Please see response to Question 3 above.



### **Question 18**

Do you have any other comments on the proposals?

Additional examples on lessee accounting, including initial and subsequent measurement of the lessee's liability to make payments, including changes in lease term and lease payments, would assist preparers.

Additional examples of presentation of lessee and lessor accounting, including for short term leases, would also assist preparers.