



Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

15 December 2010

Dear Sir David,

RE: IASB EXPOSURE DRAFT ED/2010/9 LEASES

Thank you for the opportunity to comment on the IASB exposure draft ED/2010/9 Leases ('ED').

Wesfarmers Limited is one of Australia's largest listed companies, retailers and employers. Wesfarmers' portfolio of businesses includes retail operations covering supermarkets, department stores, fuel and liquor, and home improvement and office supplies; coal mining; gas processing and distribution; insurance underwriting and broking; chemicals and fertiliser manufacture and sale; and industrial and safety product distribution. Wesfarmers operates from approximately 4,000 discrete locations across Australia and New Zealand and has approximately 6,500 leases across the group, including 3,500 property leases.

Wesfarmers, with the assistance of external consultants, has modelled the likely impact of the ED on its financial statements. This exercise provided substantial insight into the practical considerations and difficulties of the proposed lease changes, which are particularly onerous for Australian retail companies with extensive property lease portfolios.

The extensive work undertaken has led us to a primary conclusion that property leases for lessees need to be considered separately from the proposed leasing standard.

This letter summarises Wesfarmers broader concerns of the impact on financial statements from the proposed changes, which relate to:

1. Increased subjectivity and volatility of results, with reduced comparability;
2. Need for increasing restatement of results;
3. The premise of the ED, particularly in respect to property leases;
4. Significant compliance costs for questionable benefit; and
5. Proposed transitional arrangements are inappropriate

Increased subjectivity and volatility of results, with reduced comparability

For businesses with extensive lease portfolios, the proposed changes will significantly increase the subjectivity of financial statements as well as the volatility of results between periods.

Relatively modest changes in key lease assumptions, such as base rent review outcomes, likelihood of lease renewals, contingent rental conditions and discount rates used will significantly affect the financial statements and introduce large non-cash based volatility. This will be particularly the case where lease periods are long, as is common for property leases in Australia, and future trading environments and decision making difficult to predict requiring substantial subjectivity and constant re-evaluation.

Our modelling suggests, that where significant long dated complex leases exist, changes to lease assumptions would become potentially the most significant driver of changing reported profitability, however this would not reflect operating performance so much as changes in assumptions on long-term future forecasts. We believe this would be confusing and detrimental to investors and other users of financial statements.

We also believe that the proposed changes would significantly reduce comparability of results. Relatively small changes to lease assumptions, particularly where there are numerous long dated leases, will have a material impact on reported financial statements. It is highly unlikely that any two like companies will make the same subjective judgements, meaning there is a high potential for there to be material differences in reported profitability or balance sheet positions for similar companies post the introduction of the proposed lease standard. Wesfarmers is concerned that this is not in the best interest of investors and other users of its financial statements.

Need for increasing restatement of results

It is evident from our discussions following release of the ED that many users of financial statements have not done detailed modelling of the impacts of the proposed lease changes, and in particular have not considered in detail, long dated complex leases such as those associated with Australian retail property.

Discussions we have had with those analysts and investors that have done a degree of modelling, reveal that there will be a greater emphasis placed on the statement of cash flow, as this is removed from the subjectivity and effect of the proposed lease changes. We have also been advised that investors largely expect to restate the statement of financial performance to treat property leases (in particular) as operating expenses as the proposed changes will otherwise inhibit their ability to analyse the underlying operational performance of the business. It is evident that, given the complexity associated with these adjustments in a company where there are many operating leases present, detailed additional disclosure will be required if this is to be achieved. In effect, we expect broad based unaudited restatement of earnings will be undertaken by companies to assist users in this process. We are concerned that this is in direct conflict with where accounting standards should be driving financial reporting.

It also suggests that current disclosure requirements, which include audited detail regarding companies' future lease obligations, already enable analysts to understand leasing liability and make appropriate investment decisions.

The premise of the ED, particularly in respect of property leases

We believe property leases should be considered separately as the proposed changes overlook the economic reality of leasing property, particularly for retail operations, and simplistically treat property leasing as a financing alternative.

Leasing of generally appreciating real estate assets, given their significant residual value, is significantly different to leasing depreciating plant and equipment assets. The economic reality of this, however, is ignored by the ED. This argument for considering property separately for lessees we believe is strong given the proposed scope exclusion for lessors and the accounting inconsistency that will otherwise exist between the two parties.

The proposed lease changes also ignore the service component of property leasing, where lessors are required to provide a range of functions and services to enable a store to properly operate and a lessee would have no liability were these functions and services not provided.

It is also not valid to treat a property lease decision as a financing alternative as compared to many lease decisions associated with plant and equipment. Most of the locations Wesfarmers' businesses operate from are not separable as an underlying purchasable asset, for instance where they form part of a larger shopping centre or retail complex.

Significant compliance costs for questionable benefit

The implementation and ongoing costs to address the requirements of the ED will be significant and we believe outweigh any benefits.

For companies such as Wesfarmers, compliance costs associated with the ED are expected to be substantially higher than the implementation and ongoing costs associated with moving to A-IFRS. In addition to new IT systems, which would in all likelihood need to be custom built, the ongoing human resource and auditing costs associated with assessing, capturing and re-evaluating inputs to lease models will be substantial.

In addition, there will be great time and cost involved in educating users on the changes to reported results, dealing with lenders on financial ratios, making changes to internal management accounting systems and reassessing the impact on executive remuneration targets.

Given the concerns outlined in this letter and detailed in the attached appendix, we do not consider that there will be any real benefits for the users of financial statements to outweigh the substantial compliance costs.

Proposed transitional arrangements are inappropriate

Under the ED, the simplified retrospective approach for lessees significantly increases the value of the right-of-use asset as compared to a full retrospective approach. As a result, reported earnings will be incorrectly materially negatively affected and we support the choice of a full retrospective approach.

In summary, as a minimum we request that the Board excludes property leases from the standard in respect to lessees, changes transitional arrangements and limits the current high level of subjectivity required under the ED, most notably by excluding options and contingent rentals.

We further encourage the Board to take more time to educate users and complete a more detailed cost/benefit analysis as feedback Wesfarmers has received from investors, analysts, rating agencies and other users of its financial statements that have a detailed understanding of the effects of the proposed changes, directly contradicts the benefits outlined in the basis of conclusions.

Our detailed responses to the questions raised in your ED are contained in the Appendix to this letter.

If you have any questions regarding this submission, please do not hesitate to contact Terry Bowen (+618 9327 4301) or Judd Greenway, General Manager, Group Accounting (+618 9327 4275).

Yours sincerely,



Terry Bowen
Finance Director
Wesfarmers Limited

Encl: APPENDIX – WESFARMERS' RESPONSE TO LEASE EXPOSURE DRAFT

APPENDIX: WESFARMERS' RESPONSE TO LEASE 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?

Premise

We disagree with this view. We believe property leases should be considered separately as the proposed changes overlook the economic reality of leasing property, particularly for retail operations, and simplistically treat property leasing as a financing alternative.

Leasing of generally appreciating real estate assets, given their significant residual value, is significantly different to leasing depreciating plant and equipment assets. The economic reality of this, however, is ignored by the ED. This argument for considering property separately for lessees we believe is strong given the proposed scope exclusion for lessors and the accounting inconsistency that will otherwise exist between the two parties.

The proposed lease changes also ignore the service component of property leasing, where lessors are required to provide a range of functions and services to enable a store to properly operate and a lessee would have no liability were these functions and services not provided.

It is also not valid to treat a property lease decision as a financing alternative as compared to many lease decisions associated with plant and equipment. Most of the locations Wesfarmers' businesses operate from are not separable as an underlying purchasable asset, for instance where they form part of a larger shopping centre or retail complex.

Unreliable measurement

It would be difficult to recognise an asset and liability in an operating lease arrangement due to the inability to provide reliable measurement. The definition of a contingent liability in IAS 37 provides that a present obligation from a past event cannot be recognised if the amount of the obligation cannot be measured with sufficient reliability. Given the complexity of measuring multiple permutations in a lease we consider that reliable measurement could not be obtained that provides comparability to other companies. Therefore a liability cannot be recognised.

The approach proposed to recognise a right-of-use asset and a liability to make lease payments will overstate the assets and liabilities of the statement of financial position, and thereby diminishing the values of the core assets presented. The approach would not significantly increase the understanding of the lease arrangement by users of financial statements or represent the nature of all lease transactions.

Proposed alternative

The analysis of the rights and obligations in the lease standard should be consistent with the Conceptual Framework project currently being undertaken.

The existing executory contract approach to accounting for operating leases is well understood and consistently applied by preparers of financial information. We are aware that there may be some views that companies are structuring lease arrangements so as to remove funding from the balance sheet. While this may be the case in some industries, the proposed lease standard, which will be applied to all industries, would not sufficiently address the shortcomings of the existing standard and would not provide useful information in the financial statements, especially in regard to property leases.

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We recommend that the existing executory contract (operating leases) approach to rental property leases be retained.

(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?

Premise and impact

Wesfarmers believes that the scope of the ED should exclude property leases.

The proposed treatment will result in a greater expense recognised in the early years of a lease compared to the existing model, and possibly lower than the lease payment in later years, due to the effective interest rate method. Given that long-term operating leases are continually being renegotiated and the liability includes renewal options and contingent rentals that may not occur, the benefit of the comparatively lower lease expense in later years may never eventuate, resulting in an overstatement of expenses in the profit or loss with a corresponding reduction in net assets. The resulting distortion in earnings is illogical.

The default straight-line amortisation method for the right-of-use asset would result in a significant mismatch between the physical rental payments and the proposed profit or loss impact. An alternative model for the right-of-use asset would be to allow a revenue-based method of amortisation, which would likely result in a slightly closer matching of the rising lease costs, because as turnover increases so would the rental payments and consequently so would the amortisation charge.

Usefulness to users

Many analysts that we have held discussions with largely expect to restate the statement of financial performance to treat property leases (in particular) as operating expenses as the proposed changes will otherwise inhibit their ability to analyse the underlying operational performance of the business. It is evident that, given the complexity associated with these adjustments in a company where there are many operating leases present, detailed additional disclosure will be required if this is to be achieved. In effect, we expect broad based unaudited restatement of earnings will be undertaken by companies to assist users in this process. We are concerned that this is in direct conflict with where accounting standards should be driving financial reporting.

It also suggests that current disclosure requirements, which include audited detail regarding companies' future lease obligations, already enable analysts to understand leasing liability and make appropriate investment decisions.

With existing disclosures providing sufficient information regarding property leases for retail businesses and analysts expecting to back out the proposed amendments, there is no justification for the proposed changes as they relate to property leases.

Commercial implications

The significant distortion of earnings arising from front ending of an arbitrary interest expense (which is compounded by the proposed transitional arrangements) may create an artificial incentive for retail businesses to own a higher portion of property they operate from. This could change the risk profile and funding flexibility of the business. Alternatively, retailers could seek to reduce lease terms which would likely result in an increase in rent costs and possibly change industry dynamics. We believe accounting standards should reflect commercial transactions and not drive them.

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Proposed alternative

An alternative model is to account for the right-of-use asset, particularly in the case of property leases, under IAS 40 using the fair value model, with fair value movements going directly to the profit or loss. The fair value of the right-of-use asset would typically decrease incrementally over time. Therefore, the devaluation of the right to use property would be less in the initial years than in later years, essentially the inverse to interest expense in respect of the lease liability, producing a more even net impact to profit or loss. This net profit or loss impact would also much more closely follow the physical rental payment stream than would be the case under the IAS 38 cost or revaluation model, with straight-line amortisation and front-loading of interest expense. Therefore, the use of the IAS 40 fair value model would not only produce a more even net impact to profit or loss, but also significantly decrease the mismatch between actual lease payments and the net profit or loss impact and therefore better reflect the economic reality.

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?

Wesfarmers disagrees with the proposed approach. The phrase 'risks or benefits' in the proposed lease model is similar to 'risks or rewards' in the existing lease model for distinguishing between finance and operating leases. The performance obligation approach appears to be inconsistent with the framework for the proposed lessee model and is conceptually inconsistent with the Conceptual Framework, which proposes a 'control' model as per the proposed revenue accounting (ED/2010/6 *Revenue from Contracts with Customers*).

Under the ED proposals, a lessee recognises an asset representing its right-of-use of the underlying leased item. This asset is a consequence of the lessor having performed under the lease on the lease commencement date by making the leased asset available to the lessee. It is therefore inconsistent to require a lessor to recognise a performance obligation liability on the same date as this suggests that the lessor has still to perform throughout the lease period. We also believe that the performance obligation approach results in double-counting of the asset. A lessor continues to recognise the whole underlying asset but is also required to recognise a lease receivable. This lease receivable represents part of the future cash flows that the underlying asset will generate for the lessor. Recognising these, while not derecognising that part of the underlying asset that has been leased, appears therefore to result in the double counting of the same cash flow potential. The presentation of the performance obligation together with the underlying asset and right to receive lease payments reduces the effect of this double counting, but we do not believe it sufficiently eliminates this concern.

The derecognition approach, specifically regarding the portion of the underlying asset to be derecognised, contains significant practical difficulties as the fair value of the rights to receive payments would not necessarily be equal to the value of the lease asset, and therefore may be difficult to derive in practice.

Furthermore, we believe that there are practical issues of applying the derecognition approach for property leases where only a portion of the asset is leased and/or where the

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lease term is for a period substantially less than the life of the asset. We recommend that the boards consult further on these practical issues.

Requiring lessors to decide between the performance obligation approach and derecognition approach introduces unnecessary subjectivity and complexity into lessor accounting and does not provide financial statement users with decision-useful information. We do not believe that the 'hybrid approach' is an improvement on current lessor accounting in accordance with IAS 17.

(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?

As explained in our response to question 2(a), we do not agree with the principles and mechanics of the proposed performance obligation and derecognition approaches.

The lessor accounting model should be consistent with the lessee accounting model and the Conceptual Framework.

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 profit or loss, 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).**

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?

Short-term leases should be excluded from the proposed new standard altogether. The administrative cost, arising from system and process changes, to determine the right-of-use asset and rental obligation liability will be significant for a large number of short-term leases. There is also different treatment for short-term leases between a lessee and lessor, where the lessor is permitted to not recognise assets or liabilities in respect of short-term lease contracts. Including short-term leases would not provide users of financial statements meaningful information for the cost of providing the information.

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Given the short-term duration of such leases, the costs of complying with the full requirements proposed in the ED would be substantial and most likely outweigh the benefits in practical terms. For lessees, the discounting effect is expected to be immaterial because of the short lease duration. Therefore, it makes sense to relieve lessees from the requirement to discount the lease payments.

The proposed model may result in a lessee recording amortisation for a short-term lease and a lessor recording rental income which does not make sense conceptually. However, the ED does not describe how the short-term lease payments would be classified, either as rent or as amortisation, or their recognition pattern in the profit or loss. We recommended that the boards clarify this in the final standard.

Although we accept that the value of these short-term leases may in some cases be significant in aggregate, we do not believe that they are normally material to the economic decisions made by users. We therefore propose that the simplified requirements for lessees should mirror those of the lessor such that lease rentals are recognised on an accruals basis similar to the current operating lease accounting by lessees under IAS 17.

Definition of a lease

The exposure draft proposes to define a lease 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 (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

Question 4

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

We believe that further guidance is needed to assist preparers in applying the definition to their lease contracts. See further our response to question 4(c).

(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?

This criteria shows the boards are indecisive between the 'control model' and the 'risks and rewards model' (as discussed at Question 2(a)). Specifically, the segments '...transfers...control' and '...all but a trivial amount of the risks and benefits...' in paragraph B9 appear to be a mixture of the two models. The boards should consider the benefits of the 'risks and rewards' model versus the 'control' model and take a consistent approach on which model to adopt for financial reporting.

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

We disagree that the guidance for distinguishing leases from service contracts is sufficient. The accounting under the proposed lease model is significantly different to IAS 17, and the

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consequence of concluding whether a transaction represents a lease or service contract will affect earnings.

We recommend providing examples in the application guidance to illustrate its meaning. For example, a number of issues can be raised in determining if a leasing arrangement exists where a contract is in place with various transport providers for the provision of distribution services. The difference in classification would result in whether the accounting treatment of the contract is classified as a service charge expense, or amortisation is recognised and an asset and liability is recognised in the statement of financial position.

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 (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

We recommend that the scope of the proposed lease accounting standard should exclude rental properties, similar to the investment property exclusion, for the reasons outlined above.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

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

(b) the IASB proposes that:

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

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

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

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

We disagree with the approach for lessees to apply the lease accounting requirements to the combined contract for service components that are not distinct. Applying the lease accounting requirements to the combined contract would overstate the financial statement effect of the leases and misclassify the profit or loss effect. The statement of financial position would be

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overstated as it would include the capitalisation of non-distinct service costs. The resulting effect on the statement of comprehensive income is a misclassification of the service costs to amortisation and interest. This may also result in service costs being recognised before the service is performed.

'Executory costs' in the current lease accounting guidance includes insurance, maintenance and taxes. In practice, this term is often extended also to apply to other common cost allocations including common area maintenance, utilities, security, landscaping and other similar shared operating costs. These costs are frequently included in the quoted lease terms for property leases. There are several different types of lease that are common, and each may have some unique issues to be addressed.

It is unclear if these common executory costs would meet the 'distinct service' definition. For example, it would be difficult to determine whether a tenant in a multi-tenant building paying a pro-rata portion of landscaping or utilities would meet the definition. Notwithstanding that they may not meet the definition contained in the ED, we believe that these service/executory costs should be excluded from the payments the lessee uses in measuring the lease asset and obligation, as failure to do so would not meet the stated desire to put leasing on parity with owning the asset. For example, when purchasing a real estate asset outright an entity does not capitalise the present value of expected future operating costs, so why capitalise them as part of the lease accounting?

Alternatives for measuring non-distinct service components would be to separate the service components using relative fair values or if the fair values are not available, then using a reasonable basis for allocation. However, applying these alternatives to a lease contract with a non-distinct service component would require an arbitrary allocation between the lease component and the service component and would be costly to perform.

Both of the IASB and FASB methods proposed would result in the misstatement of the financial statements for a large portfolio of leases and would reduce comparability and understanding by financial statement users.

For the IFRS to be a strong set of principles-based standards, consistency in the application of fundamental principles is paramount. Changes from those fundamental principles could result in 'rules' in standard-setting. This goes against the conceptual foundations of the IFRSs.

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 that a lessee or lessor should only account for a purchase option at the point of exercise, as this is the only point that it becomes unconditionally committed. This treatment should also be consistently applied to renewal options and contingent rent. The treatment for both purchase options and renewal options should be consistent in the proposed lease accounting standard.

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It is appropriate to treat the lease contract as terminated when the purchase option is exercised, and to account for the transaction as purchase by the lessee and a sale by the lessor. However, in more complex lease contracts, it will be necessary to consider the purchase option clause in relation to other contractual clauses to ascertain the economic significance of exercising the purchase option.

Measurement

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

(c) is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).

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?

Wesfarmers disagrees with the ED's proposed approach of including any option to extend or terminate a lease into the measurement of the lease term. The requirement of assessing the likelihood of renewal options being exercised ignores the purpose of renewal options— the business doesn't know what will happen in 10 to 20 years time so includes renewal options to ensure flexibility. There is no present obligation to pay rentals over a renewed term until the option has been exercised and therefore a liability cannot be recognised.

There are a number of factors in determining whether a lease renewal option is exercised. These factors are extremely subjective, speculative and difficult to predict over the lease term (which can extend beyond 45 years in Wesfarmers' case). This judgement cannot be made until closer to the lease expiry date as there are a number of market conditions that influence the option to renew such as; prevailing trading performance of a store; lease attractiveness; site constraints and availability of more prospective real estate in comparable sales catchment; competitive activity; capital investment within store; lessor performance (adjacent tenancy mix and centre/site condition/amenity); changes in demographics; changes in business environment; format strategy and requirement for realignment or market withdrawal; and strategic objectives.

The ability of a company to perform such predictions with reasonable accuracy is questionable due to the number of underlying variables which impact a lessee's decision to

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exit a lease or to exercise term renewal options. Also in many cases, a lease is renegotiated as opposed to exercising a renewal option, which results in further measurement uncertainty if renewal options are included at inception. A significant amount of judgement will be required to determine the likelihood of exercise of the options so far into the future, resulting in speculative assessments. This would further drive lack of comparability between market participants.

It appears that there are inherent conceptual and practical problems with the boards' proposed lease term definition and application. Wesfarmers propose that the initial recognition threshold be raised from 'more likely than not' to 'virtually certain'. This would significantly reduce the volatility in the profit or loss, requiring less frequent need to remeasure, and more closely resemble the result already achieved by the current accounting under IAS 17. It will also reduce the amount of estimates and judgements involved in determining the right-of-use asset and obligation to make lease payments for lessees, which would reduce the ongoing costs of implementing the new standard.

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 disagree with this approach as we do not think that the contingent rental payments are a liability. The proposed changes will likely reduce financial statement accuracy, decrease comparability and introduce earnings volatility. Relatively modest changes in key assumptions such as base rent review outcomes and contingent rentals will significantly affect the financial statements. Accurately estimating base rent increases in the future which are dependent on future market conditions or contingent rental assumptions, which are based on future sales, will be impossible.

The definition of a contingent liability in IAS 37 provides that a present obligation from a past event cannot be recognised if the amount of the obligation cannot be measured with sufficient reliability. Given the complexity of measuring multiple permutations in a lease we consider that reliable measurement could not be obtained. To estimate the contingent rental amount the ED requires the calculation of the probability of the contingent rental being payable for each year of the lease, requiring a large amount of speculation of the probability of future events. This unnecessarily over complicates the determination of the lease payments and consequently the lease liability and right-of-use asset.

Contingent rentals in the retail environment can include rental payments based on inflation and a percentage of sales. Forecasting these factors over a long period of time, where in the retail environment leases of 45 years are not uncommon, would not be reliable as the forecast period would be well beyond normal planning or budgeting methodology and would be inconsistently applied across different companies. Furthermore, the proposals provide no guidance as to what would be considered a reasonable number of possible outcomes. This

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would result in a significant cost and involve significant time to perform this exercise across a large number of property lease agreements with different types of contingent rentals. The requirement for ongoing reassessment thereof becomes totally impracticable.

We agree with the approach to include all components of a lease in measuring the obligation to pay rental, though do not think it should include components that cannot be recognised in the financial statements under the current Conceptual Framework.

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?

For businesses with extensive lease portfolios, the proposed changes will significantly increase the subjectivity of financial statements as well as the volatility of results between periods.

Allocating changes in contingent rentals, term option penalties and residual value guarantees to current or prior periods and future periods is the most onerous provision of the ED for lessees with a large number of leases. Also, a new accounting system, which would in all likelihood need to be custom built, will be necessary to enable lessees to determine such allocations reliably and would place a significant burden on administrative resources at an excessive cost.

A short-coming of requiring reassessment is that relatively modest changes in key lease assumptions, such as base rent review outcomes, likelihood of lease renewals, contingent rental conditions and discount rates used will significantly affect the financial statements and introduce large non-cash based volatility. This will be particularly the case where lease periods are long, as is common for property leases in Australia, and future trading environments and decision making difficult to predict requiring substantial subjectivity and constant re-evaluation.

Our modelling suggests, that where significant long dated complex leases exist, changes to lease assumptions would become potentially the most significant driver of changing reported profitability, however this would not reflect operating performance so much as changes in assumptions on long-term future forecasts. We believe this would be confusing and detrimental to investors and other users of financial statements.

We also believe that the proposed changes would significantly reduce comparability of results. Relatively small changes to lease assumptions, particularly where there are numerous long dated leases, will have a material impact on reported financial statements. It is highly unlikely that any two like companies will make the same subjective judgements, meaning there is a high potential for there to be material differences in reported profitability or balance sheet positions for similar companies post the introduction of the proposed lease standard. Wesfarmers is concerned that this is not in the best interest of investors and other users of its financial statements.

As stated in Question 9, we do not believe that contingent rentals should be recognised as a liability. The requirement to review all lease arrangements for a change in estimates on long-

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term leases would be an excessive administrative cost without providing additional meaningful information to users of financial statements. We believe that the boards have not sufficiently demonstrated that the benefits of reassessing lease payments during the lease term outweigh the costs associated with doing so.

Wesfarmers recommends that at inception of the lease, the threshold for the determination of the lease term be raised from 'more likely than not' to 'virtually certain', as this would lead to a reduction in the likelihood of changes in the carrying amount of the lease liability due to reassessment of the lease term, and a consequential reduction in profit or loss volatility.

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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 disagree with the criteria for classification as a sale and leaseback transaction. Consistent with our response to question 4(b), we propose that sale and leaseback accounting should only result in a sale if the criteria within the proposed revenue standard are met.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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?

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(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?

We disagree with recognising operating leases for property in the statement of financial position.

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 agree that amortisation of the right-of-use asset and interest expense on the liability to make lease payments should be presented separately from other amortisation and interest in the profit or loss to allow users to remove the effect of leases on the profit or loss, consistent with the statement of financial position. Users have different needs and most would need to exclude the effect of leases from the financial statements.

Retail businesses will be forced to report underlying profit measures when presenting results from operations to the investment community.

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 agree with this approach as it will allow users to remove the effect of leases on the profit and loss, consistent with the statement of financial position and statement of comprehensive income. Users have different needs and most would need to exclude the effect of leases from the financial statements. However, the classification of lease payments as a financing activity will be inconsistent with the treatment of interest payments on other debt obligations.

Disclosure

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

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(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?

The disclosure requirements as presented would be burdensome for companies with large varied lease portfolios. The information disclosed would not be useful for financial statement users as it would not be possible to disclose details on a large varied portfolio of leases and the information presented would be misleading.

It also appears counter intuitive to recognise in the financial statements an asset and liability based on contingencies, though to provide a disclosure in the notes on the minimum lease obligations with a reconciliation to the statement of financial position.

Transition

Question 16

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

The new lease accounting model proposed in the ED is significantly different from IAS 17. We believe that it will be extremely costly and challenging to gather or 'reconstruct' the requisite information to operationalise the new requirements under the proposed approach. This is especially so for the large number of property leases that are currently accounted for as operating leases under IAS 17. The resulting impact on earnings is significant given the front-loading of the interest expense in the early years of a lease under the proposed right-of-use model. Whilst the IASB intended this approach to be less costly and burdensome for preparers, Wesfarmers considers preparers should be given the option to apply the ED on a full retrospective basis or 'partial' retrospective basis as discussed below.

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

Wesfarmers considers preparers should be given the option to apply on a full retrospective basis to minimise the significant impact on earnings given the front-loading of the interest expense in the early years of a lease under the proposed simplified retrospective approach.

However, given the current proposals for full retrospective application, specifically with regards to lease term, contingent rentals and discount rates, this alternative would likely be more burdensome than the current transitional provisions. Given the average length of property leases, a requirement to go back to the initial commencement date of each lease would further increase the degree of subjectivity, as raised in previous questions, and would also require careful application to ensure that the benefit of hindsight is not applied.

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

We believe the boards would also need to address transitional issues in the following areas:

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- Those existing arrangements that are presently reported as leases under IAS 17 but will be considered as purchases or sales of the underlying assets under the proposed lease accounting model;
- Those existing sale and leaseback transactions that are presently reported as such under IAS 17 but will not necessarily meet the proposed classification criteria for sale and leaseback under the new lease accounting model; and
- The treatment of lease incentives both on transition and going forward.

We note that the ED is silent on the above areas, and it is not clear if the boards require full retrospective application of the new lease accounting requirements for such circumstances. We urge the boards to provide further clarification with respect to the transitional provisions for these areas.

Benefits and costs

Question 17

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

The implementation and ongoing costs to address the requirements of the ED will be significant and we believe outweigh any benefits.

For companies such as Wesfarmers, compliance costs associated with the ED are expected to be substantially higher than the implementation and ongoing costs associated with moving to A-IFRS. In addition to new IT systems, which would in all likelihood need to be custom built, the ongoing human resource and auditing costs associated with assessing, capturing and re-evaluating inputs to lease models will be substantial.

In addition, there will be great time and cost involved in educating users on the changes to reported results, dealing with lenders on financial ratios, making changes to internal management accounting systems and reassessing the impact on executive remuneration targets.

It is evident from our discussions following release of the ED that many users of financial statements have not done detailed modelling of the impacts of the proposed lease changes, and in particular have not considered in detail, long dated complex leases such as those associated with Australian retail property.

Discussions we have had with those analysts and investors that have done a degree of modelling, reveal that there will be a greater emphasis placed on the statement of cash flow, as this is removed from the subjectivity and effect of the proposed lease changes. We have also been advised that investors largely expect to restate the statement of financial performance to treat property leases (in particular) as operating expenses as the proposed changes will otherwise inhibit their ability to analyse the underlying operational performance of the business. It is evident that, given the complexity associated with these adjustments in a company where there are many operating leases present, detailed additional disclosure will be required if this is to be achieved. In effect, we expect broad based unaudited restatement of earnings will be undertaken by companies to assist users in this process. We are concerned that this is in direct conflict with where accounting standards should be driving financial reporting.

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It also suggests that current disclosure requirements, which include audited detail regarding companies' future lease obligations, already enable analysts to understand leasing liability and make appropriate investment decisions.

Given the concerns outlined in this submission, we do not consider that there will be any real benefits for the users of financial statements to outweigh the substantial compliance costs.

We further encourage the Board to take more time to educate users and complete a more detailed cost/benefit analysis as feedback Wesfarmers has received from investors, analysts, rating agencies and other users of its financial statements that have a detailed understanding of the effects of the proposed changes, directly contradicts the benefits outlined in the basis of conclusions.

Other comments

Question 18

Do you have any other comments on the proposals?

Discount rates

The ED proposes that the lessee's lease liability be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be reliably determined. Although the impact of changing the discount rate on net profit after tax is limited, a higher discount rate has the effect of reducing amortisation and increasing the interest expense, and changing the magnitude of the effect on the statement of financial position. Therefore, earnings before interest and tax are significantly affected by the discount rate.

The ED defines the lessee's incremental borrowing rate as the rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset. The incremental borrowing rate as defined does not take into account the specific details and risks implicit within a lease contract, namely the structured financing of the arrangement or tax benefits, and takes the approach of a purchase of the underlying asset. The ED states that the lessee's incremental borrowing rate would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals, expected payments under term option penalties and residual value guarantees, the expected value of the underlying asset at the end of the lease term and security attached to the underlying asset during and at the end of the lease term. The definition of the incremental borrowing rate takes into account the purchase of the underlying asset, which appears to be at odds with the proposed practice which reflects the nature and specific terms of the lease.

On transition, the incremental borrowing rate is required to be used to discount future lease payments, though allows a choice of using the rate implicit within a lease for new leases entered into. The transitional requirements would be at odds with the ongoing accounting requirements and reduces comparability and meaning of financial results.

The other alternative provided in the ED is to utilise the rate the lessor charges the lessee which could be, for example the lessee's incremental borrowing rate, the rate implicit in the lease (i.e. the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset) or, for property leases, the yield on the property.

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The determination of the rate implicit within an operating lease for property is significantly more difficult than for a finance lease as the property has a significant residual value at the end of the lease term, which is greater than at the commencement of the lease. The characteristic of land is that it normally has an indefinite economic life; therefore, the lease term for a property would be significantly less than its useful life, and trying to find an equivalent discount rate, if the lessee were to borrow over the same term as the lease to buy instead of lease, would become impracticable.

Likewise, the rate the lessor charges the lessee has its problems. First, it would be difficult for the lessee to calculate as it would depend on the lessor's estimate of contingent rentals and the residual value of the underlying asset at the end of the lease and may also be affected by taxes and other factors known only to the lessor. However, even if it were obtained directly from the lessor, the overarching problem is that it is the rate of return required by the asset owner, over the lease period, and is therefore not appropriate for the lessee to use as the lessee only has the use of the asset not full ownership.

Another method of calculating the rate implicit within a lease is the use of an internal rate of return. The inherent limitation of this methodology is that the market yield does not represent a specific property or property portfolio and therefore does not exactly represent the rate implicit within a lease. Specifically, each lease would be different to the market yield due to factors such as location, lease term, management lease payments, risk and economic climate. The internal rate of return calculation would incorporate the estimated market value for a property along with forecast lease payments, capital expenditure, overheads and sales price. Each of these inputs would be subjectively determined as it would be impossible to accurately forecast each of these inputs for say 10 years. It is also from the point of view of the lessor and not the lessee. The end result would be a discount rate that may not reflect the commercial reality of the lease contract and may require further adjustments. It would be significantly onerous to perform this analysis on a lease by lease basis.

Therefore, it is unclear which methodology would be the best to apply as each would have its limitations. Any discount rate that is used would incorporate subjectivity and result in lack of comparability and meaning in financial results.

Impairment testing

The right-of-use asset recorded under the proposals will have to be allocated to the relevant cash generating units ('CGU'), which will result in different considerations from the current position. Specifically a mismatch will result as:

- there will have been no corresponding change in real cash flows; and
- the carrying amount of the CGU would be affected by the inclusion of the right-of-use asset and the inclusion or exclusion of the liability to make lease payments.

The proposals have swapped the operating lease expense for interest expense on the lease liability and amortisation of the right-of-use asset, and result in the net present value of the forecasted cash flows of the CGUs increasing, as the interest expense and amortisation would be excluded from the forecasted cash flows.

Therefore the net impact will be dependent on whether the discount rates used for the right-of-use asset and the impairment test differ.

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Lease modification vs. extinguishment

We note that the proposed standard does not include guidance on how a lessee and lessor should account for a lease modification. Should it be treated as an extinguishment of one lease and recognition of a new lease, or as an extension of an existing lease with revised terms? In considering including guidance on lease modifications, the boards should be mindful of the legal obligations under modified or extinguished leasing contracts.