



15 December 2010

Sir David Tweedie
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30 Cannon Street
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Dear David

EXPOSURE DRAFT ED/2010/9 Leases

The Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on the Exposure Draft ED/2010/9 *Leases*.

The FRSB supports the objective of requiring the recognition of all leased assets and obligations on the statement of financial position. However, in our view, the amounts recognised should reflect the extent to which the lessee has an unconditional liability to make lease payments without causing a breach of contract.

In addition, we have some other concerns. The FRSB's primary concerns with the Exposure Draft are as follows. We elaborate on these concerns in the appendix to this letter.

- Finance and operating leases are different economically and FRSB is concerned that the lease accounting models proposed in the Exposure Draft ignore the distinction.
- We agree with the criticisms of the current lease accounting model primarily because the rights and obligations under operating leases are off balance sheet; and two very different accounting models results in structuring opportunities. However, the proposals in the Exposure Draft can also be criticised, as the proposed model goes beyond the minimum lease period thereby requiring the recognition of a liability for lease payments for which there is no present obligation; and the measurement proposals are complex and subjective.
- There is a lack of symmetry between the proposed lessor accounting model and the proposed lessee accounting model. The FRSB considers that there should be consistency between the lessor and lessee accounting models.
- The FRSB is concerned at the practical difficulties of implementing the proposals. In particular: the need to capitalise numerous, relatively immaterial, leases.

- The FRSB considers that the exemption for short-term leases may not be sufficient to provide a reasonable level of relief. We believe that the exemption for lessees should be the same as the exemption for lessors, so should not require the recognition of assets or liabilities. Also, the proposals in regards to contingent rentals are of particular concern in the retail industry where contingent rentals are commonplace and the cost and complexity of estimating contingent rentals could be substantial for both lessor and lessee.
- The FRSB is concerned that, if an entity's leases are denominated in a foreign currency, the IASB's proposals may create a significant accounting mismatch between the right-of-use asset (which is unlikely to be restated for exchange rate movements) and the obligation to pay rentals (which is likely to be restated for exchange rate movements). It is unclear whether, under the IASB's proposals, the obligation to pay rentals is considered a monetary liability and therefore, whether it should be restated for movements in the exchange rate. The FRSB considers that this would be the case. The right-of-use asset on the other hand, being a non-monetary asset, the FRSB considers would be denominated in the entity's functional currency and, therefore, would not be restated for changes in exchange rates subsequent to inception of the lease. This mismatch is likely to be a significant issue for a number of industries throughout the Asia-Pacific region where leases of significant assets commonly are denominated in US Dollars.

To solve some of the issues we raise and dispel some of the concerns we have, the FRSB recommends that the IASB strengthen the proposed criteria and guidance on distinguishing leases from in-substance purchases by adding to the criteria and guidance the criteria in IAS 17 *Leases* on distinguishing finance leases from operating leases, and:

- for leases that are in-substance purchases, the IASB retain the existing accounting for finance leases under IAS 17; and
- for other leases, introduce the right-of-use model but measure the asset and liability recognised based on the minimum non-cancellable lease term and other payments that the lessee is obliged to make.

The FRSB considers that the above changes to the proposed lease accounting model will result in an amended model that would:

- better reflect the substance of lease arrangements being that finance leases are effectively in-substance purchases with secured financing and operating leases provide the lessee with a right of use and an unconditional obligation to make lease payments over the minimum lease period;
- address the concern with the existing lease standard by ensuring that the rights and obligations arising under operating leases are appropriately recognised on the statement of financial position but without recognising a liability where there is no present obligation to make payment;
- reduce the current difference between the accounting for operating and finance leases thereby reducing the pressure currently placed on the distinction between operating and finance leases; and

- require less of a change from current practice than would be required to implement the models proposed in the Exposure Draft and, as such, would be less costly to implement.

We expect that the necessary amendments that would have to be made to the proposals in the Exposure Draft in order to produce a final standard would result in any final standard not being issued within the deadline of 30 June 2011. We would prefer a high quality standard to a lower quality standard issued within a self-imposed deadline. Therefore, we are prepared to accept any necessary delay required for further consultation and re-exposure.

Responses to questions for respondents

The FRSB's responses to the specific questions for respondents to the Exposure Draft are provided in the appendix to this letter.

If you have any queries or require clarification of any matters in this submission, please contact me.

Yours sincerely



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Appendix – FRSB’s responses to specific questions for respondents raised in the Exposure Draft

The accounting model

Question 1: Lessees

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

1. The FRSB supports the objective of requiring the recognition of all leased assets and obligations to make lease payments on the statement of financial position. However, the amounts recognised should reflect the extent to which the lessee has an unconditional liability to make lease payments without causing a breach of contract. The FRSB is not convinced that optional lease periods and contingent rentals based on factors within the entity’s control (such as sales and usage) give rise to a liability and therefore disagrees with the inclusion thereof in the obligation to pay rentals.
2. The FRSB recommends that the IASB, within the body of the proposed standard or within the application guidance, provide more explanation for recognising lease assets and liabilities on the statement of financial position to clarify that lease contracts subject to the lease accounting model are not executory contracts.
3. The FRSB also recommends that the IASB limit the lease term to the non-cancellable term and require that optional lease periods and contingent rentals be recognised only when those options and contingencies are outside of the control of the lessee or lessor. Refer to our Responses to questions 7, 8 and 9 below for further discussion on accounting for options and contingencies.
4. The FRSB agrees that a lessee should recognise interest on the liability to make lease payments. The FRSB considers the obligation to pay rentals to be a financial liability. Therefore, the FRSB considers that accounting for the obligation to pay rentals should be consistent with that of similar financial liabilities accounted for under IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments (2010)*. In addition, the FRSB considers that a lessee should have the option of measuring lease liabilities at fair value as an alternative accounting policy choice consistent with the option of being able to revalue the right-of-use asset.

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?

5. The FRSB does not agree with a multiple-model approach to lessor accounting. The FRSB agrees that a lessor's right to receive rentals under a lease meets the definition of an asset. The FRSB supports having a single approach to lessor accounting being the derecognition approach. The FRSB considers the derecognition approach to be consistent with the substance of a leasing arrangement whereby the lessor's asset is no longer the whole leased item but is the portion of the leased item remaining after the lessee's use thereof. By derecognising a portion of the leased asset, the lessor's financial statements appropriately reflects that the lessor has satisfied a performance obligation created by the lease contract and has no ongoing performance obligation in respect of the right-of-use asset. This approach is also consistent with the lessee accounting model because the lessor must have transferred an asset in order for the lessee to have acquired an asset from the lessor.
6. The performance obligation approach to lessor accounting is inconsistent with the lessee accounting model. It is not clear how the lessee can have received an unconditional right to use the leased asset over the lease term if the lessor continues to have an obligation to permit that use.
7. The FRSB recognises that implementing the IASB's proposals, and particularly implementing the derecognition approach, could be onerous in the case of short-term leases. However, the FRSB considers that following our recommendations in response to question 3 below, such as limiting the lease term to the non-cancellable lease term, would alleviate these concerns.

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?

8. The FRSB is concerned that the proposals will be both onerous and costly to implement. In particular, the FRSB is concerned about the need to capitalise numerous, relatively immaterial, leases based on probability-weighted estimates including optional periods and contingent rentals. In addition, the lack of symmetry between the proposed lessee and lessor accounting models will result in unnecessary cost for entities acting as both lessor and lessee of the same property. This is because the entity would have to use one set of cash flows when accounting for the property from a lessee perspective and a similar, but not identical, set of cash flows when accounting for the property from the lessor perspective.

9. For short-term leases, we believe that the proposed approach for lessors should also apply to lessees, which would mean it would not be necessary for the lessee to recognise assets and liabilities for short-term leases.
10. In addition, as discussed in our response to questions 7, 8 and 9, the FRSB considers that the lease term should be limited to the non-cancellable lease term and that optional lease periods and contingent rentals be recognised only when those options and contingencies are outside the control of the lessee or lessor. The FRSB considers that the FRSB's recommendations, combined with the exemption for short-term leases, should provide sufficient relief from the IASB's proposals in instances where application of those proposals would be onerous. For example, the FRSB's recommendations would be easier to apply and provide more appropriate outcomes for multiple short-term leases of property under lease agreements that permit either the lessor or the lessor to, without reason and without penalty, terminate the lease with only one month written notice.

Definition of a lease

Question 4: Definition of a lease

- 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 B5–B8 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

11. The FRSB agrees with the proposed definition of a lease. The FRSB considers the definition to be appropriately broad so as to capture all leases. However, as noted in our response to question 5 below, we are concerned that, despite the appropriately broad definition, the scope of the lease standard is limited to leases of property, plant and equipment.
12. The FRSB considers that the criteria in paragraphs B9 and B10 ought to be expanded to incorporate the criteria for identifying a finance lease currently in IAS 17 in order to appropriately reflect that finance leases are effectively in-substance purchases with secured financing and operating leases provide the lessee with a right of use and an unconditional obligation to make lease payments over the minimum lease period.
13. The FRSB also considers that the proposal to include all leases on balance sheet will place more emphasis on distinguishing between leases and purchases/sales and distinguishing between leases and other services. The FRSB is concerned that not enough guidance is provided in this area and recommends that the IASB provide further guidance. In particular it would be useful for the IASB to clarify:
 - how the IASB intends entities to deal with instances where, based on the indicators for assessing the transfer of control, control is judged to have transferred from the 'lessor' to the 'lessee' but the 'lessor' has some continuing involvement in the 'leased' asset; and

- the boundary between leases and other services in the case of, for example, shipping services where an entity provides the use of a ship as well as related stevedoring services or property development services where contractors provide necessary machinery as well as qualified operators.

Also refer to our response to question 6 below for further comments on distinguishing lease and service components.

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?

14. The FRSB does not agree with the scope of the proposed standard. The FRSB considers that the scope of the proposed new lease accounting standard should be based on the scope of the existing lease standards and should be broad enough to encompass the scope of both of the existing lease standards within IFRSs and US GAAP rather than the proposed narrowing of scope.
15. The FRSB considers that the scope should not exclude leases of intangible assets and sees no reason to reduce the current scope of IAS 17. This reduction in scope may have unexpected and costly practical implications, including requiring entities to review their existing approaches to lease accounting for assets that are no longer within the scope of any specific standard.. For example, an entity leases a computer together with software. It would be necessary for the lessee to bifurcate the lease payments into that relating to the hardware (under the new standard) and that relating to the software (potentially requiring a new accounting policy), which may be costly, impractical and lead to divergent treatments.
16. The FRSB agrees with excluding assets measured at fair value from the scope of the proposed standard on the basis that accounting for such assets at fair value provides more relevant information to users than would be provided if the proposed lease accounting model were applied. Although we agree with the scope inclusion of leases of investment property carried at cost and the scope exclusion of investment property carried at fair value, the FRSB recommends that these inclusions and exclusions be better explained in the basis for conclusions.

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?

17. The FRSB is concerned that the IASB and the FASB have not reached agreement on all aspects of the proposed lease accounting models. As noted in our comment letter on the IASB's Discussion Paper *Leases: Preliminary Views* the FRSB considers that the IASB and the FASB goal of convergence of US generally accepted accounting principles (US GAAP) and IFRSs will not be served if significant differences were to remain by the time the lessee accounting standards is finalised as such differences would only create new divergence.
18. The FRSB is unclear as to how the IASB would expect an entity to make reliable apportionment of a contract between lease and service components when the contract does not contain a distinct service component. The FRSB recommends that, if an entity is able to apportion a contract between lease and service components, the entity be required to do so and account for each portion under the appropriate standard. However, if an entity is unable to make a reliable apportionment, the entity be required to determine whether the contract is predominantly a lease contract or predominantly a service contract and then apply to the whole contract the relevant standard (i.e. the IASB's proposed revenue standard or the proposed lease standard respectively). The FRSB considers that this approach will result in appropriate accounting and avoid the recognition of inappropriate day-one gains under the derecognition approach for lessor accounting.

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?

19. The FRSB agrees with the proposals in the Exposure Draft. The FRSB considers that the appropriate accounting for purchase options depends on the affect of the options on the substance of the lease contract as follows:

- In the case of an option to purchase the leased asset at market value (or at a fixed price set at inception of the lease, which is likely to be market value at that date), the FRSB agrees that the option should be accounted for only when exercised and agrees that, being within the control of the lessee, the option should not be considered part of the lease term or lease payment.
- In the case of a bargain purchase option however, the bargain purchase option could result in the lease contract being judged to be an in-substance purchase in which case the entity would account for the contract as a purchase of the underlying asset rather than as a lease.

Measurement

Question 8: Lease term

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

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?

20. We have an overall concern that the lease term used for measurement appears to be based on the potential for transfer of control of the leased asset rather than on the obligation of the lessee to make lease payments. On balance, the FRSB holds the view that the obligation should be the determinant of the lease term rather than the potential for extension of the lease term.
21. In the *Framework for the Preparation and Presentation of Financial Statements* a liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. An essential characteristic of a liability is that the entity has a present obligation being a duty or responsibility to act or perform in a certain way. A distinction needs to be drawn between a present obligation and a future commitment. A decision by management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.
22. The FRSB considers that the non-cancellable term of a lease contract meets the definition of a liability being a present obligation of the entity being an irrevocable agreement to use the leased asset and an obligation to make lease payments which the entity has little, if any, discretion to avoid.

23. However, options to extend or terminate the lease and contingent rentals based on factors within the entity's control (such as sales and usage) do not necessarily give rise to a present obligation unless there are significant economic consequences for an entity failing to act in particular manner, such as a substantial penalty.
24. In the case of options outside the control of the entity, the entity has little, if any, discretion to avoid obligations that might arise. As such the FRSB agrees that options and contingencies outside the control of the entity meet the definition of a liability and should be included within the measurement of an entity's obligation to pay rentals. In the case of contingencies and options within the control of the entity, however, until the entity has exercised the option or until the contingency has arisen, the entity has not committed to an irrevocable agreement and has the discretion to avoid obligations that could arise. Therefore, the FRSB considers that such options and contingencies do not meet the definition of an obligation and no liability should be recognised until the options are exercised or the contingencies arise i.e. when it is reasonably certain that lessee will exercise the option or that the contingency will arise.
25. Therefore, the FRSB recommends that the IASB limit the lease term to the non-cancellable term and require that optional lease periods and contingent rentals be recognised only when those options and contingencies are outside of the control of the lessee or lessor. However, the FRSB recognises that this approach could create structuring opportunities. For example, an entity could lease a specialised machine under a short-term lease with multiple renewal options but, given the specialised nature of the asset, it is virtually certain that the entity would renew the lease. In order to address concerns about structuring opportunities, the FRSB recommends that, where a lessee has the option to extend a lease, the lease term include any further terms for which the lessee has the option to continue to lease the asset when it is virtually certain that the lessee will exercise the option. Therefore, the FRSB recommends that, similar to the definition of lease term in IAS 17, the IASB define the lease term as:
- The non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset when it is virtually certain that the lessee will exercise the option.
26. The FRSB considers that it will be extremely complex and costly to measure amounts using detailed probability-weighted averages of all possible outcomes. As such, the proposed approach to dealing with measurement uncertainty would create: (i) considerable compliance costs; (ii) overly complex reported amounts (that do not equate to actual or expected outcomes); and (iii) tension between reporting entities and their auditors. The FRSB considers measurement at the most likely amount or best estimate to be preferable as it would be less costly and would provide users with the most relevant and useful information.

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?

27. The FRSB agrees 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. If the assets and liabilities are not reassessed when facts and circumstances change, the information presented to users will become increasingly outdated, irrelevant or misleading.
28. We agree that changes that relate to future periods should result in an equal adjustment to the right-of-use asset and changes that relate to current or prior periods should be recognised immediately in the income statement.

Sale and leaseback

Question 11: Sale and leaseback

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

29. The FRSB agrees with the criteria for classification as a sale and leaseback transaction. The FRSB considers that the resulting accounting would appropriately reflect the substance of the arrangement.

Presentation

Question 12: Statement of financial position

- a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (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?

30. To avoid presenting overly complicated primary financial statements the FRSB considers that the disclosures described in paragraph 25 of the Exposure Draft should be presented in the notes to the financial statements. That is, on the face of the statement of financial position an entity should present: (i) only one line item for property, plant and equipment being the total of owned property, plant and equipment and right-of-use assets for leases of property, plant and equipment; and (ii) one line for financial liabilities carried at amortised cost comprised of lease liabilities and financial liabilities. In the notes to the financial statements the FRSB agrees 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 owned assets. In addition, the FRSB considers that the IASB should acknowledge that the leased assets are intangible assets but, for practical reasons of comparability between entities that own their assets and entities that lease their assets, right-of-use assets are presented alongside owned assets similar in nature to the underlying leased assets.
31. The FRSB considers that entities should be required to disclose a note on liabilities for lease payments that presents information on opening and closing balances, showing separately cash lease payments and interest expensed during the period. This disclosure would present the complete picture in a concise manner for users rather than having the information users require disclosed separately in different locations throughout the notes to the financial statements.
32. The FRSB does not support the performance obligation approach for lessors. The FRSB supports the derecognition approach. The FRSB is concerned that the need to present balances arising under the performance obligation approach on a net basis suggests that the performance obligation approach is flawed. However, if the IASB proceeds with allowing both approaches, the FRSB considers that a lessor applying the performance obligation approach should present only the net amount on the face of the statement of financial position and the gross amounts in the notes to the financial statements. This is because the gross amounts relate to the same counterparty. Also, presenting only the net balance would aid comparison with lessors following the derecognition approach and avoid presenting primary financial statements that are overly complicated.
33. The FRSB considers that a lessor applying the derecognition approach should, on the face of its statement of financial position, present all financial assets and property, plant and equipment together with other items similar in nature. Only in the notes to the financial statements should the lessor disclose rights to receive lease payments separately from other financial assets and residual assets separately within property, plant and equipment.
34. The FRSB agrees that lessors should distinguish assets and liabilities that arise under a sublease. These balances arise from arrangements with different counterparties and, as such, should not automatically be offset. However, distinguishing these assets and liabilities need not be on the face of the statement of financial position. For example, these assets and liabilities could be included on the face of the statement of financial position within totals of similar assets and liabilities, the detailed composition of which is disclosed in the notes to the financial statements. Disclosure of the information proposed in paragraph 43 of the Exposure Draft would be appropriate in the notes to the financial statements to provide users with concise summary of the sublease arrangement.

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?

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?

35. The primary financial statements rapidly becoming too detailed. Providing too much detailed information on the face of the primary statements could result in important information being obscured. As such the FRSB agrees that lessees and lessors should disclose lease income and lease expense and cash flows arising from leases separately from other income and expense and cash flows but only in the notes to the financial statements. As alluded to in our response to question 12 above, disclosing in the notes to the financial statements a complete, cohesive but concise note covering all leasing activities would provide users with far more meaningful and understandable information than would separate disclosure of lease related amounts throughout the financial statements and notes.

Disclosure

Question 15: Disclosure

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

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

36. The FRSB agrees with the disclosure principles. However, the FRSB considers it imperative that disclosure requirements do not become so detailed that significant issues or material items are obscured, or that financial statements become so complex that the vast majority of users are unable to understand them. The FRSB is concerned with the following proposed disclosure requirements:
- Disclosure of detailed reconciliations (in paragraphs 77 and 80 of the Exposure Draft) of leases balances may require disclosure of too much detail. The IASB appears to have concluded that disclosure is required of complete reconciliations of all major balances in the statement of financial position but without providing justification for such a blanket approach to determining disclosure requirements.

- The proposed disclosure (in paragraph 83 of the Exposure Draft) in respect of significant judgments in the application of the proposed standards would potentially duplicate the disclosures required by IAS 1 regarding judgements made in the process of applying the entity's accounting policies and information about sources of estimation uncertainty.

Transition

Question 16: Transition

- 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?
- 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?

37. The FRSB agrees that lessees and lessors should be permitted to recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach. The FRSB considers the proposed approach to be a practical and reasonable means to achieving initial implementation in the most cost effective manner possible.
38. However, the FRSB considers that full retrospective application of the lease accounting requirements should be permitted. If entities have the necessary information to undertake full retrospective application, they should not be prevented from full retrospective application if they consider that full retrospective application would provide more relevant and reliable information.

Benefits and costs

Question 17: Benefits and costs

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?

39. The FRSB is concerned that the proposals will be both onerous and costly to implement. Refer to our comments in response to question 3 above.

Other comments

Question 18: Other comments

Do you have any other comments on the proposals?

Foreign-exchange risk exposure

40. The FRSB wishes to raise an issue which is not currently covered explicitly in the Exposure Draft for the IASB to clarify the treatment because this will be a very significant issue for entities which have leases denominated in another currency (typically the USD for a number of industries such as the airline, shipping and oil and gas industries). The FRSB recommends that the IASB provide some guidance around whether the gain or loss arising from a change in foreign exchange rate should be recognised immediately or whether the change in the exchange rate is considered to give rise to contingent rental. We consider that there is an argument to consider the gain or loss contingent rental. In the Exposure Draft contingent rental is defined as 'lease payments that arise under the contractual terms of a lease because of changes in facts or circumstances occurring after the date of inception of the lease other than the passage of time'. The change in the exchange rate could be considered a change in circumstance which changes future lease payments. Given that the asset and liability are inextricably linked it would make sense to adjust the asset for the gains and losses which relate to the future lease payments, the same as for other contingent rentals. The right-of-use asset is measured at its estimated cost, and hence changes in the estimated future lease payments - whether because of movements in foreign exchange rates or other external factors (e.g. a change in an index to which the lease payments are linked) - result in a change to the asset's estimated cost.
41. This issue needs serious consideration because it will give rise to a very significant impact on entities which do not have a US Dollar functional currency. It is unlikely in many Asia-Pacific countries for example that entities would be able to negotiate these types of leases in their own functional currency. In New Zealand the exchange rate varies widely over relatively short time spans and the impact could give rise to significant volatility for equipment intensive entities if the exchange gains and losses are not adjusted against the right-of-use asset. We understand that practically while entities do hedge their operating lease payments now, that they often do so only for the short-term (for example the next financial year) the same as for their other operating expenses and that it would be prohibitively expensive to hedge over the full term of the lease for long-term leases for aircraft for example, which can be well in excess of 10 years.

Accounting for government grants

42. Many governments provide grants to businesses through low-cost leases. The FRSB considers that, in these instances, the right-of-use asset should be initially measured at fair value, rather than the present value of the lease payments. However, following the requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, an entity could record the right-of-use asset at a nominal amount which again indicates that IAS 20 ought to be revised.