



15 December 2010

International Accounting Standards Board
30 Cannon Street
London
EC4M6XH
United Kingdom

Dear Sir/Madam

IASB/FASB *Leases* Exposure Draft

Members of the Australian Equipment Lessors Association (AELA) and the Australian Fleet Lessors Association (AFLA) appreciate the invitation of the IASB and FASB (the boards) to comment on the exposure draft (ED) 'Leases'. AELA and AFLA members are the major providers in Australia of equipment leasing and fleet leasing, and the appendix to this submission contains a listing of members.

We recognise the boards' motivation in developing the ED, however our members have identified major reservations. Under the proposals, when an entity has a contractual obligation which delivers physical access to an asset it is regarded as a right of use asset and capitalised; if the contractual obligation does not deliver physical access to an asset it is an executory contract and not capitalised. Because this distinction is so fundamental to the ED framework, we believe that the current IAS 17 treatment should remain until a cogent case is made as to why amounts are capitalised under leases but not other contracted obligations which continue to be treated as executory contracts.

Our accompanying response to the specific questions posed in the ED notes other concerns. To include amounts due under options and contingent rentals in the measurement of lease assets and liabilities is inconsistent with the IASB Conceptual Framework definition of a liability or asset; the performance obligation approach for lessors is inconsistent with the right of use model; under the derecognition approach there is no ability to accrete the residual asset to reflect the time value of money; intangible assets are not included within the scope of the ED; lease expenses are front-loaded; reassessment should only occur where an actual change in lease parameters has occurred; the transitional proposals have substantial impact on lessee profitability.

Significantly, similar fundamental concerns with the ED have been raised in independent responses. These include the alternative view of Mr Stephen Cooper, a member of the IASB, the European Financial Reporting Advisory Group (EFRAG), and the Swedish Financial Reporting Board. Given the significance of the concerns raised, we are of the view that the

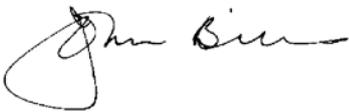
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ED in its present form is not an effective improvement on IAS 17, that more time should be taken to finalise the new leasing standard, and that this should involve extra months rather than years. This approach could, for example, see a final Standard issued in July 2012.

The ED has been most useful in focusing debate on lease accounting, and has elicited constructive proposals in response; we look forward to the outcome of the consultation process. We would be pleased to provide further input in this regard.

Yours sincerely

A handwritten signature in black ink, appearing to read "John Bills". The signature is fluid and cursive, with a large initial "J" and "B".

JOHN BILLS
Director



15 December 2010

IASB/FASB Leases Exposure Draft (ED)

Response by Australian Equipment Lessors Association and Australian Fleet Lessors Association

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?

AELA/AFLA Response

We do not agree that a lessee should in all circumstances recognise a right of use asset and a liability to make lease payments. Presently IAS 17 makes a risk/reward distinction between finance and operating leases. One of the purposes of a new lease standard is to eradicate 'bright-line' distinctions of this nature. However the ED merely moves the 'bright-line' to a different point on the spectrum; service contracts will still be treated as executory contracts and remain off balance sheet. The ED has not provided illumination as to why a lease is not regarded as an executory contract in the same way as similar obligations. Under the ED, if an entity has a contractual obligation which delivers physical access to an asset it is regarded as a right of use asset and capitalised; if the contractual obligation does not deliver physical access to an asset it is an executory contract and is not capitalised. This issue is fundamental to the ED consultation process, and until a cogent explanation is made as to why amounts are capitalised under leases but not other contracted obligations which continue to be treated as executory contracts, we believe the current IAS 17 treatment should remain.

Such fundamental concerns with the ED have also been raised in independent responses. These include the alternative view of Mr Stephen Cooper, a member of the IASB, the European Financial Reporting Advisory Group (EFRAG), and the Swedish Financial Reporting Board. Given these legitimate reservations, we note the EFRAG view that more time should be taken to finalise the new leasing standard, and that this should involve extra months rather than years; we thoroughly support this approach, which would see a final Standard issued for example in July 2012

We also note that the ED has been very useful in focusing debate on lease accounting, and has elicited much attention and constructive proposals in response. We believe one particular approach which has emerged should be carefully considered by IASB/FASB, and that is to treat 'basic' rental arrangements as service contracts. This, for example, would mean that an agreement which is not for substantially all of the economic life of the asset, does not contain an option to purchase the asset, has no renewal option, and a residual value guarantee is not provided by the lessee (or a related party), would be treated as a service contract. We urge that this approach be further evaluated, and note that EFRAG has suggested a conceptual approach which has some similarities.

(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?

AELA/AFLA Response

We do not agree with the amortisation proposals; these would result in the largest charge to earnings in the first year of the lease, with the charge decreasing over the term of the lease. This effect is exacerbated when the lease is required to include estimates of contingent rentals and extension options. This is not reflective of the cash flows of the lease where lease rentals are the same over the term of the lease, and is likely to result in the right of use asset amortising more quickly than the liability.

In addition, this proposal creates front-ended lease costs which are illusory, and therefore defers revenue. It results in the lease being 'under water' from inception (ie, in a net liability position), with the book value of the asset amortising faster than the liability. This front-end cost pattern is exacerbated the longer the lease term. We believe lease accounting should ensure the continuing equivalence of the lease asset and liability amounts over the life of the lease, with both the asset and liability amortising under the same methodology. Further, we believe the total expenses recorded in the income statement should be disclosed together as 'rental expense' so readers of the financial statements can identify an entity's total expenditure under lease contracts, as opposed to separating and separately disclosing interest expense and amortisation of the right to 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?

AELA/AFLA Response

We submit that the performance obligation approach is inconsistent with the right of use model. The ED requires use of the 'performance obligation' approach where the lessor retains exposure to significant risks and benefits in the underlying assets, and the 'partial derecognition' approach for remaining leases.

The performance obligation approach is complex and requires value judgements, and is open to different auditor interpretation. It is fundamentally inconsistent with the 'right of use' model being proposed; the IASB view is that a lease is no longer an executory contract once it has been entered into, with the lessee having an unconditional right to use the asset and an unconditional liability to make lease payments. If the lessee has an obligation for all of the lease term from the date the lease contract is entered, it must also be the case that from that time the lessor does not have an ongoing performance obligation to continue to make the asset available to the lessee. The retention of risk by the lessor is not determinative of whether a lessor performance obligation exists; there is no logical connection between the two.

The lessor accounting approach consistent with the right of use model is derecognition. The draft standard proposes a partial derecognition approach, with the lessor required to maintain the residual asset on its balance sheet; accordingly it accommodates any concern that this approach fails to represent that the lessor may still have exposure to some asset risk. The derecognition model should apply to lessor accounting irrespective of the degree of lessor risk retention.

(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?

AELA/AFLA Response

Whilst supporting the derecognition over the performance obligation approach, we submit that derecognition must allow for accretion of the residual asset. Under the ED derecognition approach where lessors recognise a residual asset, the valuation of the residual asset is 'frozen' throughout the accounting periods. This is not logical, as the asset is initially recognised as the present value of the residual asset at the end of the lease term. As the residual asset is the present value of the expected cash flow from the sale of the asset at lease end, accordingly this amount should change at each accounting period, reflecting that the amount will be received sooner than at the previous accounting period.

Accordingly the derecognition approach should enable the recording of the residual asset at its present value at each accounting period, and allow accretion of the residual asset over the lease term. Without this ability, the derecognition approach will result in volatility in earnings which is artificial, as the only income derived over the period of the lease is the interest on the receivables. At the end of the lease there is then a large reversal of income as the difference between the balance sheet value of the residual asset and its market value is realised. The alternative approach of accreting the residual value over the life of the lease would smooth earnings to resemble the present accounting for a finance lease. Furthermore, the sharp drop in the value of the asset followed by a reversal at the end of the lease could unnecessarily give rise to capital management issues.

Question 3: Short-term leases

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?

AELA/AFLA Response

We do not believe the ED achieves a practical framework for short term leases-the omission of a present value requirement does not provide real simplicity; we suggest they be treated as operating leases are currently treated.

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?

AELA/AFLA Response

We do not believe this is the appropriate definition of a lease in the context of the ED. We acknowledge that it flows from the existing lease standard, but submit there is a need for a definition that reflects the conceptual approach of the ED proposal. We request that the definition be reviewed in the context of our comments above about the need to explain why amounts are capitalised under leases but not other contracted obligations, which continue to be treated as executory contracts. We also referred above to the approach which has emerged during this process to treat 'basic' rental arrangements as service contracts, and suggest that consideration of this approach could result in a more appropriate definition of a lease for the purposes of the ED.

(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?

AELA/AFLA Response

In the Australian context we believe these distinguishing criteria would be satisfactory.

(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?

AELA/AFLA Response

No, please see response 4(a) above. More fundamentally, not only do we believe the guidance for distinguishing leases from service contracts is insufficient, we submit that the ED does not provide a robust justification for capitalising all 'lease' agreements but treating service contracts as executory contracts.

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?

AELA/AFLA Response

The ED excludes leases of intangible assets; intangibles are currently addressed in IAS 17. Contracts which incorporate hardware and software will need to be accounted for separately, whereas many leases incorporate hardware and software, and this will increasingly be the case. The ED in paragraph BC36 acknowledges that the Boards have identified no conceptual reason why a lease accounting standard should exclude intangible assets, but they have been excluded because of broader consideration of intangibles. This shortcoming needs to be addressed, and the scope of the final standard needs to incorporate intangibles.

Question 6: Contracts that contain service components and lease components

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?

AELA/AFLA Response

Lessors should always be able to separate service components within the overall lease rental; if lessees are unable to do so they should not be required to capitalise the full rental amount, but in conjunction with their auditors make an informed assessment of the service component. We strongly disagree with the FASB proposal to apply lease accounting to the whole agreement.

Question 7: Purchase options

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?

AELA/AFLA Response

We believe options to purchase and options to extend a lease should only be accounted for when exercised.

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?

AELA/AFLA Response to questions 8 and 9

We strongly disagree with these approaches. The ED requires amounts due under options and contingent rentals to be included in the measurement of lease assets and liabilities on an estimated basis.

Accordingly all leases within the scope of the new standard will be included on the balance sheet of lessees, initially measured at the present value of the expected lease payments, discounted at the implicit interest rate in the lease (or the lessee's incremental borrowing rate). Currently under IAS 17, *minimum lease payments* are included in the calculation of assets and liabilities, but the ED requires estimates of contingent rentals and optional rental periods that are more likely than not to occur to be included.

Amounts due under options and contingent rentals are not liabilities or assets, and should not be included in the measurement of lease assets and liabilities. Inclusion of these amounts results in too much being capitalised; this requirement capitalises amounts that are estimates, and not contracted liabilities. Such treatment is inconsistent with the IASB Conceptual Framework definition of a liability or asset, in that the lessee does not have an unconditional obligation to pay these amounts (until for example the option is exercised), nor does the lessor have an unconditional right to receive these amounts. This requirement also introduces unwarranted complexity and the need for value judgements.

Only contractual commitments should be include in the measurement of lease assets and liabilities. To address abuse, rather than a requiring all contingent rents/options to be capitalised, include only those where failure to exercise the option or renew the lease would result in a penalty; these payments should rightly be treated as disguised minimum lease payments.

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?

AELA/AFLA Response

Under the ED, lessees and lessors would be required to remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate 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 guarantees) since the previous reporting period.

As stated, we believe only contractual commitments should be included in the measurement of lease assets and liabilities. Periodic reassessment of optional rent periods and contingent rentals would create unnecessary volatility in financial statements and would be costly for preparers to implement. Further, we believe the costs of this requirement outweigh the benefits, and it does not provide the user of financial statements with more relevant and reliable information.

Reassessment of the carrying values should be required only for impairment purposes or where an actual change (eg, exercise of an option) has occurred. Apart from impairment, reassessment should be required only when it is likely that a residual payment is probable under a residual value guarantee, when a renewal option is exercised, or an event triggering contingent rent payments occurs.

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?

AELA/AFLA Response

We believe these criteria for classification are appropriate; we disagree that the lessor in a sale and leaseback transaction be required to use the performance obligation approach, as we support a modified derecognition approach for lessors.

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?

AELA/AFLA Response

We agree with this approach; it reflects that the lessee's right of use assets are clearly distinguishable from those owned by the entity.

(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?

AELA/AFLA Response

As noted above, we submit that the use of the performance obligation approach for lessors is inconsistent with the right of use model, and cannot be justified.

(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?

AELA/AFLA Response

As noted above, leased assets are different from the lessor's 'Plant, Property and Equipment', and rather than separate the residual assets within PPE, they should be shown as a separate item or included within other financial assets, with the amounts relating to the lease payments documented in the notes.

(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?

AELA/AFLA Response

We agree.

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?

AELA/AFLA Response

We support this approach of distinguishing lease income and lease expenses.

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?

AELA/AFLA Response

Again we support the separate disclosure of cash flows arising from leases.

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

(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?

AELA/AFLA Response

Because of the deficiencies noted in the ED itself, we do not support these disclosures as they would impose significant burdens. The ED proposals require significant additional requirements and value judgements in arriving at balance sheet disclosures, and these requirements add significantly to the disclosures in the notes to the accounts. A less complex leasing standard would in itself reduce the need for additional disclosures of this nature.

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?

(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?

AELA/AFLA Response

The ED proposes that lessees and lessors recognise and measure all outstanding leases as of the date of initial application using a 'simplified retrospective approach'. Lessees would be required to recognise a liability to make lease payments for each existing lease. There would be no adjustments for leases previously classified as capital leases that do not contain renewal options, contingent rents or residual value guarantees.

The significant impact for lessees of this proposal would be mitigated if the front-end loading of expenses was addressed; however, if this is not addressed lessees should have the option of adopting full retrospective application, otherwise as all leases will be treated as new leases the 'front-ending' of expenses will produce significant additional expenses. Furthermore, 'capital leases' with residual value guarantees should be included in the category of those not subject to adjustment, unless a residual payment is probable under a residual value guarantee.

For lessors, there is limited value in remeasuring existing leases; they should remain at present valuation, until either terminated or an actual change in their terms and conditions occurs.

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?

AELA/AFLA Response

We are in agreement with the assessment of the European Financial Reporting Advisory Group (EFRAG), in that we are not persuaded that the ED provides an effective improvement on the existing IAS 17; we also agree with EFRAG that the additional time required to ensure a robust new leasing standard is a matter of months and not years. Accordingly we suggest that the Boards allocate sufficient time to address the legitimate concerns that have been identified, and issue a revised ED with a view to a final Standard by July 2012.

Other comments

Question 18

Do you have any other comments on the proposals?

AELA/AFLA Response

We would like to comment on two issues of particular relevance to the Australian market. Firstly, SMEs in other countries can utilise the IFRS arrangements for this grouping, but this option is not available in Australia. Because the ED proposals are so far reaching, we suggest that the final standard should specify that the IFRS SME standard is an alternative option for the treatment of leases for those entities that qualify. This would ensure consistency of treatment and comparability of like entities.

Secondly, the novated lease is a form of lease unique to Australia; it is an agreement between the employee, employer and lessor, under which the obligation to pay the lease rentals is transferred (novated) by the employee to the employer for the period of employment; these obligations revert to the employee on cessation of employment. The agreement also contains an indemnity under which the employee indemnifies the employer for any payments under the lease. Under the current proposals these contracts could be regarded as a head lease (between the employer and lessor) and a sub-lease (between the employee and employer). In this context, we suggest that an arrangement be scoped out of the Standard and be treated as a service contract (ie, not capitalised) where it satisfies the following criteria: it does not contain an option to purchase the asset; it does not contain a renewal option that allows the lessee to extend the term; the lessee does not provide a residual guarantee.

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Alliance e-finance	Komatsu Corporate Finance
ANZ Asset Finance	Lanier (Australia)
Atlas Copco Customer Finance	Macpherson + Kelley Lawyers
Australasian Asset Residual Management	Macquarie Leasing
Australian Structured Finance	Mallesons Stephen Jaques
Allens Arthur Robinson	Medfin Australia
Baker & McKenzie	Members Equity Bank
Bank of Queensland	Mercedes-Benz Financial Services
Bendigo & Adelaide Bank	Mercer Australia
Blake Dawson	Morris Finance
BMW Australia	National Australia Bank
Bynx Australia	NLC
Canon Finance Australia	Norton Rose Australia
Capital Finance Australia	PACCAR Financial
Caterpillar Financial Australia	Pitney Bowes Credit Australia
Challenge Consulting Australia	Print Solutions Finance
CHP Consulting	Protecsure
Cisco Systems Capital Australia	Queensland Treasury Corporation
CIT Financial	Realtime Computing
Clayton Utz	RentSmart
CNH Capital Australia	Ricoh Finance
Colin Biggers & Paisley	RR Australia
Commercial Asset Finance Brokers Assoc.	Selectus Managed Services
Commonwealth Bank of Australia	Service Finance Corporation
De Lage Landen	SG Equipment Finance
Deloitte Touche Tohmatsu	Sharp Finance
DibbsBarker	Sofico Services Australia
equigroup	Solutions Asset Management
Experien	Southern Finance Group
Flexirent Capital	Spectra Financial Services
Freehills	St. George Bank
Fuji Xerox (Finance) Australia	Suncorp
GE Commercial Finance	SunGard Asia Pacific
Henry Davis York	The Leasing Centre (Australia)
Holman Webb Lawyers	Traction Group
HP Financial Services	Toyota Finance Australia
IBM Global Financing	United Financial Services Capital
Innovation Fleet	Volvo Finance
Insyston	Westlawn Finance
International Decision Systems	Westpac Institutional Banking
John Deere Credit	White Clarke Asia Pacific
Kemp Strang	Yamaha Motor Finance

December 2010



Australian Fleet Lessors Association

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AFLA MEMBER COMPANIES

Alphabet Fleet Services

Capital Finance

Custom Fleet

Fleetcare

FleetPartners

FleetPlus

LeasePlan Australia

McMillan Shakespeare

NLC

ORIX Australia

QFleet

sgfleet

StateFleet

Summit Auto Lease Australia

Toyota Fleet Management

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