15 December 2010

Sir David Tweedie
Chairman
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

ED 2010/9 LEASES

Thank you for the opportunity to comment on this exposure draft (ED). The New Zealand Treasury is pleased to submit its comments below.

The Treasury consolidates the Financial Statements of the Government of New Zealand. At 30 June 2010 the Government, as a lessee, has operating lease commitments of NZD6.1 billion, of which NZD2.9 billion relate to non-cancellable accommodation leases with the remainder relating to other non-cancellable leases. The Government is also the largest lessor of residential property in New Zealand, renting out 69,000 houses to citizens and their families through its subsidiary Housing New Zealand Corporation.

We agree with the Board that it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity’s leasing activities. We also acknowledge that the current model for accounting for leases has created structuring opportunities as a result of the bright line between finance and operating leases. In our view it’s inefficient for the economy to have accounting rules drive the structure of transactions.

“Rent vs Buy”

The Treasury understands why the Board has proposed that all lessee rights and obligations be recognised on balance sheet. However, in our internal consultations on the proposed standard, we have frequently come up against a different view on the economic substance of lease transactions. This view acknowledges two perspectives:

- the economic substance of some lease contracts is the purchase of a right-to-use asset through a financial liability that is settled over the term of the lease; but
- the economic substance of other lease contracts is to arrange for a stream of operating benefits that will be met through an operating expense.
This alternative view suggests to us that the substance of some lease agreements are less about establishing rights and obligations, but more about establishing the conditions under which the entity does business i.e. "operating arrangements". These "operating arrangements" type leases are more appropriately categorised with collective employment contracts, retainer contracts and other executory contracts than they are with assets and liabilities for reporting purposes. According to this view the "rent vs buy" decision can lead to significantly different economic impacts and under the IASB's proposed model, this difference in economic substance may be lost in reporting. We expand on this further in our response to Question 1 below.

If the IASB does not think that lease arrangements exist with a different economic substance other than the acquisition of a right-to-use asset, it needs to more clearly state this and state why.

We have concerns with the measurement proposals

The Treasury does not agree with a number of measurement proposals in the ED.

We do not agree that the present value of the lease payments should be determined by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease.

Lease Term
The Treasury believes that the option to extend or terminate a lease term is a future event and does not reflect a present obligation on either party upon signing a lease. User needs are better met by disclosure of options attached to leases rather than forcing any subjective and complex measure for accounting for these at inception.

Lease Payments
We do not agree that in determining the present value of lease payments that estimates of all contingent rentals and residual interest should be included. We think that contingent rentals are future events that are not certain at the outset of the lease. In our view, contingent rentals, penalties and residual guarantees do not represent a present obligation.

The Treasury believes that the present value of the lease payments should be based on the non-cancellable lease term and unconditional lease payments. We acknowledge that the IASB is concerned that potential structuring opportunities for lessees may emerge if the lease term and payments reflect only the unconditional elements of a contract. A possible way to mitigate this risk is to include a rebuttable presumption that the lease term is for the contractual term, unless there is evidence that this is not the case. If the presumption can be rebutted, the lease term should be measured using the term that is more likely than not. This is discussed further in our responses to Question 8 & 9 below.

Balance between the costs and benefits not achieved

We believe the ED fails to strike the right balance between costs for preparers and benefits for users.

In our view the measurement proposals are subjective, complex and will be very costly for preparers to measure and costly for auditors to verify. We are also concerned that these additional costs will not result in commensurate benefits to users, particularly for the reporting of leases where the economic substance of the lease is close to "operating arrangements".
We support the Board’s proposals to provide relief for short-term leases with a maximum lease term of 12 months. However, we urge the Board to consider extending the proposed relief for lessors to lessees. We expand on this further in our response to Question 3 below.

Yours sincerely

Hugh Packer
for Secretary to the Treasury
Annex One: The New Zealand Treasury’s Responses to Specific Questions

**Lessees**

**Question 1(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?*

We are not convinced by the single model for lessees

We agree that a lessee has a right-of-use asset and a liability to make lease payments when a lease agreement is signed. Therefore, our first instinct is that it is appropriate that all these rights and obligations should be recognised on the lessee’s balance sheet to reflect the economic substance of a lease contract.

We also acknowledge that the distinction between finance and operating leases in IAS 17 created incentives for the leasing industry to design contracts to get around the constraints. In our view, it’s inefficient for the economy to have accounting rules driving the structure of transactions. In that regard, we support the efforts of the IASB in trying to solve the “leasing problem”.

Therefore, the Treasury understands why the Board has proposed that all lessee rights and obligations be recognised on balance sheet. However, in our internal consultations on the proposed standard, we have frequently come up against a different view on the economic substance of lease transactions. This view acknowledges that while the economic substance of some lease contracts is the purchase of a right-to-use asset through a financial liability that is settled over the term of the lease, the economic substance of other lease contracts is to arrange for a stream of operating benefits that will be met through an operating expense. According to this view the “rent vs buy” decision can lead to significantly different economic impacts and under the IASB’s proposed model, this difference in economic substance may be lost in reporting.

The types of leases cited to support this additional view of leases include:

- Cancellable leases (if a right or obligation can be cancelled by the other party it is not in substance a right or obligation). For example in NZ, much of the home rental market is leased this way.
- Leases where the lessor follows the performance obligation model (if the lessor has a performance obligation then the lessees right is more faithfully reported as a right to enforce performance, than as a right to an asset).
- Leases where there are significant restrictions on the right to use an asset (at some point the value of reporting the right-to-use the asset becomes so fettered that it is a more faithful approach to report the costs and benefits as they emerge). For example, this is likely to be the case where the lessor requires their own staff to operate the asset as in the case of a driver operating a crane on a construction site.

Our analysis of these comments suggests that the substance of such lease agreements is less about establishing rights and obligations, but more about establishing the conditions under which the entity does business. In our analysis we describe such arrangements as “operating arrangements”. In our view, these operating arrangements are more appropriately categorised with collective employment contracts, retainer contracts and other executory contracts than they are with assets and liabilities.
From a user needs perspective, the Treasury considers these operating arrangements are more effectively presented separately from the present financial rights and obligations reported on the balance sheet. Accounting for such arrangements does not lead to a different view on what is the amount of an entity's net worth, but rather provide information on how that net worth is being applied.

Treasury notes the IASB has itself referred to similar comments in BC8 and BC9, but we do not consider that the IASB has effectively engaged with these arguments in its conclusion in BC10. If the IASB does not think that lease arrangements exist with a different economic substance other than the acquisition of a right-to-use asset, it needs to more clearly state this and state why. However, if the IASB accepts that, for example, cancellable leases do not create separate rights and obligations, then such leases need to be scoped out of the proposed requirements and separately dealt with.

Mirroring of lessee and lessor accounting is desirable

While the ED proposes a single model for lessees, two models have been proposed for lessor accounting. These two lessor models reflect that there is an economic difference between a lessor retaining exposure to significant risks or benefits of an asset (the performance obligation approach) and a lessor in-substance selling an asset with lease finance with some interest in the residual value asset (derecognition approach). As discussed above the mirroring of the lessor's performance obligation approach from a lessee's perspective is more aligned to the lessee's right to enforce performance, rather than as a right to an asset

The Treasury thinks that this difference in economic substance from a lessor's perspective is equally important to users of lessees' financial statements. Again, this doubts that one lessee model meets user needs.

Boundaries still exist along a lease contract “continuum”

The major advance the standard makes is the withdrawal of the inappropriate boundary currently drawn between operating and financing leases. However, we note that under the proposals there are still boundaries where different accounting treatments apply. Our analysis of this is shown in the diagram on the next page.

The Treasury accepts that wherever the Board draws a boundary along such a continuum, it may not fully meet the needs of all users and will introduce additional preparer costs. In short, there is no perfect answer and opportunities for structuring will always exist. Under the current proposals structuring opportunities may move to the boundary that this proposal draws between right-of-use contracts and executory contracts.

The harm from such structuring is reduced however when the recognition or measurement requirements most closely approximates economic substance. In the Treasury’s view, this will be achieved if specified operating arrangements we have discussed above are excluded from these proposals, and if our measurement proposals under Question 8-9 are adopted. If these recommendations are adopted, the rights and obligations (and only the rights and obligations) that arise from lease contracts, whether currently defined as operating or financing, will be reported on the balance sheet.

Even if the IASB continues to seek a single model for lessee accounting, we urge to Board to revisit at least the measurement aspects of the proposal to ensure there is an appropriate balance between preparer costs and benefits to users. The Treasury believes that under the current proposals the Board has not achieved the right cost/benefit balance.
Question 1(b): Lessees

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

We agree with the proposals. Under a model that develops a right-of-use asset and an obligation to pay future lease payments, the natural consequences are that:

(a) the asset is amortised as it's used; and

(b) there is an interest expense as a result of recognising the obligation at the present value of future cash flows.

However, as discussed above where a lessee has "operating arrangement" type leases the inability of a user identifying a periodic rental expense on the face of the operating statement is not necessarily an improvement. Also in such cases, the introduction of interest expense using effective interest rates is likely to result in the operating statement being less understandable to some users.
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?

(a) We believe that two separate approaches to lessor accounting appropriately reflects the differences in the underlying substance of leases. In other words, the removal of the physical assets and recognition of a residual interest under the lessor derecognition approach is reflecting

- the lessee has made an in substance purchase of the underlying asset; and
- the lessor only retains rights to receive principal and interest payments plus any residual interest in the asset.

Under the lessor performance obligation approach, we agree that users may find it useful if the accounting reflects that the lessor retains the risks and rewards of the underlying asset. The natural consequence under the Board’s rights and obligation model is that the lessor also has a performance obligation to provide the asset, and rights to receive lease payments for doing so. Essentially, the lessor is providing, and the lessee is receiving, services which are more akin to “operating arrangements” as described in Question 1 above.

In summary we are supportive of a lessor model that reflects if you don’t have the underlying asset, derecognise it, but if you do, continue to recognise the asset but also recognise your performance obligation to allow the lessee access to it.

We note that the performance obligation approach has strong parallels to the proposed approach that the International Public Sector Accounting Standards Board (IPSASB) exposed in their ED 43 Service Concession Arrangements: Grantors. We understand that the IPSASB has received a significant number of comments on the validity of their performance obligation approach. We request that the Board liaise with the IPSASB to ensure that no unnecessary or inappropriate differences arise between the final leasing standard’s requirements for lessors and the IPSASB’s requirements for service concession arrangements.

As the lessor does not have a choice of model to apply, but must select the appropriate model on the facts, we would like the Board to provide additional guidance between the performance obligation and the derecognition approach. In particular, we believe that more guidance is required around what is ‘significant’ in relation to transferring the risks and rewards. We also would like the Board to clarify in the Basis of Conclusions why the use of risks and rewards is appropriate when the recently exposed revenue standard centred on the concept of ‘control’ in determining a sale.
(b) The Treasury agrees with the board’s proposals for recognition.

(i) Under the **derecognition approach** where the lessor removes the physical asset from balance sheet and creates a residual asset it makes sense that the other side of that entry (the net debit) is recognised in the operating statement. It also makes sense that the when the lessor recognises an asset for the right to receive lease payments, the other side of that entry (or the net credit) is also recognised in the operating statement.

Under this derecognition model, we believe that the above items should be shown as one net amount in the operating statements as they are similar to a day one gain / or loss of entering the lease contract. Showing these component items separately on the face, in our view, does not faithfully represent the intricate linking and timing of the components of the one lease contract. Grossing up the income and expense components on the face of the operating statement in our view may be more complex and less understandable for users.

We agree that interest income be recorded over the lease term, because it reflects an in-substance sale from the lessor’s perspective with financing income in return.

(ii) For the **performance obligation approach**, we agree with the recognition proposals. Where the lessor retains significant risks or benefits associated with the underlying asset, we believe it is appropriate to retain the asset on the lessor’s balance sheet. In our view, it is appropriate to reflect assets and liabilities for the right to receive lease payments and the obligation to provide the asset over time. However, we think the proposed presentation on the face of the balance sheet may be difficult for users to understand (see our response to Question 12 below).

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**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).

(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?
The Treasury agrees with reduced requirements for short term leases as a minimum.

However we would prefer the relief proposed for lessors to be mirrored for lessees. Under the proposals a lessor that has short-term leases may elect on a lease-by-lease basis not to recognise assets or liabilities arising from a short term lease in the statement of financial position. For the same cost/benefit arguments for lessors, we think this applies equally to lessees. Therefore, the Treasury would prefer lessees with leases of 12 months or less not to recognise right-of-use assets and lease liabilities, but rather expense lease payments.

The Board may be concerned that this raises structuring opportunities for lessees/lessors to structure long-term leases in 12 month tranches. The Treasury would prefer the Board to consider mitigating this risk with a rebuttable presumption that the lease term is for the contractual lease term, unless there is evidence otherwise. We discuss this rebuttable presumption concept further in Question 8 on lease terms below.

**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 B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

(a) Based on the current “bright lines” in the ED, we agree that the definition of a lease is appropriate.

(b) The Treasury thinks the Board has introduced unnecessary complexity and judgment, and therefore additional cost, in their proposals to determine whether a lease contract should be accounted for as an outright sale and purchase at inception, rather than a lease. As illustrated above in Question 1, *Diagram A: Contract Continuum*, the ED proposes to scope out lease contracts if, at the end of the contract, an entity transfers to another entity control of the entire underlying asset in all but a trivial amount of the risks and benefits associated with the entire underlying asset.

While we understand that the Board is attempting to "look through" the lease contract and identify in-substance sales and purchases, we think that the benefits of doing so are not significant enough to warrant the added complexity and judgments that will be involved. For example, a lease contract that is not determined to be an outright sale and purchase, but nevertheless the lessee has use of the asset for 95% of the asset’s useful life; the lessee will record a right-of-use asset and a lease liability. We would argue this is in fact an in-substance sale and purchase. Alternatively, if a lease contract is considered to be an outright sale and purchase under the proposals the lessee/purchaser will record an asset and finance obligation. In both cases assets and liabilities are appropriately recognised on the lessee’s balance sheet. We accept that the measurement will be different under both scenarios, but the difference is unlikely to be significant.
Also, a "lease contract" which is determined to be a sale and purchase is quite different legally from sales and purchases of assets where no leasing is involved. In a lease contract the title of the asset does not generally pass to the lessee/purchaser until all lease payments have been met in full at the end of the contract. In an ordinary sale and purchase with no leasing contract, the title of the asset generally passes on settlement date, even if separate financing arrangement exists. We think that the accounting should reflect this legal difference.

Therefore, on balance, the Treasury thinks that outright sales and purchases under lease agreements should be based on whether legal title is transferred to the lessee/purchaser at inception of the lease contract. If not, we think the lease agreement should be accounted for under the leases ED. In our view, this provides a much cleaner "bright line", accounts for the fact that legal title does not pass until final lease payments are made and appropriately recognises right-of-use assets and lease obligations on balance sheet of the lessee.

(c) The Treasury thinks the definition of the lease in relation to the guidance in B1-B4 is not sufficient. The Board should make it clear why all guidance in IFRIC4 was not included in the proposed standard. We would prefer that all existing guidance was retained. We think that the distinction between future service contracts and genuine operating leases is an important one to avoid structuring opportunities.

**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 think that the proposed IFRS should apply to all leases, and the Board should have a valid conceptual basis for exclusion of any particular lease from this standard.

In saying this, we believe that leases for biological assets or leases for exploration are appropriate to exclude from the scope of this IFRS. They are unique assets with different measurement rules to most non-financial assets. They therefore have their own distinct accounting standard that more appropriately addresses their unique nature.

We are unsure why leasing of intangible assets have been scoped out of this ED as they were not scoped out in IAS 17. We would request the Board to explain in their Basis of Conclusion why their scope inclusion is now necessary.

Further we observe that many intangible assets are similar to leases in the fact that they incorporate the concepts of "right to use" and "obligations to pay for that right". For examples where entities enter into contracts to use radio spectrum or fishing quotas, they are purchasing the access to a specific resource for either a specific time or an indefinite time. We suggest that the Board in future projects considers bringing the accounting for leases and accounting for intangibles under one umbrella to reflect the conceptual similarities.
**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 agree that the proposals in the revenue standard should be applied to the service components of a contract where they are distinct.

The Treasury questions that where a lessor applies the performance obligation approach and the services and lease components are not distinct if the automatic default should be lease standard in all circumstances. For example where a lease contract is similar to the "operating arrangement" described above and where the lease asset component is an insignificant or trivial component of the overall service contract the revenue standard may be more appropriate accounting for the "lessor" rather than defaulting to the lease standard.

However, we agree that if the lessor applies the derecognition approach to the contract that the lease and service components should be identified, even when it may be difficult to distinguish between the two. The Treasury thinks the proposed method for splitting the asset and service components on a 'reasonable basis' is arbitrary and very subjective and further guidance is needed. We note that the IPSASB have recently exposed a methodology for splitting service and asset components for grantees in service concession arrangements. We believe that the IPSASB's ED provides a more objective approach than that proposed in this leases ED. Treasury recommends that the Board should consider using this approach as a possible basis for providing guidance on separating the components where they are not distinct.

**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?

In line with our response to question 4(b) we think that the purchase option should be accounted for only once exercised. In our view, user needs are better met by disclosure of
purchase options attached to leases rather than forcing any subjective and complex measure for accounting for these at inception.

The Treasury supports the underlying concept behind this as the existence of an option does not represent a present obligation of the lease contract. We think that this concept should also be applied to options to extend the lease term and the inclusion of contingent rentals in lease payments. We elaborate on this in our response to the proposed measurement questions 8 and 9 below.

**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?*

The Treasury does not agree that the lease term should include options to extend or terminate the lease. These are future events where no present obligation exists upon signing a lease.

The aim of the standard should be to faithfully represent the lease in the financial statements and report relevant information to users. The reality of many leases is that an entity is contracted for a non-cancellable period and often has the ability to extend or cancel. Therefore, the leasing arrangement provides the business with flexibility and the accounting for the lease should match this economic reality. We believe that the lease term recognised should be for the contractual period only as this portrays the underlying reality at inception. It is not appropriate to include potential extensions in the lease term as they merely represent future options for the business, and being future options, we do not believe that they meet the definition of a liability.

Recognising the contractual term as the lease term would:

(a) be more simple than the proposed approach;

(b) better represent the present obligations to the lessee/lessor; and

(c) require less disclosure of significant judgements by management.

As we noted earlier, we are aware of the Board’s concern of leases being structured to take advantage of ‘bright lines’ in the accounting standards. We acknowledge that if the lease term is measured based on the contractual term, leases could be structured to reduce the amount of assets and liabilities on balance sheet.

As an alternative measurement approach, we propose that a rebuttable presumption could be applied. We envisage a presumption that the lease term is for the contractual lease term, and unless there is evidence that this is not the case, then this would be applied. We note that this is consistent with the recently exposed amendment to IAS12 in relation to deferred tax on investment property. If there is evidence the lease term is longer (i.e. a lessee obtains a lease for a building for one year that is simply rolled over every year), then the lessee and lessor would be required to estimate the lease term that is most realistic. We believe that this would reduce the risk of structuring leases, as those structured for short periods but in reality extended every year would be accounted for as such. We believe that this would deter structuring because leases for the realistic contracted period would be simple to measure; whereas leases structured for shorter periods would require increased
management judgement to get to the same result. Using the rebuttable presumption, the cost to structuring may outweigh the benefits and result in an accounting standard that is based on the reality of the lease.

We also support the view discussed by Stephen Cooper in the Basis of Conclusion. He asserts that optional lease periods should be reflected in measurement of assets and liabilities "only when the arrangement includes an incentive to extend the lease period such as penalties payable on cancellation or reduced rentals in the optional period". This provides a more definitive threshold for determining the lease term than the approach proposed by the Board.

We believe that these principle based models for determining the lease term are better than the proposed approach by the Board because they:

(a) more faithfully represent the lease transaction; and
(b) require less judgement and therefore less cost.

We strongly urge the Board to reconsider the proposals on accounting for the lease term.

Cancellable leases with no or minor penalties

We acknowledge leases that can be cancelled by both parties, with relatively short notice and no or minor penalties, don't effectively have a "defined contract term". We also believe that the rights and obligations are much "weaker" than the rights and obligation of parties who sign non-cancellable leases. However, we recognise that cancellable lease arrangements, particularly in the housing market; can last years, albeit there is no fixed lease term.

The Treasury sees two options to deal with these leases when determining the term of the contract. The first option would be to scope them out of the lease standard because the signing of the cancellable lease does not create a present obligation for either party. The second option would be look at history to determine if the most likely lease term is greater than 12 months. In accordance with our arguments about reflecting economic substance, the Treasury would prefer the Board explores option one.

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<th>Question 9: Lease payments</th>
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<td>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?</td>
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<td>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?</td>
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The Treasury disagrees with the proposals for lease payments. We think that contingent rentals are future events that are not certain at the outset of the lease. In our view, contingent rentals, penalties and residual guarantees do not represent a present obligation at the outset, and therefore, should not be included in the value of any liability (or asset). Including contingent rentals would overstate lease assets and liabilities and also complicate
the accounting and add significant preparer costs with numerous judgements for every lease contract required to be made.

Similar to our response to Question 8, we envisage a presumption that the lease payments are for the contractual payments in the lease, and unless there is evidence that this is not the case, then this would be applied. We believe that this rebuttable presumption reflects the economic substance of the lease contract and reduces the risk of structuring leases. It also results in a cohesive standard with measurement based on the same conceptual basis, and one that faithfully represents the lease transaction. Further, it involves less judgement and subjectivity for most preparers, resulting in more understandable financial statements with less cost.

The Board argues that contracts may be constructed so that all payments are contingent. We believe this is unlikely to occur in practice because it opens the lessor to significant business risks. Further, we believe that a rebuttable presumption, as we have suggested, will capture these lease payments if this were the case. For the same reasons we outlined in relation to the lease term, we think that this might deter lease structuring for rental payments.

Again, we also agree with Stephen Cooper's views presented in AV5-AV8 of the basis for conclusions. 'Reflecting all expected contingent rentals in the measure of the lessee's liability and lessor's receivable does not provide relevant information about the economics of such leasing arrangements.

We particularly agree with his point that the IASB are attempting to avoid structuring opportunities in leases and that this should not outweigh the provision of relevant information. We agree that it is possible to avoid structuring opportunities by establishing principles for identifying where optional lease periods and contingent rental agreements lack economic substance.

If the ED is implemented without change, we think that the method that the Board has proposed for estimating the contingent rentals is too subjective and does not appear to be thoroughly tested. The requirement for both lessees and lessors to estimate payments on such a judgemental basis will lead to a lack of comparability. It does not appear that the Board has widely considered this and state that 'it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows'. We do not find this a convincing statement and think that many preparers would struggle to implement this, and that it would result in varied outcomes for the same lease due to the lack of objective, reliable measures.

**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?

The Treasury does not agree with the proposals for remeasurement as we do not agree that contingent rentals or options to extend should be included in the initial value of the lease liability. Reassessment should only occur if contingent rentals or options are actually exercised. This would significantly reduce preparer costs which we think under the proposals are excessive.
However if the Board continues with their proposals on remeasurement, we agree that the “significant” criterion is beneficial rather than requiring reassessment of all leases every period. We question the benefits in practice, as we think that the lessee and lessor will need to assess each lease in order to determine if there have been significant changes.

We agree that the discount rate should not be reassessed as this is set at inception as the incremental borrowing rate/implicit rate in the lease. This is consistent with amortised cost principles in IAS39.

**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?*

In Question 4(b) above we believe that the Board has introduced unnecessary complexity, and therefore cost, in determining whether a lease contract is an outright sale and purchase at the inception of the lease. This unnecessary complexity has been extended to accounting for sale and leaseback transactions.

Again, we understand why the Board have proposed that if the seller/lessee does not actually “sell” the asset to the purchaser/lessor in the first place (i.e. the seller/lessee does not transfer, at the end of the contract, control of the specified asset), the lease contract is actually just a borrowing arrangement and should not be accounted for under the leasing standard. While there is conceptual basis for this proposal, we think the additional judgments and complexity (and hence cost) in making this call at the inception of a lease contract won’t result in commensurate benefits to users. This is because lessees will record appropriate right-of-use assets and lease liabilities on balance sheet under the lease proposals anyway, which will be very similar to value of assets and borrowings in an outright sale and purchase.

**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 BC142–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?*

(b)  *Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?*

(c)  *Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?*
(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

(a) We agree that leased assets should be shown separately from owned assets on balance sheet. However, we think that leased assets should be presented in their own note as they will be accounted for under a different standard using differing measurement and with disclosure requirements. This will make more sense for users of financial statements.

(b) As raised in our response to Question 2 above, we have concerns over the presentation required for lessors using the performance obligation approach. We believe that displaying the components making up the net amount on the face clutters the balance sheet and could be confusing for users. We think that level of detail is better shown in the notes to the accounts.

By having the underlying asset, an asset for the right to receive lease payments and a liability to provide an asset all on balance sheet and presented together will change the format of current balance sheet. It will gross up assets and liabilities and not be clear for users. We think that a net amount on the face of the balance sheet is more appropriate, with disclosure in the notes of the gross amounts.

(c) We agree with the presentation options for the derecognition approach.

(d) We agree with the presentation options for subleases.

**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?

Yes, the income and lease expenses should be shown separately. We think that the lessee should have the option to disclose this on the face or in the notes to the financial statements.

However as noted in our response to Question 1 above, we believe that where an entity has "operating arrangement" type leases the inability of a user identifying a periodic rental expense on the face of the lessee's operating statement is not necessarily an improvement. Also the introduction of interest expense using the effective interest rates may result in the operating statement being less understandable to some users. Therefore we request that the Board looks at whether the descriptions proposed are "user friendly" and understandable.

**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 that the cash flows should be presented separately. This is a key disclosure as it is the real outlay in relation to the lease which is useful for many users.

**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?

In general we agree with the proposed disclosures. However, as the exposure draft stands, there will be significant judgement and measurement uncertainty. This will result in considerable numeric and verbal explanation.

We think that our suggestions for simplifying the measurement of the lease assets and liabilities will reduce the judgements required, and so the disclosures.

**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?

We agree with the transition requirements in principle; a simplified retrospective approach is reasonable basis for measuring current leases. However we, like many entities, have a significant number of leases to transition, so need a long lead time to prepare.

**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?

The Treasury believes that the right balance between costs and benefits has not been achieved. As discussed in Question 1 above, the Treasury is not 100% convinced that the single lessee model will benefit all users.
**Question 18: Other comments**

_Do you have any other comments on the proposals?

The proposals require that the lessee report the initial value of the right-to-use asset and the liability at the same amount. This effectively assumes that the cost of the consideration (as represented by the liability) represents a fair value for the right-to-use asset. While this will normally be the case, it will not always be so, for example:

- if the entity has procured a lease at a concessional (or peppercorn) rate from a Government pursuing public policy objectives
- if the other party is a related party, and the transaction is not on a market basis
- if part of the consideration received is for something other than a right-to-use asset or a service component (for example a property lease might encompass the lease of a building and the sale of fixtures and fittings).

It does not appear to the Treasury that simple application of the proposals in the exposure draft will fairly present the economic substance of such arrangements.

Therefore, the Treasury proposes that the standard provide for separate valuation of the right-to-use asset in such cases. This would be similar to the approach adopted with financial instruments (see IAS 39, AG 64). If a loss results from following this approach, the entity (whether lessee or lessor) has entered an onerous contract and this expense should be recognised immediately. Conversely if entering a contract results in a right-to-use that has value over the concessional or peppercorn terms, the resulting income should also be recognised immediately.