13 December 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH
UNITED KINGDOM

Dear Sir David

ED/2010/9 LEASES

The Group of 100 (G100) is an organization of chief financial officers from Australia’s largest business enterprises with the purpose of advancing Australia’s financial competitiveness. We are pleased to provide comments on the Exposure Draft.

The G100 does not support the proposed approach in the Exposure Draft as follows:

- The costs associated with implementing and complying with the proposed approach. Lessees will be required to perform significantly more monitoring and record-keeping on an ongoing basis for all but short-term leases whose lease periods to not overlap reporting periods. In addition, the audit costs will increase arising from system and contract reviews on implementation and ongoing audit procedures applying to all leases including leases embedded in other contracts. In many cases, these additional costs will be incurred even though the financial impact on the results and financial position of the entity may be immaterial.

- The requirement for a lessee to evaluate regularly whether there are new facts or circumstances related to contingent rentals and assumptions about the lease term will provide significant challenges for entities that have a large number of leases. Although accounting is on a lease-by-lease basis entities with large portfolios of leases will need to develop robust processes to ensure compliance and practical application including developing triggers/flags indicating the need to review lease terms and identifying early terminations and extensions etc. Significant systems changes and incremental operating costs will also need to be incurred to allow for the determination and tracking of the lease term and assumptions relating to contingent rents and option periods.

- The uncertainty and degree of estimation involved in recognizing the impact of contingent rentals and lease rentals in option periods. The G100 believes that due to their nature contingent rentals should be expensed as incurred.
The G100 believes that option periods should only be recognized when the decision to exercise the option is made or for that particular type of asset the entity has previously exercised options and there is nothing in the commercial or strategic environment to indicate that future options will not be exercised.

Option periods that would materially affect the amounts recognized under the proposed standard would usually be for large value assets and exist to provide the lessee with flexibility in decision making. In practice decisions about exercising options are made quite close to the exercise date and are based on the then commercial and strategic environment of the entity.

In addition, the G100 suggests that leases of property could be regarded as having distinctly different characteristics from leases of plant and equipment as evidenced by the long lease periods and the existence of contingent rentals, renewal periods and potentially high residual values in relation to the property at lease inception and therefore might more reasonably qualify for a treatment akin to that under the present standards.

Our responses to the following questions should be considered in the context of our concerns outlined above.

1: Lessees

a. Do you agree that a lessee should recognize 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?

The G100 accepts the right-of-use approach on the basis that the rights to the services of an asset can be distinguished and separated. However, a right-of-use implies the existence of intangible assets and in a principles-based system the need to specify a rule that such assets comprise property, plant and equipment raises questions about the rationale for the right-of-use approach. However, if such an approach is adopted the assets and liabilities recognized must be consistent with the definitions and criteria outlined in the Framework.

We also note that the grossing up of the balance sheet of financial institutions and the recognition of an intangible asset may also have adverse implications for capital adequacy requirements.

b. Do you agree that a lessee should recognize amortization 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?

If the right-of-use approach is adopted it is appropriate to recognize amortization of the asset and the interest component of lease payments. However, we note that the term amortization is normally used in respect of intangible assets and under the proposals the lease asset is deemed to be a tangible asset in property, plant and equipment.
Q2: 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?

The G100 considers that the approach to lessor accounting in IAS 17 'Leases' is appropriate. In our view concerns and issues have been raised about accounting by lessees not the approach adopted by lessors.

The existing lessor accounting model in IAS 17 is well understood by users, preparers and auditors and provides appropriate financial information to users of financial statements. This model reflects the underlying economic substance of the different types of lessor transactions. However, if the IASB is to implement one of the proposed models, the derecognition approach with a minor change to measure the residual asset at its present value that unwinds over the lease term is preferred.

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?

If these approaches are adopted the proposed accounting would be inconsistent. The proposed accounting model will result in lessors retaining the leased assets in their financial statements, even though substantially all of the economic benefits from the asset may have been transferred to the lessee.

Lessors will also record a lease receivable and recognize a lease liability for a performance obligation. This approach does not provide decision useful information to either external or internal users of financial statements as occurs under IAS 17. In particular, the proposed model for lessor accounting:

- does not reflect the important economic elements of a lessor's position in a lease;
- is not consistent with the basis for conclusions on the lessee right of use model;
- results in a non-economic grossing up of the balance sheet that does not reflect the assets and liabilities retained by the lessor;
- is likely to lead to difficulties in determining and measuring impairments of the leased assets; and
- undermines the guidance included in the Revenue Recognition project as applying the performance obligation approach to lessor accounting is inconsistent with the model and requires an interpretation of this concept that is neither reasonable nor sensible.
Q3: **SHORT-TERM LEASES**

The ED 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 recognize lease payments in profit or loss over the lease term (para 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 recognize assets and liabilities arising from a short-term lease in the statement of financial position, or derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other IFRSs and would recognize lease payments in profit or loss over the lease term (para 65). (See also paras BC41-BC46).

Do you agree that a lessee or a lessor should account for short-term leases on a lease-by-lease basis on the basis of undiscounted cash payments plus initial direct costs? Why or why not? If not, what alternative approach would you propose and why?

While acknowledged as a means of reducing the compliance burden, the G100 does not believe that this concession in its present form will provide significant relief in practice. We believe that a maximum possible term of twelve months is too short to include any but the incidental leases in respect of office equipment, telecommunications, cars, hotel rooms etc. It would appear that the major concerns about existing lessee accounting relate to the lack of recognition of long-term leases of significant operating assets. As such it is suggested that short-term leases be defined as having a maximum possible term of 3 years.

Q4: **DEFINITION OF A LEASE**

a. **Do you agree that a lease (defined as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration) 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 paras 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 paras B1-B4 for distinguishing leases from service contracts is sufficient?** Why or why not? If not, what additional guidance do you think is necessary why?

The G100 considers that given the different accounting requirements it is important that there is clarity in the distinction of leases and service and to distinguish leases from a variety of concession arrangements.
For example, contracts whose main purpose is to procure a supply agreement also include obligations where one party agrees to purchase a product and make available advertising space and/or the use of facilities that are to be rented or the supplier of the product provides equipment that facilitates the final sale/use of the product. It is not clear why the physical control of an asset is emphasized in the criteria when the essence of the right-of-use approach should be on control of the rights-of-use.

However, for practical purposes, it would be useful if entities were able to combine/pool leases that have similar terms and conditions and individually are low value items.

Q5: **Scope of exclusions**
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?

In principle, the G100 believes that the standard should apply to all lease agreements. We also believe that leases of intangible assets should be within the scope of the standard as is presently the case with IAS 17 'Leases'. It is incongruous to base the approach to leases on a rights-of-use approach when similar rights in respect of leases of intangible assets are excluded. The inclusion of intangible assets within the scope would avoid inconsistencies with the proposals in respect of revenue recognition.

Q6: **Contracts that contain service components and lease components**
Do you agree with either the IASB or the FASB approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

The G100 considers that where a contract includes both a lease and a service contract the method of accounting should reflect the distinct/non-distinct services of the contract or the intent of the relationship between the parties. In many instances, for example, telecommunications, an asset provided under the contract is merely the means through which the customer is provided with the service which is the reason for entering the contract. Sponsorship arrangements are entered with the intent that one party’s products/services are to be promoted or made available with the other party providing the use of assets which may be direct physical control or access.

Q7: **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?

Yes. The G100 believes that assuming the exercise of options which is based on the occurrence of a future event is not consistent with the definition of a liability. The G100 agrees that if a purchase option is exercised it is then appropriate to account for the acquisition of a physical asset.
**Q8: 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 G100 believes that the lease asset and lease liability should be measured on the basis of the most likely lease term at the inception of the lease. It is noted that the existing requirements of IAS 17 'Leases' relating to the inclusion of lease options that are reasonably certain of exercise would be simpler to apply and would result in fewer remeasurements.

Many entities exercise options close to the exercise date based on commercial and strategic issues confronting the entity at that time.

The G100 believes that the lease asset and the lease liability should be measured on the basis of the minimum contractual liability. This would simplify the transition and reduce the implementation costs significantly given that this data is already collected for note disclosure. This approach would also eliminate much of the subjectivity and judgment required to apply the current proposals.

The existence of lease options provide the lessee with flexibility to manage risks and respond to changes in business strategy etc and even if they are not exercised they provide value to the lessee. However, measuring the cash flows which would follow from exercising the option does not reflect the inherent value of the option. In addition, any rentals payable in respect of the option period are conditional on the lessee exercising the option which is not certain at the inception of the lease. It is unlikely that such conditional payments would satisfy the definition of a liability.

**Q9: 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?

The G100 considers that the treatment of residual value guarantees and contingent rentals should be distinguished. It is normally appropriate for residual value guarantees by the lessee or a related party to be included in the measurement of lease assets and lease liabilities – an approach which should be retained.

In principle, the G100 supports an approach based on the most likely payment which is sufficiently flexible to include contingent rentals based on usage and those based on some other factor.
However, in view of the significant uncertainties in the estimation process the G100 believes that a pragmatic approach such as recognition of contingent rentals on an accrual basis in long-term contracts can be justified in order to achieve reliability and consistency. Improved disclosure would satisfy many of the concerns of users relating to the treatment of option periods and contingent rentals.

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?

Yes. The G100 believes that reliability of measurement should remain a core requirement for the recognition of assets and liabilities.

Q10: 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?

Yes, but only where the impact on the financial statements would be material. The G100 considers that remeasurement for all leases at each reporting date is impractical and would impose significant cost burdens on lessees and lessors.

Where reassessment does occur such as a change in the lease term (either by taking up an option that had not previously been considered most likely or vice versa) the carrying amount of the asset should be adjusted.

Q11: 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?

The G100 agrees with the proposals.

Q12: 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 (paras 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?
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Yes. The G100 supports the proposed approach. It is noted that under the proposals information about operating and finance leases which is used in credit assessment is lost.

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, totaling to a net lease asset or lease liability (paras 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?

The G100 does not believe that a grossing up of both the lease asset and lease receivable is appropriate and that a linked presentation showing lease receivable and the net lease asset avoids double-counting.

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 (paras 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?

Yes.

d. Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paras 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?

The G100 believes that it is sufficient to disclose this information by way of note in order to avoid confusion by users.

Q13: 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 (paras 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?

The G100 supports the proposed approach.

Q14: 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 (paras 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?

The G100 supports the proposed approach.
Q15: DISCLOSURE
Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

a. identifies and explains the amounts recognized 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 (paras 70-86 and BC168-BC183)? Why or why not? If not how would you amend the objectives and why?

The G100 supports the inclusion of the disclosure objectives. However, we do not believe that the extensive list of disclosures should be regarded as mandatory. Rather, the proposals should provide guidance that in meeting the disclosure objectives directors and management should exercise their judgment as to which of the items are relevant to users of the company’s financial statements.

Q16: TRANSITION
a. The ED proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paras 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?

Full retrospective application of the proposals would normally be onerous and costly to implement. However, this would depend on the nature of the final proposals, the length of the transition period and whether full retrospectivity only applied to material leases. For some entities the work involved in setting up the required systems may allow them to do a full retrospective application and accordingly they should be permitted to select the option that best suits their requirements.

The G100 believes that the simplified retrospective approach for material leases should be an option for lessees and that lessees should be permitted to apply full retrospectivity if they consider it to be practicable.

Q17: BENEFITS AND COSTS
Paras BC200-BC205 set out the boards’ assessment of the cost 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 G100 does not believe that the perceived benefits are likely to exceed the cost of implementation and ongoing compliance with the proposals, including the upgrading of information systems and ongoing monitoring of individual lease agreements. In addition, the process of educating and gaining acceptance of the disclosed results (particularly when reported amounts change due to reassessments) by preparers and users, particularly analysts is likely to be costly and burdensome.

The cost of compliance has been signalled as a major issue by our members. For example, one member estimates that its systems set up costs will approximate A$500,000 and will require an additional A$500,000 in annual operating costs in addition to pressure on audit fees and the flow-on effects of costs incurred by lessors. Another member estimates that with in excess of 250,000 leases the requirement to review each lease contract separately the number of man hours required on transition will be excessive. Implementation of the proposals may also have implications for capital adequacy requirements and hedging relationships.

The impact of the proposals on changes in financial ratios particularly in debt covenants, bears close consideration and an extended transition period would provide all entities needing to renegotiate debt covenants the time to do so in an orderly manner.

Q18: OTHER COMMENTS
Do you have any other comments on the proposals?

The provision of separate guidance on the grouping of leased assets such as personal computers that individually have low values, similar lease terms and expiry dates should be considered and would allow a broad brush approach to accounting for these leases leading to reduced implementation and operating costs.

Additionally, the exposure draft is presently silent on issues such as leases dominated in a foreign currency, lease incentive arrangements and make-good clauses. Given the practical issues rising in these areas guidance in the standard would be beneficial.

Yours sincerely

Group of 100 Inc

Peter Lewis
President