Wesfarmers

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

19 August 2013

Dear Mr Hoogervorst,

RE: IASB EXPOSURE DRAFT ED/2013/6 LEASES

Thank you for the opportunity to comment on the IASB exposure draft ED/2013/6 Leases ('ED' or '2013 ED').

Wesfarmers Limited is one of Australia's largest listed companies, retailers and employers. Its diverse business operations cover: supermarkets, department stores, home improvement and office supplies; coal mining; insurance; chemicals, energy and fertilisers; and industrial and safety products. Wesfarmers operates from over 4,000 discrete locations across Australia and New Zealand and has over 6,600 leases across the group, being predominantly property leases.

Consistent with the approach taken in response to the IASB's exposure draft ED/2010/9 Leases ('2010 ED'), Wesfarmers has modelled the likely impact of the 2013 ED on its financial statements and assessed the impact of such a standard being implemented on business systems and reporting.

Wesfarmers appreciates being invited to participate in the IASB's outreach program on the lease project in April 2012 that gave us an opportunity to discuss the concerns raised in our initial comment letter. In that comment letter to the IASB dated 15 December 2010 we highlighted that, in our view, property leases for lessees needed to be considered separately from the proposed leasing standard. This view was taken on the premise that the 2010 ED simplistically treated all leases as a financing alternative, from both a balance sheet and profit or loss perspective, when this is not the economic reality.

Wesfarmers still maintains that IAS 17 should be retained because on-balance-sheet recognition of leases (including property) is conceptually inconsistent with the accounting treatment of economically similar arrangements such as long-term supply agreements and service contracts.

Recognition of the lease liability on-balance sheet also overlooks the economic reality of leasing property, particularly for retail operations, by simplistically treating property leasing as a finance alternative. As acknowledged in the ED, leases of generally appreciating real estate assets, given their significant residual value, are very different to leases of depreciating plant and equipment assets. In our opinion, it is not valid to treat a property lease decision as a financing alternative as compared to many lease decisions associated with plant and equipment. Most of the locations Wesfarmers' businesses operate from are not separable as an underlying purchasable asset, for instance where they form part of a larger shopping centre or retail complex. Property is also unique because lessors are required to provide a range of functions and services to enable a store to properly operate and a lessee would have no liability were these functions and services not performed.

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In addition, Wesfarmers believes that the right-of-use model needs to be debated further at a conceptual level before issuing a revised Standard. This will assist in determining what arrangements should be considered under the right-to-use model and address the inconsistency between the lessee and lessor models in revised ED. We believe that the appropriate forum for this debate is part of the IASB's Conceptual Framework Project.

Wesfarmers acknowledges that the IASB has introduced the Type B lease classification in the dual model to respond to our concern that property leases are not financing and we agree with the proposed straight-lining profit impact as this reflects the economic reality of property leases.

Therefore, while not our preferred view, we appreciate the compromise the IASB has reached in the development of the dual model and the balance this model achieves between preparers' views and users' needs. To the extent that the IASB continues to be of the opinion that all leases should be recognised on balance sheet, we support the dual model in the revised ED, subject to our concerns expressed in the responses to the questions below. In particular, these concerns include the complexity and cost, both in terms of initial and on-going application, of:

a) The judgemental nature of the assessment of the lease term using the concept of *significant economic incentive*; and
b) The volatility and significant cost associated with ongoing remeasurement and reassessments of variable lease payments and lease terms.

We also recommend that the Board undertake a more thorough user outreach program and expose the Board's due consideration of the results of this outreach. This should also encompass disclosure of detailed cost-benefit analysis and field testing.

This letter outlines our comments to the questions put to respondents in the 2013 ED on the assumption that the dual model is retained.

If you have any questions regarding this submission, please do not hesitate to contact Terry Bowen (+618 9327 4301) or Adam Sofoulis, Statutory Reporting Manager (+618 9327 4690).

Yours sincerely,

Terry Bowen
Finance Director
Wesfarmers Limited

Question 1: identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and
(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We agree that the guidance and the examples provided assist in distinguishing leases from service contracts however, given the significant difference in the accounting treatment of contracts with similar characteristics between classifications as a service contract or lease there remains a risk that arrangements will be structured to achieve particular accounting outcomes without changing the underlying economics of the transaction. This is contradictory to the intention of the proposal and supports the position that the proposal, at significant cost, does not improve the quality or comparability of financial reporting.

We disagree with the position that a supplier's right to substitute an asset is not substantive if customer consent is required. It is common practice for consent to be required simply as a means of maintaining appropriate relationships and communication throughout an arrangement. The exposure draft's assumption that routine consent terms would result in non-substantive rights to substitute assets will significantly increase the number of arrangements designated as a lease despite the economic reality of the arrangement. We recommend that the final standard should allow for consideration of the purpose of the customer's consent, such as to keep the customer informed and manage the relationship or to provide the customer with the ability to prevent the substitution. Only the latter would indicate the existence of a lease.

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We agree that the recognition and measurement of expenses should differ for leases where their economic basis is different. Specifically, in respect of property, a straight line recognition reflects the economics of the lease as demonstrated by the lessor pricing and lack of analyst adjustments to existing operating lease expenses recognised.

The presentation of expenses and cash flows arising from leases should be consistent with the asset's underlying purpose and will become unnecessarily complex under the approach proposed in the exposure draft. The exposure draft would require the statement of comprehensive income to present expenses associated with different lease contracts across various line items including:

- amortisation expense and interest expense for Type A leases;
- lease expense for Type B leases; and
- in an unspecified line item for short-term leases, variable payments, and payments for non-lease components.

This complexity undermines the ability of users to determine the aggregate income statement effects of lease contracts. This is also applicable to the cash flow statement which requires presentation across different lines in operating and financing sections. The IASB has an existing project with the objective of improving and simplifying disclosures within existing disclosure requirements and the exposure draft requirements appear inconsistent with this objective.

Question 3: lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We maintain that the lessor accounting approach should mirror the accounting applicable to lessees. In this respect, we believe that the dual model for lessors which requires the lessor to continue to recognise the asset on the balance sheet supports our view that the lessee should not recognise Type B leases on the balance sheet.

Question 4: classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

As previously highlighted, the economics of property leases are significantly different to the economics of plant and equipment leases given:

- property is generally an appreciating asset with significant residual value;
- in some instances, they are not a separable, purchasable asset; and
- most require lessors to provide a range of other functions and services to enable use of the property.

And therefore, we agree that application of a single model is inappropriate. We agree with the principle that the lease classification should depend on the lessee's expected consumption of the economic benefits embedded in the underlying asset however, given the judgemental nature of this assessment, we question whether the extensive disclosures which would be required to explain lease classifications, when combined with the other costly complexities arising from the accounting proposed in this exposure draft outweighs its benefits.

We agree with differentiating the requirements depending on whether the underlying asset is property and that this assessment should be made considering the land and building components together.

We request:

- the exposure draft provide indicative quantitative thresholds on what constitutes a 'major part' of the remaining economic life and 'substantially all' of the fair value of the underlying asset when performing the classification test for assets of property to ensure consistency and greater comparability;
- the exposure draft provide further guidance on identification of the 'primary asset' as application of this in practice will be highly judgemental and, to the extent guidance is not provided, decreased comparability is likely to arise; and
- the exposure draft recognise that 'land' rather than 'buildings' may be the primary asset when assessing the lease of land and buildings. Based on the current exposure draft, the requirement to use the life of the building only means that, despite the building not being the critical aspect of the lease and rather, just consequential to the arrangement, the classification of the lease may be Type A and the expense profile and asset not consistent with the underlying economics.

Question 5: lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We agree with the basic definition of lease term being the non-cancellable period for which a lessee has the right to use an underlying asset.

We disagree with incorporating options to extend the lease where there is a *significant economic incentive* as there is significant judgement required in considering contractual, asset, entity and market factors on a lease-by-lease basis that give rise to a threshold that is again subjective. This complexity is repeated on an ongoing basis given the need to reassess relevant factors, again on a lease-by-lease basis. We therefore recommend retaining the existing concept of *reasonably certain* which is well understood.

To the extent the term *significant economic incentive* is retained, we request guidance on how this should be interpreted, especially where:

- the asset is generating positive cash flows; or
- the asset has been utilised for a considerable period to date; or
- historically, the leases have been renewed; or
- non-extension of an asset generating positive cash flows would enable major competitors to take up the benefits of the development.

In our view, these factors would not be indicative of a significant economic incentive, assuming no bargain renewal option at the end of the initial lease term.

Further, we disagree with the requirement to reassess throughout the lease term. Whilst recognising that this requirement may provide more up-to-date information for users of the financial statements, this benefit is significantly outweighed by the:

- significant volatility in reported assets and liabilities;
- significant judgement likely to be needed in determining whether there has been a change in factors without incorporating market-based factors each reporting period; and
- significant additional resources required to make the judgment as well as determine lease balances each reporting period.

Question 6: variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We agree with the exclusion of contingent rentals as proposed in the Exposure Draft and understand the conceptual basis for the inclusion of variable lease payments that relate to index or rates.

We disagree with the requirement to reassess the variable lease payments throughout a lease as it leads to significant complexity and costs whilst ignoring the fact that the lease terms and conditions were negotiated at a point in time and that an entity's assessment of the rate or index relevant to variable lease payments was based on expectations at that time. Further, the financial position will be susceptible to increased volatility arising from such reassessments and this will reduce comparability of financial reporting.

Question 7: transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

We agree with giving preparers the option to apply the proposals on a full retrospective basis to minimise the significant impact on earnings given the front-loading of the interest expense in the early years of a lease under the proposed simplified retrospective approach.

However, given the current proposals for full retrospective application, specifically with regards to lease term, variable lease payments and discount rates, this alternative would likely be significantly burdensome. Given the average length of property leases, a requirement to go back to the initial commencement date of each lease would further increase the degree of subjectivity.

We therefore urge the Boards to consider a significant lead-time ahead of adoption being mandated given the cost and complexities involved in transitioning systems, processes, financial statement users and business strategies to reconcile to the proposed new accounting requirements.

Are there any additional transition issues the boards should consider? If yes, what are they and why?

The new lease accounting model proposed in the ED is significantly different from existing accounting practices. We believe that it will be extremely costly and challenging to gather or 'reconstruct' the requisite information to operationalise the new requirements under the proposed approach.

Appropriate and significant education of investors, analysts, rating agencies and other users of the financial statements will be required and, as such, we strongly encourage the Board to allow considerable lead-time (at least five years) prior to the application date of any new Standard.

Question 8: disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

The disclosure requirements, such as the reconciliation of the right-of-use asset by class and information around the nature, terms and conditions of leases, are burdensome for companies with large varied lease portfolios such as Wesfarmers. The information disclosed would not be beneficial for financial statement users as it would not be possible to disclose sufficient details on a large varied portfolio of leases without compromising commercially sensitive information, and highly summarised information, if presented, could be misleading. We also do not see the benefit of disclosing the reconciliation of lease liabilities, especially when this is not required for other financial liabilities.

Further, it appears inconsistent of the Boards to implement fundamental changes in the lease accounting model whereby existing disclosures are brought onto the balance sheet **and** increase the disclosure requirements. As identified previously, bringing operating leases on balance sheet is not efficiently addressing the information needs of users and the Board, by requiring additional disclosures effectively recognises this.

Lastly, the IASB formally added a short-term initiative on disclosure to its work programme in December 2012 with the objective of improving and simplify disclosures within existing disclosure requirements. The proposals set forth in the exposure draft are inconsistent with this objective.

Question 9 (not applicable to Wesfarmers)

Question 10 (not applicable to Wesfarmers)

Question 11 (not applicable to Wesfarmers)

Question 12 (IASB-only): Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

We agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of an investment property.

Question 13: Other comments

CGU impairment assessments

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

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

The proposals have swapped the operating lease expense for interest expense on the lease liability and amortisation of the right-of-use asset, which results in the net present value of the forecasted cash flows of the CGUs increasing, as the interest expense and amortisation would be excluded from the forecasted cash flows. Therefore, the net impact will be dependent on whether the discount rates used on initial recognition of the right-of-use asset differs from the impairment test.

Asset impairment assessments

Consistent with the requirements of IAS 36 the right-of-use asset may be tested for impairment. Where a right-of-use asset relates to property and classified as a Type B lease the initial amortisation is lower and this may give rise to an impairment issue that would jeopardise the straight-line expense profile anticipated for property under the proposals. As outlined previously, we recommend that Type B leases (in particular property leases) be excluded from the proposals in their entirety as the economic basis for entering into a property lease is significantly different to plant and equipment leases.

Definition of *insignificant*

If the underlying asset is not property, an entity is required to classify a lease as a Type A lease unless one of following two criteria is met, one of which is: *the lease term is for an insignificant part of the total economic life of the underlying asset.* The exposure draft does not define *insignificant* and given the large disparity in accounting treatment arising from the classification of the lease, it is likely that divergence in practice would arise countering the improved quality and comparability of financial reporting envisaged under the proposals.

User outreach and detailed cost-benefit analysis

As noted above, we also recommend the Board undertake a more thorough user outreach program and expose the Board's due consideration of the results of this outreach. This should also encompass disclosure of detailed cost-benefit analysis and field testing.