



NZ ACCOUNTING
STANDARDS
BOARD

12 September 2013

Mr Hans Hoogervorst
Chairman
The International Accounting Standards Board
30 Cannon Street
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United Kingdom

Email: commentletters@ifrs.org.

Dear Hans

Exposure Draft ED/2013/6 Leases

Introduction

The New Zealand Accounting Standards Board (NZASB) is pleased to make the following submission on the International Accounting Standards Board's (IASB) ED/2013/6 *Leases* (the 2013 ED).

The 2013 ED was exposed in New Zealand shortly after its release and you may receive comments directly from New Zealand constituents. In addition to a general call for comments, the NZASB has consulted with constituents by way of one-on-one meetings and a round table discussion.

General View

We support the IASB's objective of developing a new lease accounting standard that better meets the needs of users of the financial statements. In particular, we support the proposal for lessees to recognise assets and liabilities arising under leasing arrangements, including assets and liabilities arising from leases that are currently classified as off-balance-sheet operating leases.

Therefore, we generally support the rationale of the IASB in proposing to issue an IFRS that will require the recognition of most leases on the statement of financial position.

We recognise that developing a new leasing standard is a difficult task. Ideally, a new lease accounting standard would reflect the economic substance of the variety of leasing arrangements that arise in practice, would not be overly complex or costly to apply, and would not provide significant structuring opportunities. Assessed against these criteria, we believe that the IASB has made significant progress over the course of the project. However, there are aspects of the 2013 proposals where we have significant concerns.

Broad Concerns

Our key concern is the complexity of the proposals. In addition to the significant judgements needed to classify leases (which exist today under IAS 17), there is added complexity in applying the right-of-use model, especially for Type B leases in the case of lessees and Type A leases in the case of lessors. This complexity, together with the extensive record-keeping and disclosure requirements, is costly for preparers. Although some New Zealand constituents support recognising assets and liabilities arising under leases in the statement of financial position, they had envisaged an approach similar to the existing requirements for finance leases in IAS 17 *Leases*. They had not expected the development of a new approach that is complex to apply and, in some cases, requires new measurement methods that are not applied elsewhere in accounting standards, and for which there does not appear to be a clear conceptual rationale.

In addition we are concerned about the opportunities for structuring under the 2013 ED:

- It will allow leases that represent in-substance purchase and sales of assets, which under IAS 17 would be treated as finance leases, to be structured to significantly reduce the amounts of assets and liabilities on the statement of financial position of lessees – potentially resulting in virtually off-balance-sheet treatment of some finance leases.
- The “identifiable asset” requirement for a lease will potentially result in a proliferation of “service” contracts to avoid the application of the leasing standard. While we agree with the proposed scope of the leases standard in principle, we are concerned about whether the accompanying guidance is sufficiently robust.

Another issue of particular concern is the accounting for foreign exchange risk exposure on leases. In our view the gain or loss on foreign exchange should be included in variable lease payments as it is a legitimate cost of the leasing contract, in the same way as other lease payments that vary based on an index or rate.

Attachments

We set out in Appendix 1 our proposals for an alternative approach. This combines aspects of the 2010 and 2013 proposals, together with some aspects of IAS 17. We believe this would result in a more workable model and would address the concerns noted above.

Appendix 2 contains our responses to the questions from the 2013 Exposure Draft, with more detailed discussion on the key issues identified above.

If you have any queries or require clarification of any matters in this submission, please contact me or Judith Pinny (judith.pinny@xrb.govt.nz).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Michele Embling', enclosed within a circular scribble.

Michele Embling

Chair – New Zealand Accounting Standards Board

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APPENDIX 1

PROPOSED APPROACH BASED ON THE 2010 AND 2013 EXPOSURE DRAFTS

In proposing this approach, our key considerations are:

1. Preserving the current treatment of “finance leases” for two key reasons:
 - a. In our view, the leases that are classified as finance leases under IAS 17 represent, in substance, the purchase (by the lessee) and sale (by the lessor) of the underlying asset in a secured financing arrangement. In other words, rather than simply creating a right-of-use asset for the lessee, these types of leasing arrangements are economically similar to the purchase of the item of property, plant and equipment with finance provided by the lessor. Hence, we consider that the current major problem with IAS 17 is its treatment of operating leases in the financial statements of the lessee, not the treatment of finance leases.
 - b. Following from the above point, we are concerned that the 2013 ED proposals would enable a finance lease (as defined under IAS 17) to be structured in a way that substantially reduces the assets and liabilities on the statement of financial position of the lessee. Under the 2013 ED proposals, it is possible to structure arrangements that would transfer substantially all of the economic risks and rewards of ownership of the leased asset to the lessee, with the lessor achieving a lender’s return, and yet only a small portion of the asset and associated liability could be recognised on the lessee’s statement of financial position. This can be achieved through structuring a lease with a short initial non-cancellable term together with multiple rights of renewal and a series of residual value guarantees at each renewal date. This would enable the lessee to continue to use the asset as long as it wished, with the asset sold when the lessee no longer wished to use the asset and the proceeds used to pay the lessor an amount sufficient to recover its remaining investment and achieve a lender’s return, in a similar manner as an asset acquired under a secured financing arrangement.
2. Requiring lessees to recognise assets and liabilities arising from “operating leases” using a single right-of-use model that is not overly complex to apply and is understandable.
3. Ensuring that the financial statements of lessors continue to provide useful information.

Based on these considerations, we suggest the best model for an IFRS on leases would incorporate the following features:

From the 2010 ED:

1. Scoping out or otherwise separating “in substance purchase or sale of underlying asset”, (which also removes the need for paragraph 31 in the 2013 ED as leases with a bargain purchase option would be classified as an “in substance purchase or sale”). The guidance in IAS 17 could be used as the basis for this separation and also to provide guidance on the consequential accounting treatment of these arrangements.

2. Scoping out leases of investment properties that are measured at fair value and apply IAS 40 *Investment Property* to these assets. This means that all investment property will be recognised on the statement of financial position of the lessor, it will satisfy user needs for information about the assets and revenue streams, and allow for consistency across the investment property industry.

From the 2013 ED:

1. Definition of a lease, including differentiation from a service contract by use of term “identified asset”, as this proposal is consistent with the conceptual rationale for recognising operating leases on the statement of financial position of lessees.
2. Definition of the lease term, as this proposal reflects the lessee’s obligations.
3. Treatment of variable payments (with one exception in respect of foreign currency movements, which is discussed below in “Other Issues” Item 1 in Appendix 2) as the proposals are consistent with the lessee’s obligations.
4. Policy election to exempt leases of less than 12 month’s maximum possible duration, on the grounds of cost/benefit.

In addition:

1. Remove the distinction between Type A and Type B leases by eliminating the Type B model – this would make the model simpler to apply and would eliminate the use of an amortisation method that lacks a conceptual rationale.
2. For lessors, do not require the residual asset to be accreted – given that it is a non-monetary asset, it should be measured at cost (less impairment) or fair value, similar to other non-monetary assets.
3. Address the issue of excess disclosures in the proposed standard by substantially reducing the disclosure requirements.

The benefits of this proposal are as follows:

- More leases on the statement of financial position of lessees.
- In-substance purchase and sales of assets would continue to be treated as such.
- Removal of structuring opportunities relating to leases currently treated as finance leases, thereby retaining on-balance-sheet treatment for these lessees.
- Removal of the need to establish whether asset consumption is more than insignificant or not more than insignificant. Instead, the classification under IAS 17 would continue to be used to distinguish between in-substance purchases/sales of assets and lease arrangements. The existing classification basis is familiar to both preparers and users and it reflects the economic substance of some lease arrangements as being in-substance purchases/sales of assets. As noted earlier, the current problem with IAS 17 is the treatment of operating leases in the financial statements of lessees, not the treatment of finance leases.
- Introduction of a single model for operating leases has lower implementation and education costs.

APPENDIX 2

RESPONSE TO QUESTIONS FOR RESPONDENTS

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 the use of an 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.

The NZASB supports the proposal in ED/2013/6 for the definition of a lease, as this proposal is consistent with the conceptual rationale for recognising operating leases on the statement of financial position of lessees.

Although the NZASB supports the introduction of the requirement of the proposed standard applying to an identified asset, it is concerned that a suitably robust definition of identified asset be introduced to ensure that the perceived differentiation between leases and service contracts is, in fact, the end result when the actual standard is introduced and operationalised. Given that the distinction between a lease contract and a service contract will have a significant impact on the accounting treatment of the contract, it is important that adequate guidance is provided to appropriately draw this distinction.

For example, it is proposed that a contract contains a lease when the entity has the right to control the use of the identified asset and receive the benefits from that use. We note that the concept of control is used in other standards, in particular, IFRS 10 *Consolidated Financial Statements* and the forthcoming revenue recognition standard, each of which contain application guidance to help assess whether the reporting entity or another party has control. We believe that similar application guidance is needed in the leasing standard. For example, guidance on how to assess situations where some significant decisions about the use of the asset are made by one party and some are made by another party, or where the two parties agree to the key terms of use as part of the contract.

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from the 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?

The NZASB questions the appropriateness of the distinction between Type A and Type B leases. In particular, the Type B lessee accounting lacks a conceptual rationale. The proposals, including the number of models, are complex to apply and result in an unnecessary administrative burden particularly for any entity where leasing is not a core business activity.

A detailed outline of the NZASB's suggested alternative approach is provided in Appendix 1.

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?

As noted under Question 2: lessee accounting, above, the NZASB questions the appropriateness of the distinction between Type A and Type B leases.

As set out in our alternative model in Appendix 1, we support the proposal in the 2010 ED to scope out investment property measured at fair value. In our view, such an approach would provide better information to the users of the financial statements, as all investment property will be recognised on the statement of financial position of the lessor, it will satisfy user needs for information about the assets and revenue streams, and allow for consistency across the investment property industry. It would also remove the need for Type B leases.

The increased complexity of the measurement for lessors under Type A leases in the proposed standard is also a concern. In particular, we highlight the complex calculations for the residual asset held by lessors under Type A leases. We also question why interest is recognised on a residual asset when it is not a financial asset. In our view, the residual asset should be measured at cost (less impairment) or fair value, similar to other non-financial assets.

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 assets 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 outlined above in Questions 2 and 3, the NZASB does not support the Type A and B classification of leases based on the consumption of the asset (paragraphs 29-30) and the existence of a “bargain purchase” option (paragraph 31). In addition, the high degree of judgement required in determining the existence of more than insignificant asset consumption is difficult to operationalise and may create structuring opportunities around the margins. It could lead to similar assets being recognised as both Type A and Type B which may provide confusing information for users.

A detailed outline of the NZASB’s suggested alternative approach is provided in Appendix 1.

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?

The NZASB agrees with the proposals on the lease term, and notes that the definition of lease term has generally not been a significant issue for constituents in New Zealand to date.

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 proposals on the measurement of variable lease payments, with one exception relating to changes in foreign exchange rates, which we discuss in ‘other issues’ below.

Common indices or rates used in New Zealand include LIBOR, the current interest rate and the Consumer Price Index, all of which change frequently. We suggest that an annual reassessment of the index or rate may be more appropriate in most cases, as the leases captured by the proposed standard are for periods greater than 12 months. An alternative would be to use the reset dates stipulated in the lease contract as the trigger points for reassessment based on the current index or rate. This would be a more practical and cost effective basis.

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?

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

We consider that the transitional provisions proposed are appropriate.

We note that the IASB has not proposed an effective date for the forthcoming standard. The general view of New Zealand constituents was that a minimum of 24 months lead time is required to implement the proposed standard, taking into account systems and process changes, and the education of stakeholder groups.

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 these proposals? Why or why not? If not, what changes do you propose and why?

The proposed disclosure requirements appear excessive, particularly for those entities where leasing is not a core business activity. As we have noted in past submissions, IFRS are frequently criticised as being overly complex and requiring excessive disclosures.

The general feeling of New Zealand constituents is that ED/2013/6 has excessive disclosure requirements. One constituent noted that the onerous disclosure requirements are a barrier against an entity with lower value items (NZD 2,000-3,000¹) becoming a lessor instead of a seller of products.

Disclosure of detailed reconciliations of leases balances is unnecessarily detailed. For example, the lists of possible reconciliation items in paragraph 61 for lessees, and paragraph 103 for lessors are likely to be interpreted as mandatory. We recommend that the standard retain the principles at the start of paragraphs such as these and delete the detailed lists of examples.

Overall, we believe that the disclosures should be to supplement the information in the primary financial statements and be consistent with the objective of financial reporting for general purpose financial statements, which aims to provide information to meet the *common* information needs of users of the financial statements. The extent of detail required suggests that the IASB is focusing on *individual* information needs – rather than common information needs – and is intended to allow individual users to deconstruct and reconstruct the financial statements according to their own particular models. In our view, this is not the objective of general purpose financial statements.

Questions 9-11: (FASB-only): non-public entities and related party leases

No comment.

¹ Equivalent to USD 1,600-2,400.

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 in the scope of IAS 40 if 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 in 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 with this proposal.

Other issues

1. Foreign-exchange risk exposure

The NZASB notes the impact of foreign currency on leases that are not written in the entity's functional currency. This is an issue for New Zealand, where major leasing transactions are often undertaken in USD. The NZASB recommends that a gain or loss arising from a change in foreign exchange rate is included in the definition of variable lease payment. Given that the asset and liability are inextricably linked it would make sense to adjust the asset for the gains and losses which relate to the future lease payments. The right-of-use asset is measured at its estimated cost, and hence changes in the estimated future lease payments - whether because of movements in foreign exchange rates or other external factors, such as a change in an index to which the lease payments are linked - result in a change to the asset's estimated cost. This approach could be achieved by scoping out lease obligations from IAS 21 and instead addressing changes in foreign currency rates in the same way as other lease payments that depend on a rate or index.

2. Perpetual Leases

The proposed Standard should contemplate the existence of a lease without an end date, i.e. a perpetual lease. In New Zealand there are many perpetual property leases with no end date between the Government and the indigenous Maori people which are the result of Treaty of Waitangi settlements. Currently the default position is that all such leases will be recognised as Type A lease per paragraph 30(a) of ED/2013/6 as the lease term is for the major part (where perpetual is interpreted as meaning all) of the remaining economic life of the underlying asset.

3. Definition of property

We note that the definition of 'property' includes a reference to buildings. Given the issue raised with the IFRS Interpretations Committee as to the meaning of building in the context of IAS 40 *Investment Property*, we recommend that the scope of 'property' for the purpose of the forthcoming IFRS be clarified. Our preference is that 'buildings' should include all long-lived structures permanently affixed to land.