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Comment Letter No. 486

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Dear Sir / Madam

**Re: Exposure Draft ED/2010/9 *Leases***

Thank you for the opportunity to comment on the above referenced Exposure Draft.

APN News & Media is one of the largest multi media companies in Australasia, operating a broad portfolio of businesses across publishing, radio broadcasting and outdoor advertising. All of our operations have significant lease arrangements including land & buildings, printing presses, transmission equipment and most significantly outdoor advertising sites.

Our outdoor advertising business, consistent with the rest of the industry, has a large number of operating leases over advertising sites. Over 50% of the operating costs of the business are lease rental expenses. Leases for Outdoor advertising sites also tend to include some form of contingent rental, normally in the form of a revenue share arrangement, as well as options over lease extensions. For these reasons the proposed standard has a particularly significant impact on this area of our business.

We agree that the existing standard on leases requires improvement, and support the IASB's and FASB's efforts to reduce diversity in accounting treatments, however, we believe that the proposed model will not improve the quality and usefulness of information provided to the users of financial statements. In our opinion, the proposed rules will result in misleading information, reduce the usefulness of the income statement, impair the comparability of financial statements both between entities and over time and also result in users needing to make further adjustments to reported amounts. This final point is likely to encourage preparers to report underlying results to users, backing out some, or all, of the lease accounting requirements.

Our main concerns are with the proposals are summarised below:

- In our view, options to extend lease terms do not meet the definition of a liability and their inclusion in the measurement of the right of use asset and liability to make lease payments is inappropriate, unless it is virtually certain that the option will be taken.

- Contingent rentals that are under the control of the lessee do not meet the definition of a liability and should not be recognised until incurred.
- Further, the inclusion of contingent rentals in the measurement of right of use assets and liabilities to make lease payments will require significant estimation and potentially result in significant volatility and impair the comparability of financial statements.
- The proposed transitional provisions will result in significant and meaningless distortion of profit in the years following transition, impairing the comparability of financial statements both between companies and from one year to the next.
- Key financial metrics including debt/EBITDA ratios and other debt covenant calculations may be adversely and inconsistently impacted. The scale of the impact is likely to vary between preparers and is likely to confuse users of financial statements.
- The costs to implement the proposed rules would be significant and in some cases prohibitive. Further, some of the proposed guidance is impossible to apply with any degree of accuracy or consistency, given the need to make forecasts for many years into the future.
- We believe that many users of financial statements would demand financial information with the impact of the proposed requirements backed out, particularly from a profit and loss perspective.

We are particularly concerned that the proposed rules will impact the competitive dynamic in certain industries, and we assume this is not the intention of the Boards. The significant and inconsistent impacts that the proposed rules will have on reported profits, key financial metrics and debt covenant measures have the potential to cause significant operational issues for some companies. The Boards appear to have assumed that all companies will have an equal ability to amend their debt covenant measures to adjust for the impacts of the changes. It is our view that this is not the case, and that the proposed rules will provide a competitive advantage to some companies over others.

In responding to the questions raised in the Exposure Draft we have assumed that the main proposals will proceed and have focused on areas that we believe are either contrary to underlying accounting principles; will result in a significant and unfounded distortion to the financial statements or are impractical to apply without either further guidance of simplification.

In particular we would like to draw your attention to our responses to questions 8, 9 and 16. In each of these cases we largely agree with the concerns raised by IASB member Stephen Cooper in his alternative view.

If you have any questions regarding this letter please do not hesitate to contact us.

Yours faithfully

**Peter Myers**
Chief Financial Officer

**Tim Norman**
Group Reporting Manager

## APPENDIX

**Question 1: Lessees**

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

We agree with the proposed approach to recognise a right of use asset and a liability to make lease payments. However we have significant concerns regarding the proposed rules on the measurement of leases, particularly those that include contingent rentals and option periods. These concerns are addressed in our responses to questions 8 and 9.

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

We agree that if the 'right of use' model is adopted the lessee should recognise amortisation of the right of use asset and interest on the liability. However we note that the current proposals will result in a front loading of expense in the early years of a lease. While this is reflective of a financial transaction, we expect that it will confuse users of the financial statements and may need to be backed out in providing more meaningful results to certain users of the accounts.

Further, we believe that the proposed simplified retrospective approach on transition will significantly exacerbate this front loading issue and will create a significant distortion in the income statement for a number of years following transition. We address this further in our response to question 16.

**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?**

We are not a significant lessor of assets and therefore have not considered the lessor proposals in sufficient detail to be able to respond to this question.

**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 the statement of financial position, 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).**

**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?**

We believe that from a lessee perspective the cost of applying the proposed rules to all short terms leases would potentially be prohibitive, with the main difficulty being the identification of all leases. We agree with the proposed guidance for lessors and would suggest that this could also be applied to lessees. While we acknowledge this creates an artificial distinction between leases that are recognised on the balance sheet and those that are not, we believe the information provided would still be adequate for all users and the benefits of the information provided would outweigh the costs of providing it.

**Question 4**

**(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?**

We agree that a lease is appropriately defined, although please refer to our responses to question 8 regarding the lease term and question 9 regarding contingent rentals.

**(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?**

We agree with the criteria in paragraphs B9 and B10.

**(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?**

The guidance given appears to have been taken from IFRIC 4, which in our experience can be difficult to apply. As the difference in treatment between operating leases and service contracts under current rules is relatively small this has not caused significant issues. However under the new guidance, as the difference in accounting is so significant, we would recommend that additional guidance is given to assist preparers to determine the difference between a lease and a service contract.

**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 agree with the scope exclusions.

**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 with the proposal to account for distinct service components in accordance with the proposals in the revenue exposure draft.

**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?**

We do not agree that purchase options should only be accounted for once they are exercised. This is inconsistent with the approach proposed for optional lease extensions. Consistent with our response to question 8 we believe that purchase options should be accounted for once it is virtually certain the option will be taken.

**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?**

We strongly disagree with the proposed approach from both a conceptual and practical perspective. Firstly, we do not agree that the payments that would be made during an option period meet the definition of a liability. Secondly, we believe that the 'more likely than not' threshold would be very difficult to apply, particularly on options many years in the future, and reassessments of likelihood to extend would result in significant volatility in amounts recognised.

We accept that options form an important element of lease arrangements, in particular where they are at a bargain price and therefore almost certain to be taken by the lessee. In this situation, i.e. where it is almost certain that the lease will be extended, we would support the inclusion of the lease payments in the determination of the right of use asset and liability to make lease payments. In other cases, where the option can be avoided by the lessee we do not believe the lease payment should be included until the point that it becomes virtually certain that the option will be taken. We would also support additional disclosure requirements in relation to option periods if they assist users of accounts to understand the lease arrangements.

**Question 9: Lease payments**

**Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?**

**Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?**

We strongly disagree with the proposed approach to the treatment of contingent rentals from both a conceptual and practical perspective. In our case, the majority of our contingent rentals are revenue share arrangements and therefore dependent on both a large number of variable factors out of our control as well as the actual use of the asset, which naturally is under our control.

Firstly we do not believe that these contingent rentals do not meet the definition of a liability as they are avoidable through our control over the use of the asset. Secondly, from a practical point of view we do not believe it is possible to accurately forecast revenue share contingent rentals, particularly where leases can be 10 or even 20 years long. Indeed, it would be contrary to the guidance in other standards, which limit the period over which management can use internal forecasts to five years (e.g. IAS 36 Impairment). The requirement to estimate contingent rentals would also result in significant volatility as forecasts were reassessed as market conditions altered.

For the above reasons we believe that contingent rentals, particularly those that are dependent on factors under the control of the lessee, should not be recognised until incurred.

**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?**

We agree with the Boards proposal to require reassessments, however believe that the current proposal to reassess when facts or circumstances indicate that there is a significant change is not sufficiently clear and would result in inconsistent application. We would suggest that either some additional guidance is given on triggering events that would require a reassessment and/or a minimum requirement to reassess on an annual basis is included.

**Question 11**

**Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?**

We have not considered this area in detail or the guidance included in the revenue exposure draft and therefore are not able to comment on this question.

**Question 12: Statement of financial position**

**(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?**

**(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 with the proposals to present right of use assets and liabilities to make lease payments separately from other assets and liabilities.

b,c,d) We are not a significant lessor of assets and therefore have not considered the lessor proposals in sufficient detail to be able to respond to this question.

**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?**

We believe there is sufficient guidance in IAS1 as to which items need to be presented separately on the face of the statement of comprehensive income, however we would support the requirement to disclose these amounts separately in the notes at a minimum.

**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?**

Consistent with our response to question 13, we believe there is sufficient guidance in IAS 1 as to what information should be presented on the face of the statement of cash flows rather than the notes.

**Question 15**

**Do you agree that lessees and lessors should disclose quantitative and qualitative information that:**

**(a) identifies and explains the amounts recognised in the financial statements arising from leases; and**

**(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?**

We agree with the disclosure objectives above, however note that the disclosure requirements proposed are extensive and may be of limited value where companies have limited leasing activity. We therefore support the proposals in paragraph 71 to allow aggregation and disaggregation of disclosures as necessary to achieve the disclosure objectives above.

**Question 16**

**(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?**

**(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?**

**(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?**

We strongly disagree with the proposed transitional provisions. As highlighted in the alternative view of Board Member Stephen Cooper, we believe the simplified retrospective approach will lead to a misleading and inconsistent reduction in profits of lessees on transition, as a result of treating all leases as if they are in the first year of their life. This would continue for a number of years following transition and would significantly impair the comparability of financial statements, both between different preparers and from one year to the next. Therefore we would expect that users would require that the impacts of the proposed leasing rules be backed out.

For this reason, we believe that alternative transitional arrangements should be considered, including permitting full retrospective transition. We agree that the costs of full retrospective application may be prohibitive for some companies, but if preparers are willing to invest the time required to produce more relevant and useful financial information they should be allowed and encouraged to do so.

**Question 17**

**Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?**

We do not agree that the benefits of the proposed requirements outweigh the costs. While we support the underlying objectives of the proposed standard, the requirements relating to contingent rentals and option periods (please refer to our responses to questions 8 and 9) will be particularly onerous to apply, and in our view the costs of applying will outweigh the benefits of potentially confusing and incomparable information. As noted in our responses to questions 8 and 9 we do not agree with the inclusion of option periods and contingent rentals in the right of use asset and liability to make lease payments, and believe additional disclosures would be a more appropriate way of dealing with these areas.

If the proposed rules around these areas were modified, while we still believe the costs to apply the proposed requirements would be very significant, we agree that the information provided would be beneficial to users of financial statements.

**Question 18**

**Do you have any other comments on the proposals?**

No further comments