

23 December 2010

The Director – Accounting Standards
New Zealand Institute of Chartered Accountants
PO Box 11 342
Wellington
6142

Dear Sir/Madam

SUBMISSION ON EXPOSURE DRAFT – ED 2010/9 Leases

Thank you for the opportunity to comment on the Exposure Draft on the proposed amendment to IAS 17 – Leases. Wellington City Council (the Council) is pleased to provide comments on this Exposure Draft.

Our specific comments are outlined in the attached appendix. In developing our comments we have considered the impact of the proposals on the Council as a reporting entity (for example, compliance costs and changes to information and reporting systems), and whether we believe the proposals are appropriate, from a standard setting perspective.

If you would like further clarification on the issues raised in our submission please don't hesitate to contact me.

Yours sincerely

Nicky Blacker
Manager, Financial Accounting
Wellington City Council

Appendix

The FRSB welcomes comment on the proposals in the Exposure Draft. In addition to the IASB's questions in the Exposure Draft, the FRSB seeks constituents' views on the following:

1. Do you agree with the proposals in the Exposure Draft. If not, please provide reasons supporting your response.

See below.

2. The FRSB has deferred consideration of proposals for PBE modifications for the Exposure Draft for the reasons discussed above. Notwithstanding this, if the final IFRS were to apply to PBEs, do you consider that the proposals in the Exposure Draft would give rise to the need for PBE modifications? Please identify the modifications that you consider appropriate and provide reasons supporting your response.

The Wellington City Council (WCC), along with Housing New Zealand, expresses some concerns relating to lessor accounting for the provision of social housing, and the costs versus benefits of implementing these proposals in the ED. With approximately 2300 social housing units, it is our view that the ED is going to have significant implications for WCC and that the costs of implementing the proposals to our social housing leases will significantly outweigh the benefits. Gathering the data and continually amending the data for changes in lease term estimates will create a substantial burden for limited value when the significant majority of the assets the leases relate to are already recognised at fair value in accordance with NZ IAS 16.

Residential tenancy leases are driven by social housing objectives unlike other private or business leases that are profit-oriented. Lessee's for the majority of WCC's social housing leases are individuals, not entities applying NZ IFRS. This situation is highly likely to continue into the future. Recognising the assets and liabilities for the lessor and lessee in a commercial business makes sense for both parties to ensure comparability of accounts following NZ IFRS, but we do not feel this make sense for residential tenancy leases.

All of WCC's social housing leases are covered under the Residential Tenancies Act 1986. This means that there is a right for either party to give written notice to terminate the lease without reason or incurring any penalty. For WCC, social housing is provided to those most in need, for as long as they need. This makes the lease term difficult to determine at the time of entering the lease. The measurement of these leases is therefore extremely subjective as the lease term cannot be quantified with any certainty.

The termination provisions in the Residential Tenancies Act 1986 mean that it is hard to argue that there are unconditional rights and obligations for a lessor. This means that recognising assets and liabilities under such leases becomes highly subjective as lease terms cannot be quantified with certainty. Therefore we believe that such residential property leases should be excluded from the definition of a lease.

3. The FRSB has deferred consideration of proposals for differential reporting concessions for the Exposure Draft for the reasons discussed above. Notwithstanding this, if the final IFRS were to apply to qualifying entities, do you consider that the proposals in the Exposure Draft give rise to the need for differential reporting concessions for qualifying entities? Please identify the concessions that you consider appropriate and provide reasons supporting your response.

No response required as this is not applicable for WCC.

4. Are there any regulatory issues or other issues arising in the New Zealand environment that may affect the implementation of the proposed New Zealand

pronouncement arising from the Exposure Draft, particularly any issues relating to:

- a. profit-oriented entities;***
- b. public benefit entities; or***
- c. the Privacy Act 1993.***

Please provide reasons supporting your response.

PBE issues are already included in response to question 2.

5. Do you consider the proposals in the Exposure Draft to be in the best interests of the users of general purpose financial reports in New Zealand and Australia? Please provide reasons supporting your response.

See 2 above. Also, WCC agrees in principle with recognising assets and liabilities arising under lease arrangements but argue the special nature of social housing leases mean that the assets and liabilities may not be controlled by the entity, and the receipt of future lease income may not be probable. We do not believe that grossing up the balance sheet for such assets and liabilities where there is no certainty over the lease term and future rental income provides useful information to ratepayers.

Under the performance obligation model an entity as a lessor will recognise the underlying asset in the balance sheet adding a new asset and liability. The lease liability would be amortised to the income statement as lease revenue over the term of the lease. Lease payments received would be allocated between interest income and a reduction of the lease receivable, using the effective interest rate method. We believe that carrying the assets relating to social housing fair value gives the ratepayer a better indication of the overall value of the properties.

WCC do not have a large number of leased assets so the proposals regarding lessee accounting would have minimal impact.

IASB questions

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 proposals for lessees in the ED. We believe there are assets that arise when entering a lease agreement and liabilities in the form of lease payments. We believe it is appropriate that these assets and liabilities should be recognised by lessees entering lease arrangements.

(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?

Yes we agree with the proposals.

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 de-recognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

Yes this seems reasonable. However, the WCC's social housing portfolio would fall into this category and we have a number of concerns around the application of this ED to social housing leases. The POA views the asset as the lessor's economic resource and therefore considers the lease contract as creating an asset and liability to be recognised in addition to the underlying asset. The de-recognition approach views the lessor as having transferred the economic benefits of the asset to the lessee at the beginning of the lease.

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and de-recognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Under the POA the underlying asset would be measured in line with NZIAS 16. The lease asset would be measured at the PV of the lease payments, plus any initial direct costs. The obligation would be measured at the PV of the lease payments. The discount rate would be the rate charged to the lessee, and contingent rentals and amounts receivable under residual value guarantees would be included only if the amounts can be reliably measured.

Under the de-recognition approach the lessor initially measures the lease asset as the PV of lease payments plus initial direct costs. The remaining portion would be classified as a residual asset. Any gain or loss arising on commencement of the lease would be recognised in profit and loss.

We agree with the proposals for short-term leases as we believe this would avoid the unnecessary costs of implementing the full proposals to those leases that will span one year or less.

However, we also believe that the scope of the short-term lease requirements should be extended to other situations where the costs outweigh the benefits of applying the proposals in the ED. For example, to those leases where both the lessor and lessee have the ability to terminate the lease without penalty through written notice.

The assets that arise under leases such as social housing leases, which can be terminated by either party at any time without penalty, are more subjective than leases where the parties to the lease are locked in for an agreed period of time. The asset is not within the control of the lessor as the lessee could withdraw from the lease at any time. Further, it could be argued that the obligation may not be 'probable' of giving rise to an outflow of resources in accordance with NZ IAS 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37). This is because the obligation can be cancelled at any time. For this reason we believe that leases where there is an option for either party to cancel the lease without penalty and with limited notice should also fall within the short-term lease accounting model.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65). (See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

This assumes leases have a defined period (see comments on social housing leases). Otherwise, it seems reasonable and practical.

Question 4

Definition of a lease

The exposure draft proposes to define a lease 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 (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

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

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

See comments on PBE scope exemption.

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?

It also says leases of investment property are within the scope of the ED apart from those where the lessor applies the fair value model in NZ IAS 40. For WCC our ground leases would therefore not fall within the scope of this ED.

It seems reasonable that right-of-use assets in a sublease should be treated in a similar manner to other leases.

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 de-recognition 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?

Yes, we agree with the proposals.

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?

Yes, we agree with the proposals.

Measurement

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120)

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

(c) is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).

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?

In situations where leases can be cancelled at any time with no penalty such as for WCC's social housing leases, the determination of the lease term will be, in our view, too subjective.

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?

Yes, we agree with the proposals.

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, we agree with the proposals.

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?

For lease agreements where the term is difficult to determine as they can be cancelled at any time we believe that the costs of remeasuring the lease asset and liability under the performance obligation model for a lessee will outweigh the benefits.

If the IASB disagree with our comments and go ahead with the proposals as currently worded, we would request that the final standard include some guidance on how to determine the lease term in the situation where lease agreements can be cancelled without penalty or warning by either party. It makes it very difficult to determine the lease term and the value of the asset and liability and could result in significant volatility in our balance sheet if lease terms are continually changing.

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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?

Yes, this seems reasonable.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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?

Disclosure in the notes would seem sufficient.

(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?

Disclosure at the net amount and in the notes would seem sufficient.

(c) Do you agree that a lessor applying the de-recognition 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?

Disclosure in the notes would seem sufficient.

(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?

Disclosure in the notes would seem sufficient.

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?***

Disclosure in the notes would seem sufficient.

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?

Disclosure in the notes would seem sufficient.

Disclosure

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?***

Yes, we agree with the proposals.

Transition

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?

We agree with the boards proposals for the simplified retrospective application.

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

See (a) above.

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

See (a) above.

Benefits and costs

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 believe the costs outweigh the benefits for our social housing leases. See our response to question 10.

Other comments

Question 18

Do you have any other comments on the proposals?

None.