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Dear Kevin

AASB ED 202R & IASB ED 2010/9 LEASES

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ED 202R which is a re-badged copy of the International Accounting Standards Board's (the Board) Exposure Draft ED 2010/9 (the ED). We have considered the ED as well as the accompanying draft Basis for Conclusions, and set out our preliminary comments in the Appendix.

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies, and public and private businesses, and this submission has benefited with some initial input from our clients, Grant Thornton International which is working on a global submission to the IASB, and discussions with key constituents.

The views expressed here are very preliminary in nature, and a more detailed Grant Thornton global submission will be finalised by the IASB's due date of 30 November 2010. We also note that the AASB is conducting workshops on 7 December 2010, and this is an indicator that the proposals in the IASB's ED are still being subject to detailed debate.

We note that the IASB has not indicated whether it will amend the existing requirements for non-publicly accountable entities, and on that basis we believe the AASB should not consider any decisions on RDR disclosures until the IASB has considered this further, given that the RDR is 'loosely' based on IFRS for SMEs disclosures.

Grant Thornton does not believe that at this time amendments to the existing leasing standard should apply to non-publicly accountable entities. Instead Grant Thornton believes that the AASB should allow the IFRS for SMEs accounting standard as an option for non-publicly accountable entities. Adoption of IFRS recognition and measurement principles which the AASB believes necessitates an increase in disclosures compared to IFRS for

SMEs, does add significant complexity and costs that would not be borne by similar structured overseas entities.

If you require any further information or comment, please contact me.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

Keith Reilly
National Head of Professional Standards

Appendix 1: Preliminary comments

ED questions

Question 1: Lessees

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

We agree with the concept of a lease liability and a corresponding right of use asset but we do not agree with the proposed measurement provisions. We believe that the right of use asset is often different in substance from a tangible asset that is controlled by the entity that can be pledged as collateral or sold to meet liquidity requirements or obligations to creditors. The right of use asset therefore may require definition of a new type of asset.

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

Recognition of interest on the liability will have the consequence of divorcing the recognition of expense from the cash flows. This may be appropriate when a lease is in substance a financing, but would not be appropriate when a lease is more in the nature of services. Also, it would require the use of different accounting models for the lease elements and for service elements within a single contract.

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?**

We note that the performance obligation approach is not consistent with the performance obligation approach in the revenue recognition paper. In particular, the performance obligation approach in the leasing paper would front load revenue and, as described, would lead to recognizing interest income on future contingent rentals at the front end of a lease prior to resolution of the contingency. We would prefer a consistent application of a performance obligation approach between the leasing and revenue recognition papers or a better explanation as to why there should be a difference.

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 prefer a single approach to lease accounting and note that there is diversity of opinion as to which approach best reflects the economic substance of a lease. However, better specification of when a lease is a sale would obviate the need for the derecognition approach.

c. Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

The criteria for a sale are overly restrictive and would prohibit sales recognition in many instances where control of an asset for its economic life has been passed to the lessee. We do not agree with the use of a control model for determining when a lease has been a sale that is different from the control model used in revenue recognition. We do not agree with using a control model for determining whether a sale has occurred and a risks and benefits model for determining whether a partial sale has occurred. A consistent control model should classify as sales many of the transactions that would be accounted for under the derecognition approach under the proposal and may eliminate any need for its use. Many of the indicators used to describe when the derecognition approach is appropriate may be better characterized as indicators when the lessee has obtained more than temporary control of the underlying asset and therefore the transaction could be accounted for as a sale.

Question 3: Short-term leases

This 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 12 months or less:

a. At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently;

i the liability to make lease payments at the undiscounted amount of the lease payments and

ii **the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).**

We agree with the proposed model for short term leases.

b. **At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement 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?

We agree with the proposed accounting by lessors for short term leases but would prefer that the model for short term leases be consistent with the model for recognizing a continuous transfer of services in the revenue recognition paper

Question 4: Definition of a lease

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 do not agree with the proposed definition of a lease. The term asset is too broad. The proposed definition should exclude consumable items such as inventory and financial instruments which should not be the subject of a lease and financial instruments. The ideal definition would be property, plant and equipment and intangible assets with similar characteristics.

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 do not agree. The definition of a sale in this paper is not consistent with the proposed guidance in Revenue Recognition. We believe that there should be a consistent definition of control between the two projects and that a transaction which is a non temporary transfer of control should be accounted for as a sale or purchase. A transaction which is a temporary transfer of control should be accounted for as a lease.

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?**

This will be very burdensome, adding to complexity and lead to the front loading of income. The ideal solution would be a single model for accounting for leased assets and service elements so that there is no need to bifurcate.

Question 5: Scope exclusions
This exposure draft proposes that a lessee or a lessor should apply the proposed guidance 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 guidance? Why or why not? If not, what alternative scope would you propose and why?

We believe that agreements that transfer temporary control of intangible assets that are similar to property, plant, and equipment should be within the scope of this project unless the transaction is a financing within the scope of IAS 39. We do not believe that current assets such as inventory or supplies should be within the scope of this project.

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 support the principle, 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. However, we expressed our belief that it may be appropriate for an entity to account for goods and services as a single performance obligation if accounting for those performance obligations together would result in the same amount and the timing of revenue recognition as if they were accounted for separately.

We agree that a lessee should apply the lease accounting requirements to the combined contract. The basis of our agreement is the absence of information available to the lessee to allocate payments reliably.

We do not support having a different requirement based on the accounting model used by the lessor. We expect the lessor is able to determine the price of non-distinct services because they need the information on all components of the arrangement (the lease, distinct services and non-distinct services) to price their contracts.

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 believe that the accounting for purchase and renewal options should be the same.

We agree that a lessee or a lessor should account for purchase options only when they are exercised as the exercise of a purchase option is merely dependent on future business conditions. Therefore, until exercised we believe that the purchase option is not relevant to determining whether a contract represents a purchase or sale. We believe that the same treatment should apply to bargain purchase options.

We acknowledge that conceptually purchase and renewal options are likely to meet the Framework requirements for separate recognition and measurement. However, we believe that given the amount of judgement required and the complexity of that judgement a disclosure approach is more appropriate.

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 agree with the alternative view expressed in paragraphs AV2 – AV8 in the Basis for Conclusions to the [proposed] Standard to exclude from the measurement of assets and liabilities those optional lease periods that are merely dependent on future business conditions. Accordingly, we do not support the proposal that the lessee determine the lease term taking into account options to extend or terminate the lease that are merely dependent on future business conditions.

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 agree with the alternative view expressed in paragraphs AV2 – AV8 in the Basis for Conclusions to the [proposed] Standard to exclude from the measurement of assets and liabilities those contingent rentals that are merely dependent on future business conditions.

We believe that residual value guarantees do meet the definition of a liability to be recognised subject to their reliable measurement.

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 do not support the proposals for reassessment as they are onerous. We consider a reasonable approach is to requires the lessee and the lessor to reassess estimates included in the measurement of assets and liabilities if there has been a change in management expectation on which those estimates were originally based and the changed expectation would result in a significant change in the liability to make lease payments or the right to receive lease payments.

Question 11: Sale and leaseback

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

We support the 'partial asset' approach, whereby the lessee would continue to recognise a portion of the underlying asset representing the right to use the asset during the leaseback period and derecognise that portion of the asset relating to the rights transferred to the lessor. We do not believe the partial asset approach is more complex than the partial derecognition approach, and we believe it is better able to represent the economic positions of the lessee and the lessor (than does the 'whole asset' approach).

Presentation

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?**

We support the proposals.

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 support the proposals.

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?

We support the proposals

Question 15: Disclosure
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 support the proposals.

Question 16: Transition

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 welcome the decision of the Boards to develop a simplified retrospective approach to recognise and measure all outstanding leases as of the date of initial application. We agree that a mandatory full retrospective application would be onerous; however, we do not think that it should be prohibited for use by those entities that have the necessary information.

Question 17: Benefits and costs
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 support the principle that lessors and lessees recognise and measure all their assets and liabilities; however, we are most concerned about the level of complexity that sits behind the principle. We encourage the Boards to continue with their outreach activities to better understand the costs and benefits of the [proposed] Standard.

Question 18: Other comments

Do you have any other comments on the proposals?

We think it important that the IASB articulate its approach to accounting for leases for entities without public accountability that apply the IFRS for SMEs standard, to signal their intentions to jurisdictions that have already applied the IFRS for SMEs or are otherwise modifying IFRS for use by smaller entities.

Specific AASB questions

1. Not-for-profit entities - whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals for publicly accountable entities. We believe that there are regulatory and other issues arising in the Australian environment for non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

2. Reduced disclosures requirements – if any of the proposed disclosures should be considered for exclusion under the reduced disclosure requirements (see above in relation to the planned companion ED yet to be released).

We note that the IASB has not indicated whether it will amend the existing requirements for non-publicly accountable entities, and on that basis we believe the AASB should not consider any decisions on RDR disclosures until the IASB has considered this further, given that the RDR is 'loosely' based on IFRS for SMEs disclosures. We also recommend that the AASB consult with the UK Accounting Standards board that is proposing an RDR regime for subsidiaries of publicly accountable entities.

Grant Thornton does not believe that at this time amendments to the existing leases standard should apply to non-publicly accountable entities. Instead Grant Thornton believes that the AASB should allow the IFRS for SMEs accounting standard as an option for non-publicly accountable entities. Adoption of IFRS recognition and measurement principles which the AASB believes necessitates an increase in disclosures compared to IFRS for SMEs, does add significant complexity and costs that would not be borne by similar structured overseas entities.

3. GAAP/GFS harmonisation – in relation to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*:

a. are you aware of any implications for GAAP/GFS harmonisation of the proposed changes other than those noted below?

b. how do you think the implications for GAAP/GFS harmonisation of the proposed changes should be dealt with in the context of the principles in AASB 1049?

Apart from our earlier comments, we support the implementation of the proposals for publicly accountable entities. However we accept that there will be a need to provide detailed commentary for GAAP/GFS harmonization given the fundamental differences in accounting.

4. Whether, overall, the proposals would result in financial statements that would be useful to users and are in the best interests of the Australian and New Zealand economies

Apart from our earlier comments, we are not aware of any issues that may impact users, nor are we aware of any reasons that would impact on the interests of the Australian economy for publicly accountable entities. Our New Zealand firm may wish to comment direct to the AASB if there are any New Zealand implications. We also reiterate that for non-publicly accountable entities the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities, and hence would not result in financial statements that would be useful to users nor are they in the best interests of the Australian economy.