Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Right-of-Use Assets of NFP Entities**	**Meeting:**	September 2019 (M172)
Topic:	**Implementation issues re AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities***	**Agenda Item:** **Date of Agenda Paper:**	14.1 10 September 2019
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Objective of this paper

1 The objective of this paper is for the Board to consider implementation issues raised by the Department of Treasury and Finance of South Australia (SA DTF) regarding AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities* (December 2018) and **decide** whether amendments to Accounting Standards would be required.

Reasons for the Board to consider this paper at this meeting

2 The AASB Chair received a letter from SA DTF requesting clarification regarding the subsequent measurement of right-of-use (ROU) assets under concessionary leases and the meaning of the term 'a class (or classes)' of ROU assets introduced in AASB 2018-8.

3 AASB 16 *Leases* is effective for annual reporting periods beginning on or after 1 January 2019. SA DTF is concerned that even if not-for-profit (NFP) public sector entities elect to apply the cost model at initial recognition or on transition to AASB 16 on 1 July 2019 as permitted in AASB 2018-8, they would need to measure ROU assets under concessionary leases at fair value in their financial statements for the year ending 30 June 2020. In this meeting, staff ask the Board to consider the issues raised by SA DTF and staff recommendations.

Summary of staff recommendations

4 Staff recommend the following:

(a) extend the initial-measurement temporary relief to provide an option not to measure ROU assets under concessionary leases at fair value in subsequent measurements (Issue 1);

(b) no action from the Board with respect to Issue 2;

(c) specify in the Standards that ROU assets under concessionary leases are a separate class of ROU assets from ROU assets under market-rate leases (Issue 3); and

(d) no action from the Board with respect to Issue 4.

Attachments

14.2 Letter from Department of Treasury and Finance of South Australia (dated 13 May 2019)

Structure

5 This staff paper is set out as follows:

(a) Background (paragraphs 6–11)

(b) Overview of issues (paragraphs 12–16)

(c) Issue 1: Subsequent measurement – AASB 1049 effectively requires ROU assets to be measured at fair value for WoG and GGS financial statements (paragraphs 17–36)

(d) Issue 2: Subsequent measurement – Treasuries require government entities in their jurisdiction to measure assets at fair value (paragraphs 37–38)

(e) Issue 3: Class of ROU assets – Measuring ROU assets under concessionary leases differently to ROU assets under market-rate leases (paragraphs 39–48)

(f) Issue 4: Class of ROU assets – Measuring some ROU assets under concessionary leases at cost and others at fair value (paragraphs 49–59)

(g) Next steps (paragraph 60–62)

(h) Appendix A: Summary of factors considered by the Board when issuing AASB 1058 and AASB 2018-8 [for reference only]

(i) Appendix B: Proposed options for addressing Issue 3

Background

6 For ease of reference in this paper, leases that have significantly below-market terms and conditions principally to enable the entity to further its objectives are referred to as 'concessionary leases'.

7 At present, not-for-profit (NFP) public sector lessees do not recognise leased assets from concessionary operating leases, in accordance with AASB 117 *Leases*. For concessionary finance leases, staff have been informed by some Treasury offices and the Australasian Council of Auditors-General (ACAG) that some NFP public sector lessees measure leased assets under concessionary finance leases at fair value.

8 AASB 16 *Leases* is effective for annual reporting periods beginning on or after 1 January 2019, and removes the former distinction between operating leases and finance leases for lessees. Subject to optional practical expedients, under AASB 16, lessees recognise a right-of-use (ROU) asset and a lease liability for all leases.

9 AASB 1058 *Income of Not-for-Profit Entities*, also effective for annual reporting periods beginning on or after 1 January 2019, originally required NFP entities to measure ROU assets of concessionary leases **at initial recognition** at fair value. At the November 2018 Board meeting, the Board considered comments from constituents that they are encountering difficulties in determining the fair value of ROU assets in concessionary leases, and decided to provide a temporary option for all

NFP entities (private sector and public sector) to elect to measure these ROU assets at initial recognition either at cost or at fair value.

10 After considering comments from 20 respondents to Exposure Draft ED 286 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities* (November 2018), the Board issued AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities* on 24 December 2018 to provide the temporary relief explained in paragraph 9, with that election made for each **class of ROU assets**. The temporary relief is expected to be reassessed by the Board when further guidance has been developed to assist NFP entities in fair valuing ROU assets and the financial reporting requirements for private sector NFP entities have been finalised.

11 The AASB Chair received a letter from the Department of Treasury and Finance of South Australia (SA DTF) on 13 May 2019. The letter expresses a concern that even though the Board issued AASB 2018-8 to provide temporary relief for NFP entities to elect to measure ROU assets under concessionary leases at initial recognition either at cost or at fair value, it appears that public sector entities effectively do not have such an option and would need to subsequently measure those ROU assets at fair value. Staff's analysis of the issues is outlined in paragraphs 12–59.

Overview of the issues

12 Paragraph 35 of AASB 16 states that in subsequent measurement, "If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in AASB 116, <u>a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that **class of property, plant and equipment**</u>." [emphases added]

13 Paragraph 13 of AASB 1049 *Whole of Government and General Government Sector Financial Reporting* states that "… where compliance with the ABS GFS Manual would not conflict with Australian Accounting Standards, the principles and rules in the ABS GFS Manual shall be applied. In particular, certain <u>Australian Accounting Standards allow optional treatments within their scope. Those optional treatments in Australian Accounting Standards aligned with the principles or rules in the ABS GFS Manual shall be applied</u>." [emphasis added]

14 SA DTF noted that public sector entities typically apply the revaluation model in AASB 116 *Property, Plant and Equipment* to measure their PPE at fair value to align with Government Finance Statistics (GFS) principles (ie measurement of assets at current market value). SA DTF is concerned that, to satisfy AASB 1049 paragraph 13, public sector entities would also need to revalue their ROU assets under concessionary leases (and other leases) at fair value **at subsequent measurement**.

15 Staff agree with SA DTF that AASB 16 paragraph 35 and AASB 1049 paragraph 13 could be interpreted to require ROU assets under concessionary leases to be fair valued at subsequent measurement, if fair value measurement of ROU assets under concessionary leases (and other leases) aligns with GFS requirements and if the revaluation model is applied to the related class of property, plant and equipment (PPE) under AASB 116.

16 This is a public-sector-specific issue because AASB 1049 requires election of the accounting model that aligns with GFS requirements. There are four issues to consider:

- Issue 1: Subsequent measurement – AASB 1049 effectively requires ROU assets to be measured at fair value for Whole of Government (WoG) and General Government Sector (GGS) financial statements;

- Issue 2: Subsequent measurement – Treasuries require government entities in their jurisdiction to measure assets at fair value;
- Issue 3: Class of ROU assets – Measuring ROU assets under concessionary leases differently to ROU assets under market-rate leases; and
- Issue 4: Class of ROU assets – Measuring some ROU assets under concessionary leases at cost and others at fair value.

Issue 1: Subsequent measurement – AASB 1049 effectively requires ROU assets to be measured at fair value for WoG and GGS financial statements

Staff analysis

17 Staff performed the following steps in analysing Issue 1:

- Step 1: The Board's rationale for requiring concessionary leases to be measured initially at fair value and the rationale for granting temporary relief from this requirement;
- Step 2: Precedent in providing measurement relief to WoG and GGS; and
- Step 3: Advantages and disadvantages of extending the initial-measurement temporary relief to provide an option not to measure ROU assets under concessionary leases at fair value in subsequent measurements.

Step 1: The Board's rationale for requiring concessionary leases to be measured initially at fair value and the rationale for granting temporary relief from this requirement

18 Staff believe it would be useful to remind the Board of the aspects it considered in deciding to require ROU assets under concessionary leases to be measured at fair value on initial recognition, and the rationale behind the decision to provide temporary relief from this requirement.

19 A summary of the factors considered by the Board when finalising AASB 1058 to require NFP entities to initially measure concessionary leases at fair value is contained in Appendix A for the Board's information. Appendix A also includes an extract from the Basis for Conclusions for AASB 2018-8 in relation to the decision to provide the temporary relief.

20 When issuing AASB 1058 to require ROU assets under concessionary leases to be measured at fair value at initial recognition, the Board considered that fair value measurement is **only required at initial recognition or on transition** to AASB 1058, and that the **quantum of concessionary leases** might not be significant (AASB 1058 paragraphs BC29(c) and BC149).

21 However, as explained in paragraphs 12–15 above, NFP public sector entities would be required to measure ROU assets under concessionary leases at fair value in subsequent measurements to comply with AASB 1049 requirements. Staff have heard from some jurisdictions that the WoG and GGS might have a significant number of concessionary leases (eg 400-500 for one State, but to be confirmed).[1]

22 At its November 2018 meeting, the Board considered comments from constituents in the NFP sector that they are experiencing difficulties in applying the principles in AASB 13 *Fair Value*

1 Most local governments are not expected to have a significant number of concessionary leases, but also are not required to adopt policies consistent with AASB 1049 principles.

Measurement in determining the fair value of ROU assets under concessionary leases. The Board originally focused on the NFP private sector because it noted that public sector entities have experience in measuring assets at fair value.

23 The Board decided to provide temporary relief to NFP entities (in both the private and public sectors) not to measure ROU assets under concessionary leases at fair value on initial recognition. The Board made this decision having considered the following:

- the prevalence and magnitude of concessionary leases in the NFP sector, and the significance of restrictions on rights of use of the underlying assets in many cases (AASB 2018-8 paragraph BC6);

- further guidance might be needed to assist NFP entities in applying the principles of AASB 13 to ROU assets in concessionary lease arrangements. A temporary option for NFP lessees not to measure a class (or classes) of ROU assets on initial recognition at fair value for concessionary leases would avoid undue cost and effort being incurred by preparers in applying AASB 13 in the absence of additional guidance (AASB 2018-8 paragraphs BC5–BC6);

- the financial reporting thresholds for NFP private sector entities might be revised as a result of the ACNC Legislative Review recommendations. A temporary option would avoid smaller entities incurring costs in measuring ROU assets at fair value when they might subsequently be exempted from this requirement by not being required to prepare financial statements that comply with Accounting Standards (AASB 2018-8 paragraph BC7).

24 Staff consider that when issuing AASB 2018-8 to provide the temporary relief for NFP entities to elect to measure ROU assets under concessionary leases at either cost or fair value at initial recognition, the Board did not specifically intend for public sector NFP entities to be required to subsequently measure these ROU assets at fair value, prior to further guidance being developed to assist NFP entities in applying the principles in AASB 13. Paragraph BC6 of AASB 2018-8 does state that the temporary relief is intended to avoid NFP entities incurring undue cost and effort in applying the principles of AASB 13 to measure ROU assets in the absence of further guidance on fair value measurement, but limiting the relief only to initial measurement does not appear to have achieved that.

Guidance regarding fair value measurement of ROU assets

25 As part of the *Fair Value Measurement for Public Sector Entities* project, staff interviewed valuers from four accounting firms to discuss the approach valuers use in practice to estimate the fair value of ROU assets in lease arrangements. It appears that fair value measurement of ROU assets would depend on how the leased asset is being used by the lessee. Generally, a discount to the market rentals of similar assets in the same location would be applied if the lease has a restriction imposed on the use of the asset or on the price the lessee could charge third-party users of the asset. For example, if a parcel of land is used to build a community centre that is a restricted asset and is available to the community to use free of charge, a discount would be applied to the market value of the land (reflecting market rentals) to reflect the restrictions.

26 Given the prevalence of restrictions in the use of underlying assets associated with concessionary leases in the public sector, staff consider that further guidance would be useful in assisting preparers in applying AASB 13, for example identifying the market participant buyers of a concessionary lease in the NFP public sector context. Guidance might also be required in determining which measurement approach (market, income or cost) would be appropriate under AASB 13 in measuring the fair value of ROU assets under concessionary leases where there are restrictions on the use of the underlying asset.

27 Staff are in the process of developing guidance on AASB 13 for application by NFP public sector entities. Subject to the Board's decisions in future Board meetings, an Exposure Draft of guidance is expected to be issued during the second quarter of 2020. That guidance would have implications for how the fair value of a ROU asset held by a NFP public sector entity should be measured.

28 Staff are of the view that the difficulties in measuring the fair value of ROU assets under concessionary leases considered by the Board in November 2018 have not reduced. Staff consider that it would be appropriate to extend the temporary relief granted by AASB 2018-8 so that NFP public sector entities would not need to measure the fair value of ROU assets under concessionary leases (ie also grant relief from **subsequent** fair value measurement of ROU assets under concessionary leases) until further guidance on fair value measurement has been developed.

Step 2: Precedent in providing measurement relief to WoG and GGS

29 Even though public sector entities have experience in measuring assets at fair value, staff note that there is precedent for the Board deferring measurement requirements for the NFP public sector. For example, the Board decided to defer the requirement to recognise defence weapons platforms at fair value when the Australian Bureau of Statistics (ABS) amended the GFS Manual to treat them as assets rather than immediate expenses[2]. Paragraph BC3 to the amending Standard AASB 2012-8 (appended to AASB 1049) suggests that the Board considered the magnitude and complexity of the valuation exercise for defence weapons platforms and decided that an extension of transitional relief for two years would be required for the Australian Government to be able to comply.

30 The Board also deferred the requirement to recognise land under roads (first from 31 December 2002 to 31 December 2006, then further to 31 December 2007[3]) taking into account the lack of international convergence on the recognition of land under roads. When finalising AASB 1051 *Land Under Roads*, the Board considered that it might be onerous for entities to be required to retrospectively identify, assess the recognition criteria, recognise and measure land under roads previously acquired, and decided to allow entities to elect whether to recognise land under roads acquired before the end of the first reporting period ending on or after 31 December 2007 (AASB 1051 paragraph BC11).

Step 3: Advantages and disadvantages of extending the initial-measurement temporary relief to provide an option not to measure ROU assets under concessionary leases at fair value in subsequent measurements

31 Staff considered the following pros and cons of extending the temporary relief to provide an option not to measure ROU assets under concessionary leases at fair value in subsequent measurements until further guidance has been developed to assist NFP public sector entities to apply the principles of AASB 13. Staff are of the view that the pros outweigh the cons.

2 AASB 1049 paragraph 13C states "A government may elect not to apply Chapter 2 *Amendments to Defence Weapons Platforms of the ABS publication Amendments to Australian System of Government Finance Statistics, 2005* (ABS Catalogue No. 5514.0) – published on the ABS website on 5 April 2011 – in the financial statements prepared in accordance with this Standard for reporting periods ending before 30 June 2015." Paragraph 13C was inserted into AASB 1049 by the amending Standard AASB 2012-8 *Amendments to AASB 1049 – Extension of Transitional Relief for the Adoption of Amendments to the ABS GFS Manual relating to Defence Weapons Platforms* (December 2012).

3 In 1999 the Board extended the expiry date of the transitional provisions permitting the non-recognition of land under roads from 31 December 2002 to 31 December 2006, and in 2006 further deferred it to 31 December 2007 (AASB 1045 *Land Under Roads: Amendments to AAS 27A, AAS 29A and AAS 31A*).

32 **Arguments for providing temporary relief** at subsequent measurement:

- Consistent with the rationale in providing the temporary relief for initial measurement, providing the temporary relief in subsequent measurement would help avoid:
  - diversity in practice on how ROU assets are fair valued, particularly if the underlying asset has restrictions; and
  - undue cost and effort incurred by preparers in the valuation of these assets and the audit of those valuations.

- It appears that public sector constituents construed the Board's intention in providing temporary relief via AASB 2018-8 as enabling public sector NFP entities to avoid incurring undue cost and effort. Not extending that temporary relief to subsequent measurements might be perceived as inconsistent with the Board's previous decision, because public sector NFP entities would still incur costs in revaluing ROU assets under concessionary leases as at a reporting date (eg 30 June 2020), prior to the Board finalising its fair value guidance for public sector NFP entities.

33 **Arguments against providing temporary relief** at subsequent measurement:

- The AASB 1049 requirement to elect accounting treatments to align with GFS is applicable only for WoG and GGS. There might not be a significant number of concessionary leases that have a material impact on the WoG and GGS consolidated financial statements. Treasuries can permit government entities in their jurisdiction to measure ROU assets at cost (see Issue 2 in paragraphs 37–38).

- As noted in Agenda Paper 13.1 *GAAP/GFS Reconciliation Requirements* for this meeting, the Board has decided that reform of the Australian public sector financial reporting framework is required and has already planned a comprehensive post-implementation review (PIR) of AASB 1049. It might be prudent to not introduce amendments to AASB 1049 until the PIR is completed. Also, the magnitude of the issues described in paragraphs 12–16 might be reduced as a result of the public sector financial reporting framework reform, if it is determined that general purpose financial statements are not required to be prepared by all public sector entities (other than WoG and GGS).

- Since the temporary relief provides an option for entities to choose a measurement basis for ROU assets, it could further reduce comparability between entities and between sectors because different measurement bases might be selected to measure ROU assets under similar concessionary leases.

Staff recommendation

34 The public sector financial reporting framework reform, the PIR of AASB 1049 and the fair value guidance are not expected to be completed when public sector entities need to prepare their financial statements for the 30 June 2020 financial year. Given the potential magnitude and prevalence of restricted ROU assets under concessionary lease arrangements in the public sector and the difficulties expressed by stakeholders in this sector in measuring these ROU assets at fair value, in accordance with *The AASB's Not-for-Profit Entity Standard-Setting Framework* (paragraph 28(d)), staff recommend extending the initial-measurement temporary relief to provide an option not to measure ROU assets under concessionary leases at fair value in subsequent measurements. This would avoid undue cost and effort in applying the principles of AASB 13 in measuring the fair value of these assets before the Board issues further fair value measurement guidance.

35 If the Board agrees with the staff recommendation, staff recommend amending paragraph 13D of AASB 1049 as follows (deleted text struck through):

> 13D Notwithstanding paragraph 13, a government may elect to measure a class of right-of-use assets ~~at initial recognition~~ at cost or at fair value in accordance with AASB 16 *Leases* for leases that had at inception significantly below-market terms and conditions principally to enable the entity to further its objectives.

36 Staff consider that a new paragraph to AASB 16 – paragraph Aus35.1 – would also be required to permit ROU assets under concessionary leases to be measured on a different basis to ROU assets of market-rate leases even if the underlying assets are in the same class of PPE:

> Aus35.1 Notwithstanding paragraph 35, a not-for-profit public sector entity may elect to measure a class of right-of-use assets at cost or at fair value for leases that had at inception significantly below-market terms and conditions principally to enable the entity to further its objectives, regardless of whether the revaluation model is applied to other right-of-use assets related to the same class of property, plant and equipment to which the lessee applies the revaluation model in AASB 116.

Questions to the Board:

Q1 Do Board members agree with the staff recommendation in paragraph 34 to extend the initial-measurement temporary relief to provide an option not to measure ROU assets under concessionary leases at fair value in subsequent measurements?

Q2 Do Board members agree with the staff recommendation for revising the wording of paragraph 13D of AASB 1049?

Q3 Do Board members agree with the staff recommendation for adding a new paragraph Aus35.1 in AASB 16?

Issue 2: Subsequent measurement – Treasuries require government entities in their jurisdiction to measure assets at fair value

Staff analysis

37 AASB 1049 specifies requirements only for the WoG and GGS consolidated level and not for other public sector entities. However, staff observe that the Treasury Departments of governments require their entities to also elect the accounting treatments that align with GFS principles.

38 Staff consider that, since this is a requirement imposed by Treasury Departments on the government entities in their jurisdiction, those Departments could resolve Issue 2 by changing their instructions to the entities. Staff do not think the Board could resolve Issue 2 because AASB 1049 does not require public sector entities, other than WoG and GGS, to elect to apply accounting measurement models that align with GFS. Accordingly, staff recommend that the Board take no action on this issue.

Question to the Board:

Q4 Do Board members agree with the staff recommendation to take no action on Issue 2?

Issue 3: Class of ROU assets – Measuring ROU assets under concessionary leases differently to ROU assets under market-rate leases

Staff analysis

39 To better understand Issue 3, it is useful to revisit the temporary option introduced in AASB 2018-8. AASB 2018-8 provides a temporary option for NFP entities to elect to measure a **class or classes** of right-of-use assets on initial recognition at cost or fair value – for ROU assets arising under concessionary leases.

40 AASB 2018-8 introduced the term 'a class (or classes) of ROU assets' (paragraphs Aus25.1 and Aus59.1 of AASB 16), but did not include a definition of this term. Instead, in paragraph BC15 of AASB 2018-8, it referred to a description in other Standards, such as AASB 116 and AASB 138 *Intangible Assets*, in determining a class of assets. These Standards describe a class of assets as "… a grouping of assets of a similar nature and use in an entity's operations".

41 Paragraph 37 of AASB 116 provides examples of separate classes of PPE, including:

- land;
- land and buildings;
- machinery;
- furniture and fixtures; and
- office equipment.

42 SA DTF noted that applying this description – grouping ROU assets of a 'similar nature and use in an entity's operations' – would mean that a concessionary lease ROU asset would be classified in the same class as ROU assets arising under leases that have market terms and conditions, if they exhibit the similar nature and use. For example, a ROU asset under a concessionary lease of a parcel of land to operate a public school would be classified in the same class of ROU assets as a market-rate lease of another parcel of land to operate another school.

43 Issue 3 is more prevalent in the NFP public sector than in the private sector because public sector entities measure their assets at fair value to align with GFS and may be expected to want to use fair value for ROU assets under non-concessionary leases. Therefore, if the Board intends to provide temporary relief to NFP entities by permitting them to elect to measure ROU assets under concessionary leases at cost or fair value, at initial recognition and also at subsequent measurement, whether or not ROU assets arising under non-concessionary leases and in the same class are measured on the same basis, then further guidance or amendments would be required to define or clarify 'a class (or classes) of ROU assets' in order to apply the relief.

Staff recommendation

44 Staff consider that the amendments made to paragraph Aus25.1 of AASB 16 and the commentary in paragraph BC14 to AASB 2018-8 suggest that the Board has already distinguished a class of ROU assets based on whether the assets arise under concessionary or non-concessionary leases, in addition to the requirement for a similar asset nature and use. Staff recommend further amendments to clarify this, since stakeholders are uncertain whether the current measurement option is effective given the existing description of a class of asset.

45 Staff considered three options in addressing Issue 3, as set out in Appendix B. Staff think the option chosen should be the simplest to describe and apply without limiting the scope of the exemption from the requirements to measure ROU assets at fair value in advance of public sector NFP entity guidance on applying fair value. For these reasons, staff recommend Option 3 – specify in the

Standards that ROU assets under concessionary leases are a separate class of ROU assets from ROU assets under non-concessionary (market-rate) leases.

46 Staff note that specifying in AASB 16 that ROU assets under concessionary leases could be treated as a separate class of ROU assets from ROU assets under market-rate leases is not consistent with the concept of a 'class of assets' in other Standards, which looks only at the nature and use of the assets in an entity's operations. However, given the election to measure ROU assets under concessionary leases at cost or fair value would only be temporary, staff are of the view that Option 3 is the best option. Identifying two classes of ROU assets should not be required once fair value measurement guidance has been developed, so that all ROU assets that relate to a class of property, plant and equipment could be measured on the same basis under paragraph 35 of AASB 16, to maintain that approach.

47 If the Board agrees with the staff recommendation, staff recommend adding a new paragraph to AASB 16 – paragraph Aus25.2 – as follows:

> Aus25.2 Right-of-use assets arising under leases that had at inception significantly below-market terms and conditions principally to enable the entity to further its objectives may be treated as a separate class of right-of-use assets to right-of-use assets arising under other leases, despite their similar nature and use in the entity's operations.

48 In this case, it would also be appropriate to change the drafting of paragraph Aus35.1, as proposed at paragraph 36 of this paper, as follows:

> Aus35.1 Notwithstanding paragraph 35, a not-for-profit public sector entity may elect to measure a class of right-of-use assets at cost or at fair value if the lessee applies the revaluation model in AASB 116 to the related class of property, plant and equipment.

Questions to the Board:

Q5 Do Board members agree with the staff recommendation in paragraph 45 to specify in the Standards that ROU assets under concessionary leases are a separate class of ROU assets from ROU assets under market-rate leases?

Q6 Do Board members agree with the staff recommendation for adding a new paragraph Aus25.2 and a redrafted paragraph Aus35.1 in AASB 16?

Issue 4: Class of ROU assets – Measuring some ROU assets under concessionary leases at cost and others at fair value

Summary of Issue 4

49 As mentioned in paragraph 7, staff have been informed by Treasury offices and ACAG that some NFP public sector entities have been recognising leased assets under concessionary finance leases pursuant to AASB 117. SA DTF states that it would prefer to continue measuring at fair value ROU assets related to concessionary leases that were classified previously as 'finance leases', and measure other concessionary ROU assets at cost.

50 The issue of measuring some ROU assets at cost and some at fair value was initially raised to the Board by ACAG in its submission on ED 286 (the precursor to AASB 2018-8). Consequently, as stated in AASB 2018-8 paragraph BC15, the Standard introduced the term 'class of right-of-use assets' to address this issue. However, SA DTF commented that the definition of 'a class' of asset is

not helpful because all ROU assets related to the same class of PPE would be classified in the same class of ROU assets and therefore would have to be measured on the same basis. SA DTF therefore questioned whether ROU assets related to concessionary 'finance leases' can be a separate class.

51 SA DTF expressed the view that continuing measuring at fair value ROU assets arising under existing finance leases that are in place on 1 July 2019, when AASB 16 is first applied, would provide more relevant information to users of financial reports than if the cost approach is adopted in accordance with the policy choices provided under AASB 2018-8.

Staff analysis

52 Since a key reason for public sector entities to measure assets at fair value is to comply with AASB 1049 in electing a measurement basis to align with GFS, it is also important to understand the GFS principles regarding leases. While AASB 16 removed the distinction between operating leases and finance leases for lessees, GFS maintains that distinction, at least for the medium term.

GFS lease classification

53 The following table provides a high level overview of both the GFS principles and the accounting options that would most align with GFS under current Australian Accounting Standards (AAS) in relation to concessionary leases.

GFS lease category	**GFS principles**	**Measurement option under AAS that most closely aligns with GFS principles**
Operating lease	No assets or liabilities are recorded in relation to operating leases. Operating lease payments by lessees are classified as 'use of goods and services' expense (*The Australian System of Government Finance Statistics: Concepts Sources and Methods, Australia 2015* (AGFS15) paragraph 7.33)	Measuring ROU assets arising under concessionary leases using the cost model would result in a smaller asset carrying amount than if the revaluation model were applied. This would result in the closest GFS alignment because GFS does not recognise an asset associated with operating leases.
Finance lease	Record the current market value of finance lease assets and liabilities (AGFS15 paragraph 8.174)	Measuring ROU assets arising under concessionary leases at fair value using the revaluation model permitted under AASB 16 paragraph 35 is likely to most closely align with GFS principles.

54 Based on the above table, measuring at cost ROU assets under leases that would have been classified as a finance lease for GFS purposes would create a divergence. Conversely, measuring at cost ROU assets under leases that would have been classified as an operating lease for GFS purposes would avoid the divergence created if fair value was used. Therefore, measuring concessionary 'operating leases' at cost and measuring concessionary 'finance leases' at fair value would achieve the objective of AASB 1049 in aligning financial reporting and GFS requirements.

55 However, as mentioned in Agenda Paper 13.1 *GAAP/GFS Reconciliation Requirements* for this meeting, staff note that the GAAP and GFS divergence regarding leases is due to GFS adopting the principle of symmetry between counterparties while AASB 16 creates asymmetry in the accounting between the lessee and lessor, because lessor accounting maintains the operating and finance

lease classification. Therefore, it is unlikely that the divergence would be resolved unless IFRS 16 *Leases* (and, consequently, AASB 16) is amended to remove the distinction between operating and finance leases of lessors and GFS is amended to remove the distinction as well.

56 Staff have also been informed that jurisdictions have decided not to continue maintaining the GFS operating/finance lease classification for GFS purposes because maintaining two sets of records involves significant costs. The ABS has decided to collect its own data for GFS leasing purposes.

Staff recommendation

57 Even though electing measurement models based on the GFS categories of operating lease and finance lease could achieve better GFS alignment, staff consider that this would conflict with the accounting measurement basis for leases, given the removal of the operating and finance lease distinction for lessees. AASB 1049 (paragraph 13) does not require consistency with GFS in the event of a conflict. Permitting the election of cost or fair value measurement based on GFS categories would risk prioritising GFS alignment over faithful and comparable presentation of ROU assets in statements of financial position.

58 Therefore, staff are of the view that the Board should not permit the election of cost or fair value measurement based on the superseded categories of 'finance lease' and 'operating lease'.

59 Staff note that entities would not be required to remeasure ROU assets of existing concessionary finance leases at cost if they are already applying the fair value model to those lease assets under AASB 117 and would now measure the class of ROU assets at cost. Under paragraph C11 of AASB 16, entities can use the AASB 117 carrying amounts (fair value) as the basis for applying AASB 16 under the modified transition approach, without having to remeasure those amounts. Therefore, staff recommend no amendments to AASB 16 in respect of Issue 4.

Questions to the Board:

Q7 Do Board members agree with the staff's view that election of cost or fair value measurement should not be based on the superseded categories of 'finance lease' and 'operating lease'?

Q8 Do Board members agree with the staff recommendation in paragraph 59 not to propose further amendments to AASB 16 for Issue 4?

Next steps

60 If the Board agrees with staff recommendations to amend AASB 16 and AASB 1049, an amending Standard would need to be released prior to 30 June 2020, being the first reporting date for most NFP public sector entities applying AASB 16.

61 Staff propose that the Board exposes a Fatal-Flaw Review version of the amending Standard for public comment, with a comment period of 30 days. The shorter comment period is justified as the proposal is not introducing completely new requirements, but rather extending the initial-measurement temporary relief to provide an option not to measure ROU assets arising under concessionary leases at fair value in subsequent measurements and to clarify that ROU assets arising under concessionary assets can be treated as a separate class of ROU assets to those arising under other leases despite their similar nature and use in the entity's operations.

62 The table below provides a draft timeline for the due process.

Date	Task
3 October 2019	Circulate ballot draft of Fatal-Flaw Review Draft of amending Standard to Board for voting out of session. Propose two weeks to vote until 17 October 2019.
17 October 2019	Issue Fatal-Flaw Review Draft amending Standard with a 30 day comment period (comments due 15 November 2019)
18–27 November 2019	Staff to collate comments and prepare ballot draft Amending Standard
28 November – 12 December 2019	Board to consider comments on Fatal-Flaw Review Draft and vote on ballot draft Amending Standard out of session
12 December 2019	Issue final Standard

Question to the Board:

Q9 Do Board members agree with staff's proposed next steps and the timeline in paragraphs 60–62?

Appendix A: Summary of factors considered by the Board when issuing AASB 1058 and AASB 2018-8

A1. This appendix contains:

- a summary of previous decisions made by the Board regarding concessionary leases when issuing AASB 1058;
- extracts from the Basis for Conclusions in AASB 1058; and
- extracts from the Basis for Conclusions in AASB 2018-8.

Summary of previous decisions made by the Board regarding concessionary leases when issuing AASB 1058

A2. The Board previously considered whether to grandfather concessionary leases for NFP entities when finalising AASB 1058. While the Board decided to relieve NFP entities from revisiting the accounting previously applied on initial recognition of other assets acquired at nil or nominal amount or significantly less than fair value (AASB 1058 paragraph BC147), the Board decided not to provide such transition relief to assets acquired in concessionary leases. The Board made this decision having considered the following:

- the Board was concerned that the financial position of a NFP entity may be misrepresented, and with the lack of comparability between entities regarding concessionary leases entered into before or after adoption of AASB 1058 (AASB 1058 paragraph BC153);
- the quantum of transactions involving a lease – the Board expected an entity to have **undertaken fewer transactions** involving leases and that the terms and conditions of these transactions would be clearly identifiable, compared with acquisitions of other assets at a discount to fair value (AASB 1058 paragraph BC149);
- a lessee may not have recognised an amount in its statement of financial position in respect of the ROU asset in an operating lease (AASB 1058 paragraph BC149). This is in contrast to other assets acquired for significantly less than fair value that are already recognised (generally at cost on initial recognition) in the statement of financial position. The Board further noted that there is unlikely to be any deferred income to recognise in future periods in accordance with AASB 1058 in relation to these assets (AASB 1058 paragraph BC147);
- the Board acknowledged increased costs will arise from measuring at fair value ROU assets arising from concessionary leases. However, the Board noted that AASB 1058 requires measuring ROU assets at fair value only **at initial application**, and not on an ongoing basis, and that the use of valuation experts is not mandatory. The Board was of the view that the identified benefits exceeded the cost of the revised requirements because these requirements better reflect the value transferred to the lessee.

Extracts from the Basis for Conclusions on AASB 1058

The Board decided to grandfather assets, other than lease assets, acquired prior to initial application of AASB 1058 for an amount significantly less than fair value

BC145 In ED 260, the Board proposed requiring an asset that has been acquired for consideration that is below market but that is more than nominal to be measured at fair value. The Board decided to finalise the proposal in issuing this Standard (other than with respect to inventory). However, the

Board observed that an entity would not have previously applied AASB 1004 to these transactions, nor recognised any income on the transaction as the asset acquired will generally have been measured at the amount of the consideration transferred. Accordingly, in the absence of any transitional provisions, a not-for-profit entity will be required to apply the requirements of AASB 1058 retrospectively to such transactions, including determining the fair value (or, in respect of inventory, current replacement cost) of the asset on acquisition.

BC146 In its redeliberations, the Board considered that the costs of applying AASB 1058 retrospectively to all such assets would exceed the benefits of doing so, having regard to the need for an entity to identify and value such assets still existing at reporting date. Accordingly, the Board determined some form of transitional relief to be appropriate. The Board decided to consider transitional provisions for leases made on significantly below-market terms and conditions separately from any transitional provisions for other assets. …

BC147 With respect to assets other than lease assets, the Board decided not to require a not-for-profit entity to revisit the accounting that previously applied on initial recognition of these assets. The Board made this decision having regard to costs involved in identifying and measuring the various assets held on adoption of this Standard that may have been acquired at an amount that was more than nil or nominal, but significantly less than fair value, and the associated discount to fair value. The Board considered these costs to outweigh the benefits of retrospective application of the Standard, as these assets are already recognised (generally at cost on initial recognition) in the statement of financial position, and noting that there is unlikely to be any deferred income to recognise in future periods in accordance with this Standard.

BC149 The Board decided that the transitional relief for other assets need not be aligned with transitional relief for leases. In making this decision, the Board considered:

(a) the quantum of transactions involving a lease. The Board observed it expects an entity to have undertaken fewer transactions involving leases, and that the terms and conditions of these transactions to be clearly identifiable, compared to acquisitions of other assets at a discount to fair value; and
(b) that a lessee may not necessarily have recognised an amount in its statement of financial position in respect of the right-to-use asset in an operating lease.

The Board considered that fair value measurement required only at initial application and the use of valuation experts not mandatory

BC28 Following the consultation period, and after considering constituent comments received, the Board decided to proceed with issuing revised principles for the recognition and measurement of income of not-for-profit entities largely as exposed. The Board considered the identified benefits of the revised requirements to exceed the costs of the revised requirements.

BC29 The Board observed some of the costs of the new requirements to be:

(a) …

(c) increased costs associated with the requirement to measure more assets at fair value (or current replacement cost, in relation to inventories) at initial recognition. The Board observed that while the consequential amendments made by this Standard will require more assets to be recognised and measured at fair value, these requirements better reflect the value transferred to the entity. The Board noted this Standard does not require assets (including assets obtained in a 'peppercorn' lease where a nominal amount is made as payment to the lessor) to be measured at fair value on an ongoing basis, but only on initial recognition (or in some instances, on transition to this Standard). Further, the Standard does not require the valuations to be conducted by a professional valuation expert. In addition, the Board noted the Standard does not require assets in the form of donated inventory to be recognised and measured at current replacement cost where the item donated is not material;

(d) …

Board's decision on transition relief for concessionary leases

BC150 The Board decided to consider transitional relief for leases on significantly below-market terms and conditions separately from transitional relief for other assets. The Board made this decision having regard to:

(a) the diversity in accounting for such leases under previous requirements (see paragraph BC6 (above);
(b) the potential significance of leases made on such terms to the financial position of a not-for-profit entity; and
(c) the prevalence of below-market leases in the not-for-profit sector.

BC151 The Board considered whether to:

(a) require retrospective application of this Standard, without any relief on initial application;
(b) permit a not-for-profit lessee to continue its existing accounting for such leases, in a similar manner to the relief specified for other transactions; or
(c) permit a not-for-profit lessee access to a similar level of relief on initial application of this Standard as is available to a for-profit entity on adoption of AASB 16.

BC152 The Board decided that it should, at a minimum, permit a not-for-profit lessee access to a similar level of relief on initial application of this Standard as is available to a for-profit entity on adoption of AASB 16. However, having regard to its decisions on the measurement of assets acquired in a lease (see paragraph BC84 above), the Board concluded it would be appropriate to modify the transitional provisions set out in AASB 16 to require the lease asset, on initial adoption of this Standard, to be measured at its fair value rather than by reference to the lease liability.

BC153 In its discussion, the Board decided not to permit a not-for-profit lessee to continue its existing accounting for such leases, in a similar manner to the relief specified for other transactions. The Board made this decision having regard to its concern the financial position of a not-for-profit entity may be misrepresented, and the lack of comparability between entities if such leases were entered into before and after adoption of this Standard.

Extracts from the Basis for Conclusions on AASB 2018-8

BC4 The Board considered comments from stakeholders in the not-for-profit sector preparing for the implementation of AASB 16 and AASB 1058, some of whom expressed difficulties in applying the principles in AASB 13 *Fair Value Measurement* in determining the fair value of right-of-use assets arising under concessionary leases. The difficulties noted included how often-significant restrictions on the right of use of the underlying assets and the specialised nature of the underlying assets should be incorporated in the valuation of right-of-use assets arising from concessionary leases.

BC5 Whilst other assets required by other Standards to be fair valued might also be subject to restrictions on use or specialised in nature, the Board noted that the issues related to right-of-use assets for lessees might be different to the issues for owners of the assets, making it difficult to determine the fair value of right-of-use assets simply by reference to the fair value of the underlying assets. Since the principles in AASB 13 are based on market participants buying and selling assets, further guidance appears to be needed to assist not-for-profit entities in applying the principles to right-of-use assets in concessionary lease arrangements.

BC6 The Board considered the prevalence and magnitude of concessionary leases in the not-for-profit sector, and the significance of restrictions on rights of use of the underlying assets in many cases. The Board also noted that a temporary option for not-for-profit lessees to not measure a class (or classes) of right-of-use assets at initial recognition at fair value for concessionary leases would avoid undue cost and effort being incurred by preparers in applying AASB 13 in the absence of additional guidance. The Board assessed these factors with reference to *The AASB's Not-for-Profit Entity Standard-Setting Framework* and decided to propose the temporary option. The interpretative issues arising from fair valuing right-of-use assets arising under concessionary leases will be addressed in the AASB's Fair Value Measurement for Public Sector Entities project.

BC7 The Board also noted that the financial reporting thresholds for not-for-profit private sector entities may be revised as a result of the ACNC Legislative Review recommendations. It is possible that entities at the lower level of the reporting thresholds might not be required in future to apply the requirements of AASB 16 and AASB 1058. The temporary option would avoid such smaller entities incurring costs in measuring right-of-use assets at initial recognition at fair value when they might be exempted from this requirement in future by not being required to prepare financial statements that comply with Accounting Standards.

BC8 However, as some not-for-profit entities had already commenced the process of determining the fair value of right-of-use assets in concessionary leases, the Board decided to make the temporary relief optional. This allows these entities to continue their work on fair valuing concessionary leases and applying the fair value initial recognition measurement requirements to measure right-of-use assets.

Election of measurement basis

BC14 Some ED 286 respondents noted that there might be instances where an entity may wish to apply the option of not fair valuing right-of-use assets for concessionary leases only to some, but not all, of the right-of-use assets. This may be the case for example where the not-for-profit entity has elected to apply the revaluation model under AASB 116 *Property, Plant and Equipment* to a class of property, plant and equipment and would therefore likely elect to measure right of use assets that relate to that class also at fair value, as permitted by AASB 16, paragraph 35. However, this should not force the entity to also measure all other right-of-use assets arising from concessionary leases on initial recognition at fair value.

BC15 Consequently, the Board decided that the election of the measurement basis for initial recognition of right-of-use assets of concessionary leases should be made by class of right-of-use assets. As specified in other Standards, a class is a grouping of assets of a similar nature and use in an entity's operations.

Appendix B: Proposed options for addressing Issue 3

B1. This appendix sets out the options considered by staff in addressing Issue 3 – to permit ROU assets under concessionary leases to be treated as a separate class of ROU assets from ROU assets under market-rate leases. Staff considered the following options:

- Option 1 – permit the election of the measurement basis for ROU assets on a lease-by-lease basis;
- Option 2 – introduce a definition of 'class of ROU assets' to clarify that concessionary leases may have a different nature and use in the entity's operations compared with market-rate leases;
- Option 3 – instead of introducing a definition of 'class of ROU assets' (as in Option 2), specify in the Standards that ROU assets under concessionary leases are a separate class of ROU assets from ROU assets under market-rate leases.

B2. The table below summarises the potential advantages and disadvantages of each option.

Option	Advantages	Disadvantages
Option 1 Permit the election of the measurement basis for ROU assets on a lease-by-lease basis	• This option is easy to apply. • There is no need to introduce a new definition or develop new guidance. • This option could also address Issue 4 – measuring some concessionary leases at cost and others at fair value.	• This option would reduce comparability between entities and amongst assets of an entity. • There is a risk that entities might choose a measurement method for the purpose of achieving particular budget or actual results. Both disadvantages would be limited by the temporary nature of this election.
Option 2 Introduce a definition of 'class of ROU assets' to clarify that concessionary leases may have a different nature and use in the entity's operations compared with market-rate leases	This option clarifies that classes of ROU assets under concessionary leases can be measured differently to ROU assets under other leases.	• The definition created would not be consistent with the concept of a 'class of assets' in other Standards, which looks only at the nature and use of the assets in an entity's operations. • AASB 16 paragraphs 53(a) and (j) require disclosure of the depreciation charge and the carrying amount for ROU assets by class of underlying asset. This will be less meaningful when the disclosures aggregate amounts for different ROU asset classes measured on

Option	Advantages	Disadvantages
		different bases. • Developing a new definition might require further guidance to be developed to assist preparers in applying the new definition.
Option 3 Specify in the Standards that ROU assets under concessionary leases are a separate class of ROU assets from ROU assets under market-rate leases	• As with Option 2, this option clarifies that classes of ROU assets under concessionary leases can be measured differently to ROU assets under other leases. • Supports the distinction already drawn in previous amendments to AASB 16.	As explained in the disadvantages of Option 2: • Option 3 would not be consistent with the concept of a 'class of assets' in other Standards, which looks only at the nature and use of the assets in an entity's operations. • Aggregated ROU asset disclosures under AASB 16 may be less meaningful. Specifying that ROU assets under concessionary leases could be treated as a separate class of ROU assets from ROU assets under market-rate leases is a pragmatic response to the issue.