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| Project: | Income of NFP Entities | Meeting | AASB August 2016 (M153) |
| Topic: | Transition relief for operating leases | Agenda Item: | 3.3.1 |
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Introduction and objective of this paper

- The objective of this paper is to obtain Board's decision on the accounting for leases with below-market terms and conditions (including peppercorn leases) classified as operating leases under AASB 117 *Leases* for not-for-profit (NFP) lessees on:
 - initial application of AASB 10XX *Income of Not-for-profit Entities*; and
 - subsequent transition to AASB 16 *Leases*.
- The Board decided at its June 2016 meeting¹ that an NFP lessee should measure the carrying amount of a 'right of use' asset in a peppercorn lease classified as a finance lease under AASB 117 at the fair value on initial application of AASB 10XX. The Board also decided at its December 2015 meeting² that when AASB 16 *Leases* becomes effective, the measurement of 'right of use' assets of peppercorn leases for NFP lessees would be measured at fair value in accordance with the requirements in AASB 10XX.
- However, the Board has not made a decision on how AASB 117 operating leases should be accounted for on initial application of AASB 10XX (which could have an effective date that is earlier than the effective date of AASB 16³). The Board has also not made a decision on how these leases would be accounted for on initial application of AASB 16.

¹ http://www.aasb.gov.au/admin/file/content102/c3/AASB_Action_Alert_21-22_Jun_2016_23_6_16.pdf

² http://www.aasb.gov.au/admin/file/content102/c3/AASB_Action_Alert_2-3_Dec_2015_4_12_15.pdf

³ AASB 16 is effective for annual reporting periods beginning on or after 1 January 2019. The Board's tentative decision is for AASB 10XX to have an effective date of 1 January 2018 (same as the effective date of AASB 15 *Revenue from Contracts with Customers*).

Accounting operating leases with below-market lease terms and conditions (including peppercorn operating leases) under AASB 117 and AASB 16

- 4 Under AASB 117, a lessee with an operating lease would not recognise a ‘right of use’ asset or lease liability but would generally recognise an expense for the lease payments. However, for a peppercorn operating lease, no expense would be recognised as there are no lease payments⁴. For other operating leases with below-market terms and conditions, a lessee would recognise an expense that is lower than the expense that would have been recognised for a lease under commercial terms.
- 5 If the Board does not provide guidance on how lessees would account for leases with below-market terms and conditions that are classified as operating leases under AASB 117, when AASB 10XX is initially applied, this might result in diversity in the accounting (as some might continue not to recognise the ‘right of use’ asset of the lease while others might consider it a controlled resource and fair value it on transition in accordance with the requirements of AASB 10XX⁵).
- 6 This diversity would likely continue when the entities transition to AASB 16 from AASB 117. The transition provisions of AASB 16 provide two transition options (refer to Appendix A to this paper, paragraph C8) for leases that an entity previously classified as operating leases under AASB 117. These two options essentially result in a right-of-use asset that is measured in relation to the discounted future lease payments on the lease. The carrying amount of the ‘right of use’ asset would therefore be nil for peppercorn leases and at lower than fair value for other operating leases with below-market terms and conditions. This would not be in accordance with the requirements of AASB 10XX.
- 7 Entities that applied the principles of AASB 10XX as described in paragraph 5 would transition to AASB 16 with a fair value leased asset but AASB 16 would require them to measure the right-of-use asset as described in paragraph 6 above. This would lead to significant implementation issues if not addressed with transition guidance.

Staff recommendations

- 8 To avoid the transition issues described above for operating leases with below-market lease terms and conditions (including peppercorn operating leases), staff recommend that the accounting for these leases under AASB 117 be ‘grandfathered’ i.e. NFP lessees would continue their current accounting for operating leases with below-market terms and conditions (including peppercorn leases) and not be required to recognise a ‘right of use’ asset at fair value on initial application of AASB 10XX. This is because on initial application of AASB 10XX (which would be before the

⁴ Assuming there are no nominal amounts payable.

⁵ An asset recognised in accordance with paragraph 4 shall initially be measured as follows:

- (a) if within the scope of AASB 9, in accordance with the requirements of that Standard; and
- (b) otherwise at fair value as at the date of acquisition. The asset’s fair value shall be determined in accordance with AASB 13 *Fair Value Measurement*.

application of AASB 16), lessees of operating leases accounted for in accordance with AASB 117 would not be required to recognise a leased asset or 'right of use' asset.

- 9 However, staff recommend that when operating with below-market terms and conditions (including peppercorn operating leases) transition to AASB 16 on 1 January 2019 and lessees are required to recognise a 'right of use' asset for these leases, NFP lessees should be required to fair value the 'right of use' asset so that the inflow of resources (i.e. the right-of-use asset) is measured in accordance with the principles of AASB 10XX.
- 10 To give effect to the recommendation in paragraph 8, staff propose adding a transition paragraph in AASB 10XX as outlined in Appendix B to this paper, paragraph C8)
- 11 Staff also propose that a transition paragraphs be added to AASB 16 to give effect to staff recommendation in paragraph 9(refer to Appendix A to this paper, paragraphs AusC5.1 and AusC8.1 for the proposed wording of the transition paragraphs).

Feedback from Project Advisory Panel (PAP) members

- 12 The majority of PAP members agreed with the proposed transition relief in paragraphs 8 and 9 of this agenda paper for leases with below-market terms and conditions (including peppercorn leases) classified as operating leases.

Question for Board members

- Q1 Do Board members agree with staff recommendation to 'grandfather' the accounting for operating leases on transition to AASB 10XX and require them to be fair valued in accordance with the principles of AASB 10XX on transition to AASB 16?
- Q2 Do Board members have any comments on the draft transition paragraphs in Appendix B for operating leases with below-market terms and conditions?

Appendix A to paper 3.3.1

Extracts from AASB 16 transition provisions⁶

Lessees

- C5 A lessee shall apply this Standard to its leases either:
- (a) retrospectively to each prior reporting period presented applying AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
 - (b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application in accordance with paragraphs C7–C13.

AusC5.1 In respect of not-for-profit entities applying this Standard retrospectively in accordance with paragraph C5(a) to leases with below-market terms and conditions, a not-for-profit entity shall:

- (a) measure the right-of-use asset at fair value;
- (b) measure the lease liability in accordance with this Standard; and
- (c) recognise any related items in accordance with paragraph 26 of AASB 10XX *Income of Not-for-Profit Entities*. Any income arising shall be recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) as at the beginning of the earliest prior period presented.

...

- C7 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall not restate comparative information. Instead, the lessee shall recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

Leases previously classified as operating leases

- C8 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall:
- (a) recognise a lease liability at the date of initial application for leases previously classified as an operating lease applying AASB 117. The lessee shall measure that lease liability at the

⁶ Some transition paragraphs in AASB 16 are reproduced for context. Proposed ‘Aus’ paragraph wording is subject to change during final drafting to avoid repetition and ease of flow with other transition paragraphs whilst maintaining the substance of the transition requirements

present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.

- (b) recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying AASB 117. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:
 - (i) its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or
 - (ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.
- (c) ...

AusC8.1 In respect of not-for-profit entities applying this Standard retrospectively in accordance with paragraph C5(b) to leases with below-market terms and conditions that were previously classified as an operating lease applying AASB 117, a not-for-profit entity shall:

- (a) notwithstanding paragraph C8(b), measure the right-of-use asset at fair value as at the date of initial application of this Standard;
- (b) measure the lease liability in accordance with paragraph C8(a); and
- (c) recognise any related items in accordance with paragraph 26 of AASB 10XX. Any income arising shall be recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of this Standard.

...

Appendix B to paper 3.3.1

Extracts from AASB 10XX transition provisions⁷

Transition

- C2 For the purposes of the transition requirements in paragraphs C3–C11:
- (a) the date of initial application is the beginning of the annual reporting period in which an entity first applies this Standard; and
 - (b) a completed contract is a contract or transaction for which the entity has recognised all of the income in accordance with AASB 1004 *Contributions*.
- C3 An entity shall apply this Standard either:
- (a) retrospectively to each prior reporting period presented in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
 - (b) retrospectively with the cumulative effect of initially applying this Standard recognised at the date of initial application in accordance with paragraphs C6–C10.
- ...
- C6 If an entity elects to apply this Standard retrospectively in accordance with paragraph C3(b), the entity shall not restate comparative information. Instead, the entity shall recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application. Under this transition method, an entity may elect to apply this Standard retrospectively only to contracts and transactions that are not completed contracts at the date of initial application.
- ...

Leases

Leases with below-market terms and conditions classified as operating leases

- C8 Notwithstanding the requirements in paragraph C3, for leases with below-market terms and conditions classified as operating leases in accordance with AASB 117 *Leases*, an entity shall not apply the requirements of this Standard to recognise any asset or income. Instead, the entity shall continue to apply its accounting policy under AASB 117 to those operating leases.

⁷ Specific paragraph references might change as AASB 10XX is drafted. Additional lease transition paragraphs are subject to change.

On transition to AASB 16 *Leases*, the entity shall apply the transition requirements of that Standard to leases classified as operating leases in accordance with AASB 117.