



Project:	Income of NFP Entities	Meeting	AASB August 2016 (M153)
Topic:	Sweep issue: Measuring the lease liability and transition of a right-of-use asset/leased asset	Agenda Item:	3.3.2
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Introduction and objective of this paper

- 1 The objective of this paper is to obtain Board decisions on a sweep issue relating to measuring a right-of-use asset and a leased asset and the associated lease liability on initial recognition and transition of a ‘peppercorn lease’ (or a lease with below-market terms and conditions). Specifically, this paper proposes:
 - (a) revisions to the draft consequential amendment to AASB 16 *Leases* to clarify the accounting for the lease liability;
 - (b) transition guidance in AASB 10XX and AASB 16.

Background

- 2 The draft Standard, AASB 10XX *Income of Not for Profit Entities* provided to the Board in June 2016, contained a draft consequential amendment to AASB 16 *Leases* to insert paragraph Aus26.1 (based on decision made by Board in December 2015):

Aus26.1 In respect of the initial measurement of the lease liability in which the lessee is a not-for-profit entity and the lease provisions include a donation by the lessor or a compulsory transfer to the entity, the requirements in paragraph 26 are modified by paragraphs 25–30 of AASB 10XX *Income of Not-for-Profit Entities*. AASB 10XX requires that, in such a lease, the lease liability is initially measured at the fair value of the leased property at the commencement date of the lease.

Lessee measurement under AASB 16

- 3 Paragraph 26 of AASB 16 requires a lessee to measure a lease liability at the present value of future lease payments, discounted using the interest rate implicit in the lease. If that rate cannot be readily determined the lessee uses its incremental borrowing rate.
- 4 A lessee measures a right-of-use asset at cost, which comprises the initial lease liability amount, lease payments already made and other adjustments such as lease incentives and initial direct costs (paragraph 23 and 24 of AASB 16).

Resolving potential ambiguity in the consequential amendment to AASB 16

- 5 The consequential amendment to AASB 16 referred to in paragraph 2 above requires a not-for-profit entity to measure the lease liability at the fair value of the leased property. As noted in paragraph 4 above, AASB 16 requires the lease liability to be measured at the present value of the future lease payments and not at fair value.
- 6 Staff note that under the principles of AASB 10XX, the right-of-use asset in a peppercorn lease, or leases with below-market terms and conditions, would be measured at fair value to accurately reflect the inflow of the resource. However, as currently drafted, it is not clear why the lease liability amount should be the same as the fair value of the leased property rather than the amount that would be measured in AASB 16.¹
- 7 On the basis that AASB 10XX provides guidance regarding the treatment of amounts related to an inflow of a resource, staff suggest the consequential amendment be altered to refer entities to AASB 10XX. This would mean that a not-for-profit lessee would recognise income for the excess of (1) the fair value of the ‘right-of-use’ asset over the (2) liabilities recognised in accordance with other Australian Accounting Standards. For example, a contract liability for performance obligations in accordance with AASB 15 *Revenue from Contracts with Customers*.
- 8 Staff also suggest revising the wording to remove the reference to a donation given the broader context of AASB 10XX to apply to any inflow of a resource. Retaining the reference to a donation would inappropriately restrict the scope of AASB 10XX to only those leases that contain donation components.

Staff recommendations on initial measurement of leases with below-market terms and conditions

- 9 Staff recommend the following revised consequential amendment to AASB 16 (with updated paragraph references to reflect the draft AASB 10XX) to clarify the requirement:

Aus25.1 Notwithstanding paragraphs 23–25, where the lessee is a not-for-profit entity and the lease has below-market terms and conditions, the

1 It is also not clear why the wording in the consequential amendment to AASB 16 refers to leased property and not a ‘right-of-use’ asset. If the wording is not corrected, it could be interpreted by some that only the rights to property in a peppercorn lease or lease with below-market terms and conditions are to be revalued and not other types of ‘right-of-use’ assets. Staff consider this to be a drafting point and have updated the term accordingly.

right-of-use asset shall initially be measured at fair value in accordance with AASB 10XX *Income of Not-for-Profit Entities*. AASB 10XX does not modify the measurement requirements for lease liabilities in this Standard.

- 10 Similarly, ED 260 proposed a consequential amendment to AASB 117 which staff propose replacing for the same reasons expressed above. The original ED 260 proposal was:

Aus20.1 In respect of a finance lease in which the lessee is a not-for-profit entity and the lease provisions include a donation by the lessor or a compulsory transfer to the entity, the requirements in paragraph 20 are modified by paragraphs 31–36 of AASB 10XX *Income of Not-for-Profit Entities*. AASB 10XX requires that, in such a lease, the leased asset and lease liability are initially measured at the fair value of the leased property at the inception of the lease.

- 11 Staff recommend the following revised consequential amendment to AASB 117:

Aus20.1 Notwithstanding paragraph 20, where the lessee is a not-for-profit entity and the finance lease has below-market terms and conditions, the leased asset shall initially be measured at fair value in accordance with AASB 10XX *Income of Not-for-Profit Entities*. AASB 10XX does not modify the measurement requirements for lease liabilities in this Standard.

Feedback from Project Advisory Panel (PAP) members

- 12 The majority of panel members agreed with the staff recommendation to amend AASB 16 and AASB 117. However, one PAP member was concerned about measuring the lease liability in accordance with AASB 16 or AASB 117 (as applicable). The panel member considered that the lease liability should initially be recognised at the fair value of the right-of-use asset or the leased asset, resulting in no upfront income recognition under AASB 10XX. The PAP member stated that this was consistent with the proposed wording in ED 260 *Income of Not-for-Profit Entities*². The PAP member considered that, based on the proposed wording in ED 260, the expectation was that the lease liability recognised is initially at the fair value of the leased asset and would be extinguished over the lease term with income based on the difference between reduction of the liability and any lease payments.³

AASB staff analysis and recommendations

- 13 Staff note that the fundamental principle in AASB 10XX is to recognise the inflow of resources of not-for-profit entities. Staff also note that the lessee's actual lease liability is the lease liability measured in accordance with AASB 16 or AASB 117 (as applicable). If there are no other liabilities or performance obligations related to the lease, then the excess of the fair value of the leased asset over the lease liability should

² That is, the original version of paragraph Aus20.1 for AASB 117, set out in paragraph D5 of the ED.

³ This panel member considered that this apparent change in the measurement of the lease liability on initial recognition of the leased asset is a significant change from what was proposed in the ED.

be recognised as income in accordance with AASB 10XX to provide useful information about the lease arrangement.

- 14 Staff consider that recognising the lease liability initially at the fair value of the leased asset and extinguishing it over the lease term by recognising income over time does not have a sound conceptual underpinning. The lease liability should be the liability measured in accordance with AASB 16 or AASB 117 as applicable. If there are other obligations related to earning the income that are satisfied over time, staff consider that a liability should be recognised in accordance with the Australian Accounting Standard that prescribes the accounting for such a liability (for example, a performance obligation liability accounted for in accordance with AASB 15).
- 15 Thus, staff recommend revised consequential amendments to AASB 16 and AASB 117 as highlighted in paragraphs 9 and 10 of this agenda paper.

Question for Board members

- Q1 Do Board members agree with the staff's amendments to the consequential amendments to AASB 16 and AASB 117 on initial measurement of leases with below-market terms and conditions?

Transitional guidance for leases with below-market terms and conditions

Refer to Appendix A for flowcharts showing the interaction of transition requirements between AASB 16, AASB 117 and AASB 10XX

- 16 Paragraphs C5–C7 of AASB 16 permit an entity to choose between:
- (a) transitioning to the Standard via AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
 - (b) retrospectively with the cumulative effect recognised as an adjustment to opening retained earnings at the date of initial application of AASB 16.

Importantly, if applying the second option the entity does not restate comparative information.

- 17 The Board decided at its June 2016 meeting that entities:
- (a) would be encouraged to restate comparatives on transition to AASB 10XX, but that restatement should not be required.
 - (b) should not be required to determine the fair value of existing peppercorn leases in any period prior to the date of initial application of AASB 10XX, if entities are not applying AASB 10XX retrospectively.

Staff recommendations on transitional guidance for leases – AASB 16

- 18 Currently, there is no transition guidance in AASB 10XX and AASB 16 in relation to peppercorn leases or leases with below-market terms and conditions. Staff recommend adding the following 'Aus' transition paragraph (underlined) in AASB 16 to

implement the Board's decision not to require restated comparatives while maintaining consistency with the other transition paragraphs in AASB 16 and also to ensure that entities are not, unintentionally, required to fair value the right-of-use asset twice, once on transition to AASB 10XX and then on transition to AASB 16.⁴ (Refer to Chart 4 of Appendix A.)

C2 For the purposes of the requirements in paragraphs C1–C19, the date of initial application is the beginning of the annual reporting period in which an entity first applies this Standard.

...

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.

C6 A lessee shall apply the election described in paragraph C5 consistently to all of its leases in which it is a lessee.

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.

⁴ 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

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. ...
- (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) apply AASB 136 *Impairment of Assets*...

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.

...

Lease previously classified as finance leases

C11 If a lessee elects to apply this Standard in accordance with paragraph C5(b), for leases that were previously classified as finance leases applying AASB 117, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured

applying AASB 117. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this Standard from the date of initial application.

Staff recommendations on transitional guidance for leases – AASB 10XX

- 19 Similarly Staff propose transition paragraphs in AASB 10XX for not-for-profit lessees applying AASB 117 on transition to AASB 10XX (additional transition paragraphs are included for context).⁵ (Refer to Chart 3 in Appendix A.)

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.

C7 ...

Leases

⁵ Specific paragraph references might change as AASB 10XX is drafted. Additional lease transition paragraphs are subject to change.

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. 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.

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

C9 For leases with below-market terms and conditions classified as finance leases in accordance with AASB 117, if an entity elects to apply this Standard in accordance with:

- (a) paragraph C3(a) – the entity shall:
 - (i) measure the leased asset at fair value;
 - (ii) measure the lease liability in accordance with AASB 117; and
 - (iii) 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) at the beginning of the earliest period presented; or

- (b) paragraph C3(b) – the entity shall:
 - (i) measure the leased asset at fair value as at the date of initial application of this Standard;
 - (ii) measure the lease liability in accordance with AASB 117; and
 - (iii) 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.

C10 ...

Feedback from Project Advisory Panel (PAP) members

- 20 The majority of the PAP members agreed with the proposed transition relief in paragraph 18 C7 of this agenda paper for leases with below-market lease terms and conditions classified as operating leases.

Question for Board members

- Q2 Do Board members agree with the staff's recommended transition paragraphs for leases with below-market terms and conditions in AASB 16 and AASB 10XX?

Appendix to Agenda Paper 3.X

Chart 1: Below-market' lease transition interactions

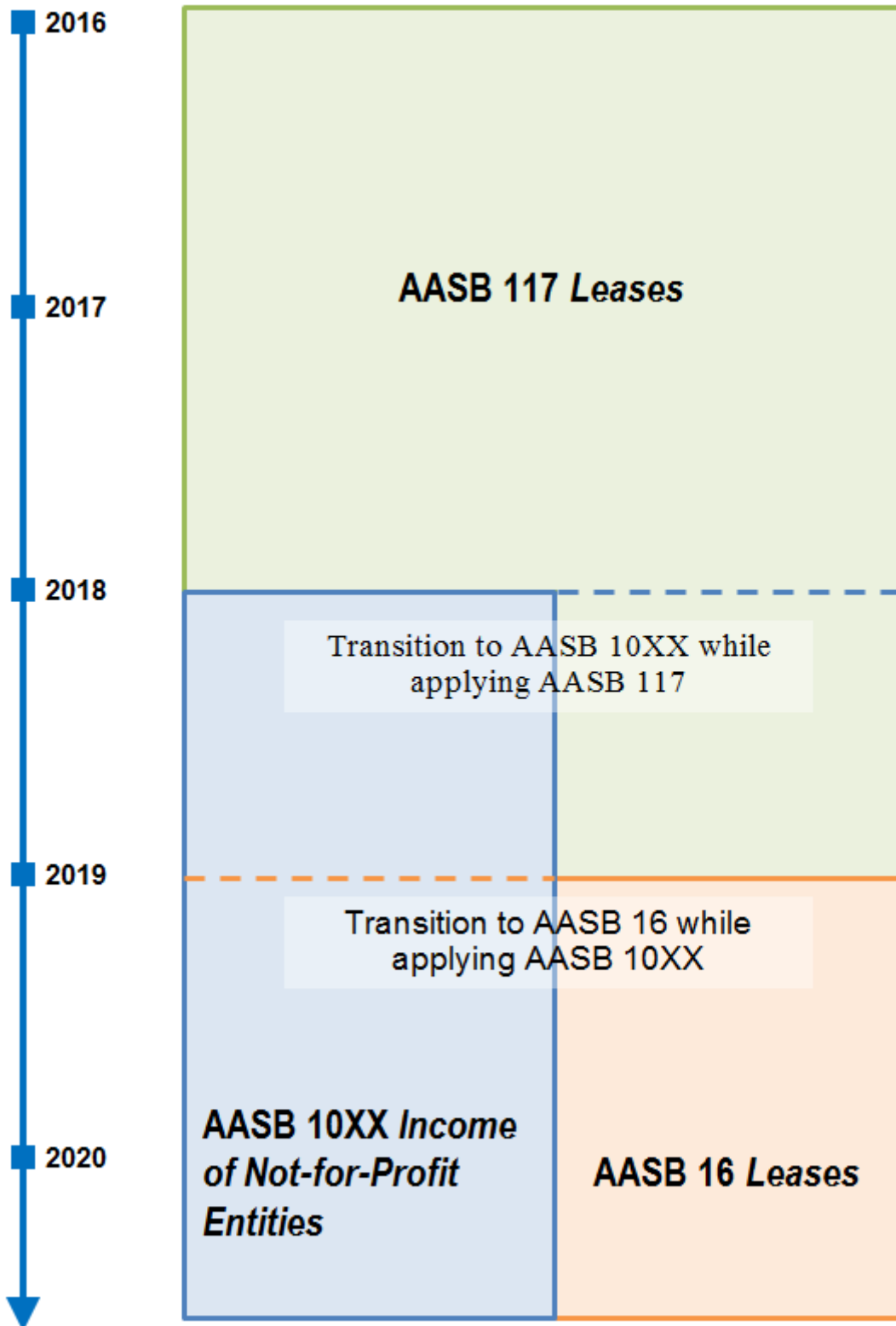


Chart 2: 'Below-market' lease transition requirements

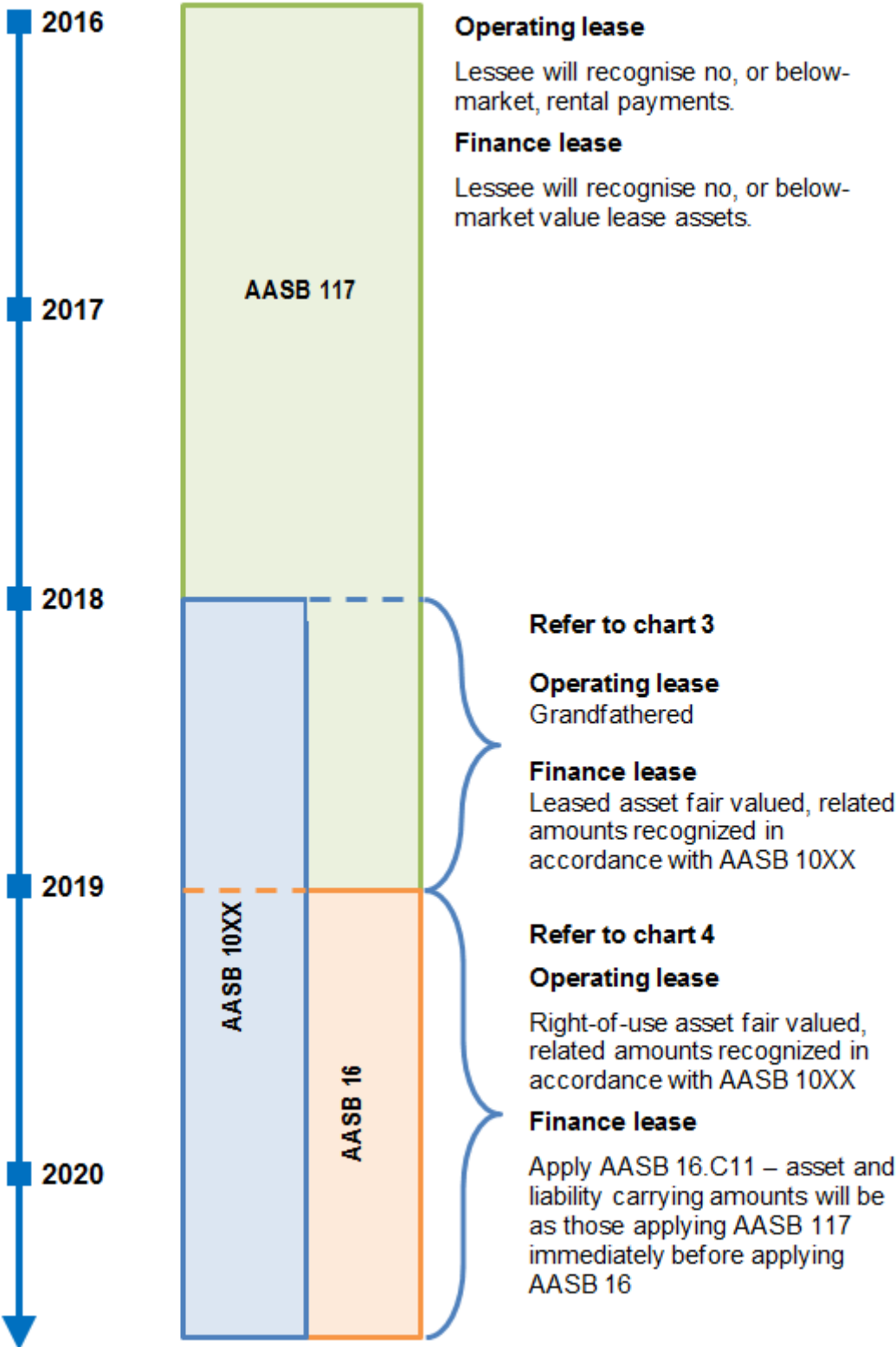
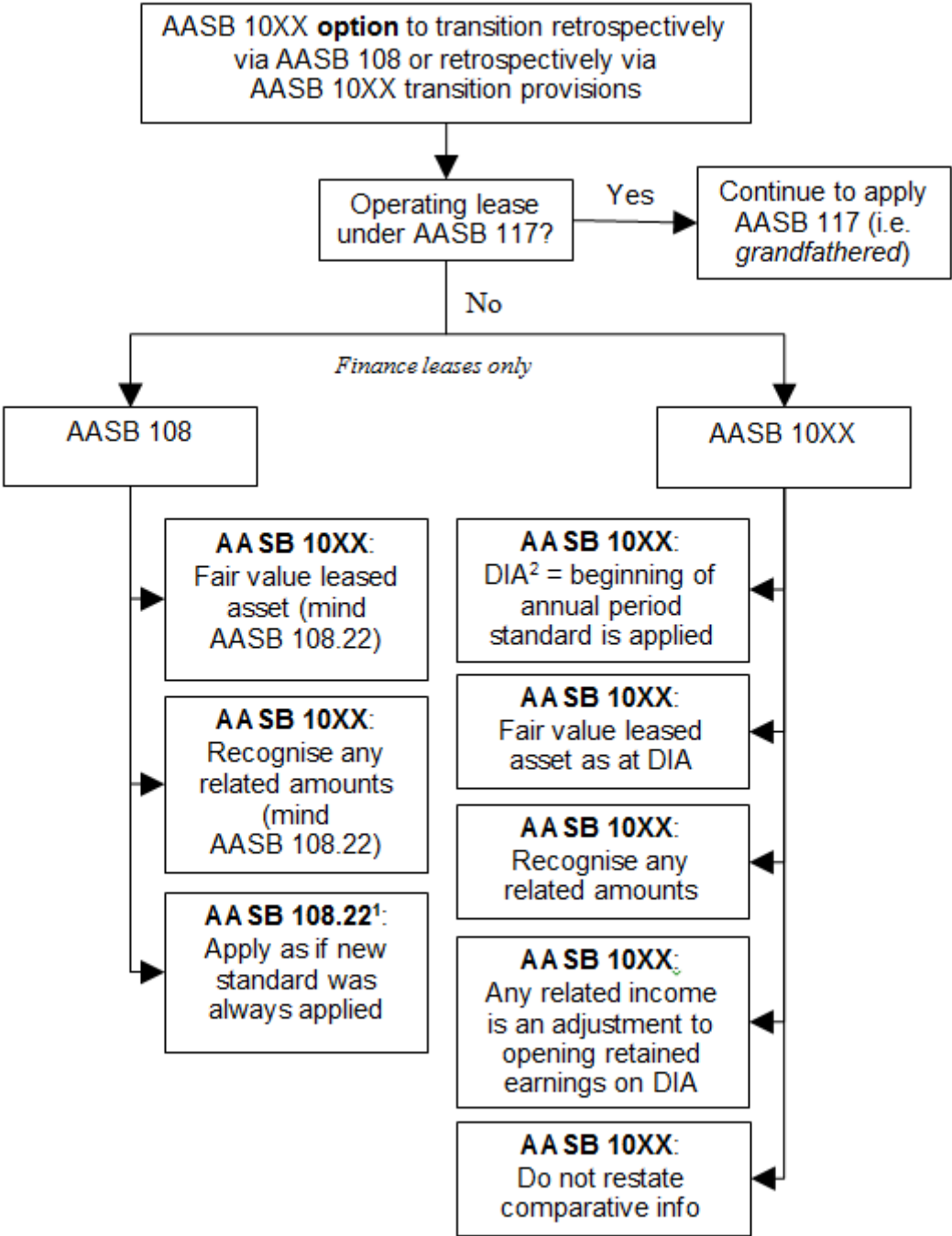


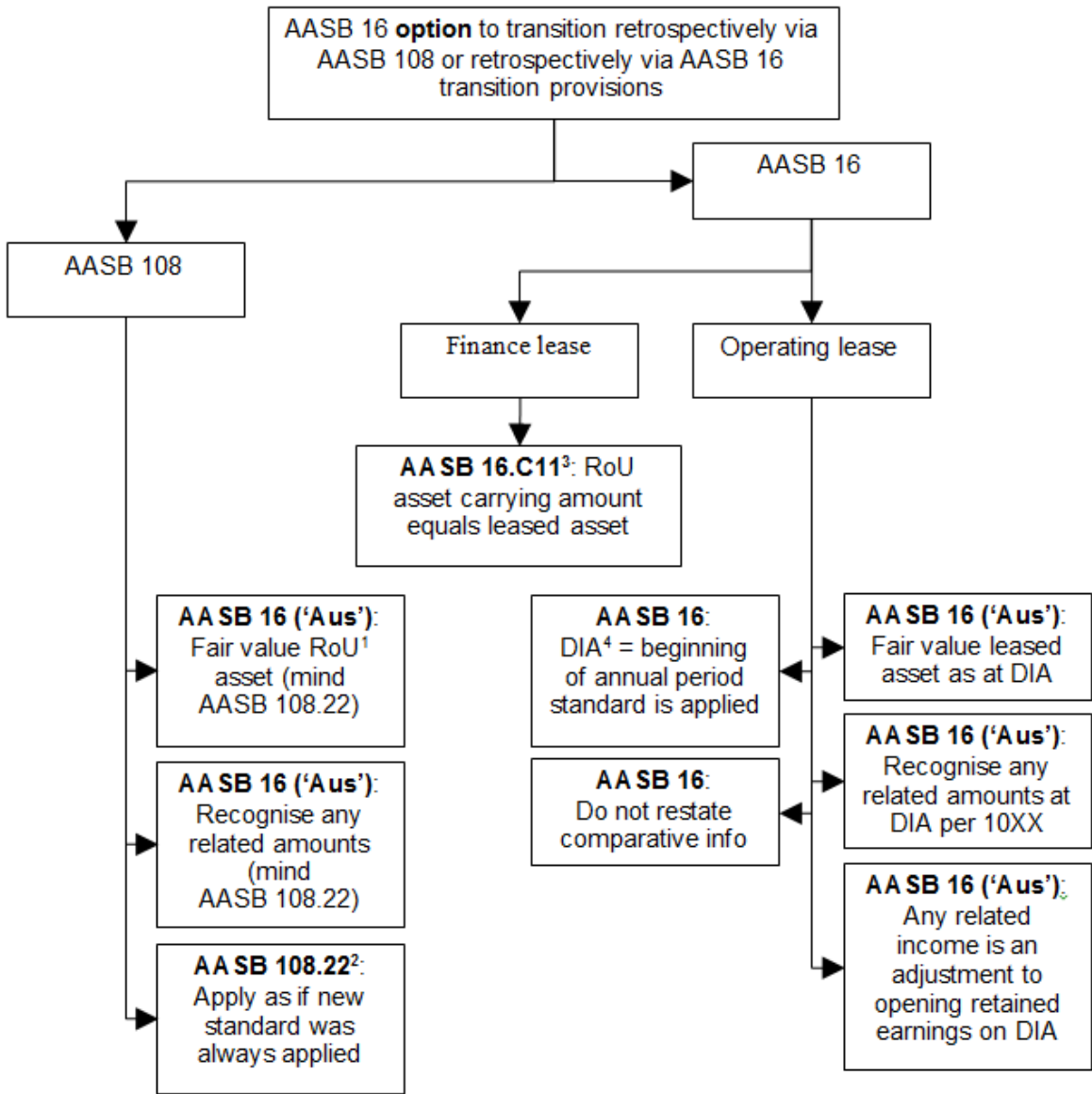
Chart 3: Transition to AASB 10XX while still applying AASB 117



1 AASB 108.22: Subject to paragraph 23, when a change in accounting policy is applied retrospectively in accordance with paragraph 19(a) or (b), the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

2 AASB 10XX.C2: For the purposes of the transition requirements in paragraphs C3–C6, the date of initial application (DIA) is the start of the reporting period in which an entity first applies this [draft] Standard.

Chart 4: Transition to AASB 16 after AASB 10XX



- 1 RoU = AASB 16 right-of-use asset
- 2 AASB 108.22: Subject to paragraph 23, when a change in accounting policy is applied retrospectively in accordance with paragraph 19(a) or (b), the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.
- 3 If a lessee elects to apply this Standard in accordance with paragraph C5(b), for leases that were classified as finance leases applying AASB 117, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying AASB 117. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this Standard from the date of initial application.
- 4 AASB 16.C2: For the purposes of the requirements in paragraphs C1–C19, the date of initial application (DIA) is the beginning of the annual reporting period in which an entity first applies this Standard.