



To:	AASB Board Members	Date:	28 June 2011
From:	Nikole Gyles and Kala Kandiah	Agenda Item:	6.2
Subject:	Below-market lease arrangements for not-for-profit entities	File:	

Action

To note the results of staff preliminary analysis and to consider whether Australian Accounting Standards should explicitly address the accounting for below-market lease arrangements in the not-for-profit (NFP) sector.

Note that staff intend to focus on the descriptions of alternative interpretations in paragraph 5 and the table on page 5 of this memo during the Board meeting.

Staff recommendations

Staff recommend the following:

- (a) not to make any amendments to the existing requirements of AASB 117 *Leases* or AASB 1004 *Contributions* to account for below-market lease arrangements for NFP entities; and
- (b) staff continue to monitor the IASB's redeliberations in its *Leases* project. Consideration should be given to whether the issue needs to be addressed explicitly in the Australian Accounting Standard that is expected to incorporate the IFRS on *Leases* for NFP entities and/or the forthcoming Exposure Draft on Income of Not-for-Profit Entities.

Staff note that these recommendations are made in the context that AASB 117 and AASB 1004 are currently subject to replacement. Amending the guidance in current Australian Accounting Standards would not be expected to be completed prior to the completion of the issuance of a replacement Standard for AASB 117 and an ED for a replacement Standard for AASB 1004

Question to Board members:

Do you agree with staff's recommendations?

Background

1. At the June 2011 AASB meeting the Board, after noting a comment from a respondent to ED 202R *Leases* relating to Crown leases, directed staff to undertake further analysis of whether NFP and public sector modifications should be made to AASB 117 and the Australian Accounting Standard that is expected to incorporate the IFRS on *Leases* in relation to Crown lease arrangements, having regard to the requirements in AASB 1004 and the Board's project on Income of Not-for-Profit Entities. Staff have undertaken a preliminary analysis of the issue and the results of the staff analysis are outlined below. Because for-profit public sector entities apply IFRS requirements without amendment this paper refers only to NFP entity issues.

Staff analysis – current Australian Accounting Standards

2. Although the original issue was in relation to Crown lease arrangements, the issue is not limited to Crown leases. Crown leases are just one example of a below-market lease arrangement entered into by NFP entities. Accordingly, the staff analysis relates to the broader issue of 'below-market lease arrangements'. The focus of the analysis is on lease arrangements entered into at no cost, or for a nominal cost. Such arrangements are often referred to as 'peppercorn' leases.
3. In summary, for the reasons discussed below, staff are of the view that the issue is addressed (albeit not explicitly) in existing Australian Accounting Standards. However, staff are aware of several interpretations that arise for a lessee from the interaction of the requirements of AASB 117 and AASB 1004. These interpretations arise because the requirements of AASB 117 do not align with the requirements of AASB 1004. As AASB 1004 does not apply to lessors, the issue primarily arises in relation to lessees. However, staff have included the alternative accounting treatments for lessors for completeness and to identify where symmetry in accounting between the lessee and lessor is not attained.

4. In circumstances where a transaction falls within the scope of more than one Standard a general principle is that an entity applies the more specific Standard in the first instance. The key issues in relation to lessee accounting for below-market government grants are uncertainty as to:
- Which is the more specific standard – AASB 1004 or AASB 117?
 - If AASB 117 is applied to the below-market lease arrangement, is the entity required to also consider the requirements of AASB 1004?
5. The three interpretations identified by staff can be broadly characterised as:
- Interpretation A – The requirements of AASB 117 prevail over the requirements of AASB 1004. That is, lessees apply the recognition and measurement requirements of AASB 117. For an operating lease, no expense would be recognised as there are no lease payments. For a finance lease, no asset or liability would be recognised as the present value of minimum lease payments is nil¹. Note that this accounting would result in a similar outcome to AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance* if the principles in the Standard were to be applied and the nominal amount option in paragraph 23 of that Standard were adopted.
 - Interpretation B – The requirements of AASB 1004 prevail over the requirements of AASB 117² – the contribution is accounted for as a grant of an asset. That is, lessees apply the recognition and measurement requirements of AASB 1004. A question arises as to what the nature of the asset would be – the underlying asset or a right-of-use asset. If it is regarded as a right-of-use asset, for an operating lease, a right of use asset would be recognised at the fair value of the total lease payments on the basis that the lessee controls the right of use asset for the lease term. Income would be measured at the fair value of the right of use asset. The same accounting would apply for finance leases.
 - Interpretation C – The requirements of AASB 1004 apply in the context of the requirements of AASB 117. That is, lessees apply the recognition requirements of AASB 117 and the measurement requirements of AASB 1004. For an operating lease, income (and expense) would be recognised for the value of each reporting period's lease benefits received (and consumed) while conforming to AASB 117's prohibition of lessees recognising lease assets in respect of operating leases. For a finance lease, a right of use asset would be recognised,

¹ Assuming there are no nominal amounts payable.

² Proponents of Interpretation B consider the contract not to be executory as there is no performance required by the lessee. Alternatively, if the contract is considered to be executory, Interpretation B could not be applied to an operating lease as no asset would arise as a result of entering into the lease contract.

consistent with AASB 117, with corresponding income measured at fair value of the right of use asset, consistent with AASB 1004. This finance lease accounting treatment coincides with the outcome of Interpretation B.

We acknowledge that some might argue there are only two broad interpretations, with Interpretations B and C being variations of different ways in which the interplay between AASB 1004 and AASB 117 are treated. However, to help structure the discussion staff have described them as different interpretations.

6. There may also be other interpretations that exist in practice, but this paper focuses on these three. The implications of each of these three interpretations are set out in the table following paragraph 9.
7. Based on the limited research undertaken by staff to date, in relation to operating leases, it is our understanding that the most common interpretation adopted in practice by NFP lessees is Interpretation A.
8. The purpose of this paper is to facilitate discussion and to identify future actions to be undertaken by staff. Staff are interested in comments from the Board on the issues raised. Accordingly, staff do not consider it appropriate to express a preference amongst Interpretations A – C at this stage. Depending on the outcome of the Board discussion of the issues raised here, staff intend undertaking further analysis and research.
9. A summary of the effect on the lessor's and lessee's statement of financial position and income statement applying each of the interpretations is outlined in the table below. The table outlines the initial impact on the statement of financial position and the first year impact on the income statement for a below-market lease assuming no amount is payable. The asset subject to the lease is assumed to be non-depreciable. The table is followed by an illustrative example of applying each of the three interpretations.

Memorandum

	Interpretation A (AASB 117 prevails over AASB 1004)		Interpretation B (AASB 1004 prevails over AASB 117 – grant of a right-of-use asset)		Interpretation C (AASB 1004 applies in context of AASB 117)	
	<i>Statement of Financial Position</i>	<i>Income statement</i>	<i>Statement of Financial Position</i>	<i>Income statement</i>	<i>Statement of Financial Position</i>	<i>Income statement</i>
Operating lease						
Lessor	Asset – Continue to recognise asset.	Income – Nil	Asset – Continue to recognise asset.	Income – Nil	Asset – Continue to recognise asset.	Income – Nil
	Liability – Nil	Expense – Nil	Liability – Nil	Expense – Nil	Liability – Nil	Expense – Nil
Lessee	Asset – Nil	Income – Nil	Asset – Fair value (equal to the fair value of the <u>total</u> lease payments).	Income* – Fair value of asset.	Asset – Nil	Income* – Fair value of the <u>current period's</u> lease payments.
	Liability – Nil	Expense – Nil	Liability – Nil	Expense – Amortise the asset.	Liability – Nil	Expense – Fair value of the <u>current period's</u> lease payments.
Finance lease						
Lessor	Asset – Derecognise the underlying asset.	Income – Nil	Asset – Derecognise the underlying asset	Income – Nil	Asset – Derecognise the underlying asset	Income – Nil
	Liability – Nil	Expense – Equal to the carrying value of the derecognised asset.	Liability – Nil	Expense – Equal to the carrying value of the derecognised asset.	Liability – Nil	Expense – Equal to the carrying value of the derecognised asset.
Lessee	Asset – Nil	Income – Nil	Asset – Fair value (equal to the fair value of the <u>total</u> lease payments).	Income – Fair value of asset.	Asset – Fair value (equal to the fair value of the <u>total</u> lease payments).	Income – Fair value of asset.
	Liability – Nil	Expense – Nil	Liability – Nil	Expense – Amortise the asset.	Liability – Nil	Expense – Amortise the asset.

* Within Interpretations B and C two views have been expressed as to how the contribution income arises for the lessee. The net effect of applying these views within each Interpretation is the same: (a) A contribution occurs because the lessee receives an asset without directly giving approximately equal value to the lessor. Accordingly, the contribution recognised by the lessee relates to receiving the asset. There is no related liability. (b) A contribution occurs because the lessee receives an asset with an associated liability to make annual lease payments. Simultaneously, the lessor forgives the liability that would otherwise be payable by the lessee. Accordingly, the contribution is the forgiveness of the liability.

Example – Below-market lease arrangement

The following example illustrates the impact on the initial statement of financial position and income statements in the first year of the lease arrangement of the alternative views identified by staff.

Entity A (lessor) enters into a lease arrangement with Entity B (lessee) to lease land with a current carrying value and fair value of \$1 million for a period of 99 years. Both entities are NFP entities. Lease payments are \$1 per year (rounded down to \$nil for financial reporting purposes). The fair value of lease payments each year is \$50 000. Amortisation of the right-of-use asset is \$10 000 per year. For the purposes of the example, ignore the effect of discounting.

	Interpretation A (AASB 117 prevails over AASB 1004)		Interpretation B (AASB 1004 prevails over AASB 117)		Interpretation C (AASB 1004 applies in context of AASB 117)	
	<i>Income statement</i>	<i>SOFP</i>	<i>Income statement</i>	<i>SOFP</i>	<i>Income statement</i>	<i>SOFP</i>
Operating lease						
Lessor	Income Nil	Asset \$1m*	Income Nil	Asset \$1m*	Income Nil	Asset \$1m*
	Expense Nil	Liability Nil	Expense Nil	Liability Nil	Expense Nil	Liability Nil
Lessee	Income Nil	Asset Nil	Income \$1m	Asset \$1m	Income \$50 000	Asset Nil
	Expense Nil	Liability Nil	Expense \$10 000	Liability Nil	Expense \$50 000	Liability Nil
Finance lease						
Lessor	Income Nil	Asset Nil	Income Nil	Asset Nil	Income Nil	Asset Nil
	Expense \$1m	Liability Nil	Expense \$1m	Liability Nil	Expense \$1m	Liability Nil
Lessee	Income Nil	Asset Nil	Income \$1m	Asset \$1m	Income \$1m	Asset \$1m
	Expense Nil	Liability Nil	Expense \$10 000	Liability Nil	Expense \$10 000	Liability Nil

* This asset would be subject to impairment testing in accordance with the requirements of AASB 136 *Impairment of Assets*. However, AASB 136.Aus32.1 requires NFP entities to calculate value in use on the basis of depreciated replacement cost for assets where the future economic benefits are not primarily dependent on the assets' ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits. Consequently, the asset would be unlikely to be impaired as a result of entering into a below-market lease arrangement.

Staff analysis – effects of the IASB’s *Leases* project

10. The IASB is continuing its redeliberations on its *Leases* project. The IASB work plan (dated 13 May 2011) indicates that an IFRS on *Leases* is targeted for Q4 of 2011. AASB staff consider that the IASB redeliberations are not sufficiently progressed to make a recommendation to the Board in relation to below-market lease arrangements for NFP entities.
11. Depending on the outcome of the Board’s discussion of the issues raised in this paper, staff will consider below-market lease arrangements as work progresses to identify any implications for the Australian Accounting Standard that is expected to incorporate the IFRS on *Leases* for NFP entities.
12. It should be noted that if the Board considers that the requirements of AASB 1004 override the requirements of AASB 117 (Interpretation B), it would not be necessary to address the issue in the Australian Accounting Standard that is expected to incorporate the IFRS on *Leases*.
13. The preliminary staff analysis below is based on the tentative decisions reached by the IASB up to the June 2011 IASB meeting.

Lessee accounting

14. Based on the most recent redeliberations of the IASB on the *Leases* project, the IASB has tentatively decided that there should be one model for lessee accounting (with an exception for short-term leases). The lessee would be required to recognise a right of use asset and a liability to make lease payments at the present value of lease payments. Preliminary staff analysis of the IASB’s tentative decisions is that they could impact on the current NFP entity lessee accounting for below-market lease arrangements, such that the current operating lease alternatives (the top half of the table outlined on page 5 of this memo) would no longer be applicable. This would result in only two of the Interpretations being applicable on the basis that Interpretations B and C result in the same accounting for finance lease arrangements. However, staff note that the IASB is yet to finalise its deliberations, consequently, the interaction between the proposed requirements and the current requirements of AASB 1004 remains unclear.
15. Staff note that, although the IASB tentative decisions would result in the recognition of a right of use asset for lease arrangements that are currently classified as operating leases, the recognition of such a right of use is based on the ‘present value of lease payments’. Accordingly, any requirement for lessees to recognise an asset and income as a result of

entering into a below-market lease arrangement would be as a result of the application of AASB 1004 (currently), or, when finalised, the Standard resulting from the AASB's project on Income of Not-for-Profit Entities.

Lessor accounting

16. AASB staff consider that IASB redeliberations in relation to lessors are not sufficiently progressed to undertake a preliminary staff analysis.

Staff analysis – effects of the AASB's project on Income of Not-for-Profit Entities

17. The Australian Accounting Standard that is expected to result from the Exposure Draft on Income of Not-for-Profit Entities would replace the current income recognition requirements of AASB 1004.
18. It should be noted that if the Board considers that the requirements of AASB 117 override the requirements of AASB 1004 (Interpretation A), it would not be necessary to address the issue in the Income of Not-for-Profit Entities project.
19. Depending on the outcome of the Board's discussion of the issues raised in this paper, staff will consider any implications in the forthcoming Exposure Draft on Income of Not-for-Profit Entities.

Appendix A

Relevant requirements of AASB 117

A lease is defined in AASB 117 paragraph 4 as:

...an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

AASB 117 does not include any 'Aus' paragraphs specific to NFP/public sector entities on accounting for below-market lease arrangements.

AASB 117 classifies leases as either operating or finance leases.

(a) Operating lease lessors:

- (i) recognise lease payments as income on a straight–line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished (AASB 117, para. 50).
- (ii) continue to recognise the underlying asset on its statement of financial position.

(b) Finance leases lessors:

- (i) at initial recognition, lessors should recognise assets held under a finance lease in their statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

(c) Operating lease lessees:

- (i) recognise lease payments as an expense on a straight–line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit (AASB 117, para. 33).

(d) Finance lease lessees:

- (i) at initial recognition recognise such leases:

...as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset. [emphasis added]

Relevant requirements of AASB 1004

AASB 1004 defines contributions as non-reciprocal transfers to the entity (Appendix A). Non-reciprocal transfers are defined as:

A transfer in which the entity receives assets or services or has liabilities extinguished without directly giving approximately equal value in exchange to the other party or parties to the transfer. (AASB 1004, Appendix A)

In relation to not-for-profit entities AASB 1004 requires that income is measured at the fair value of the contributions received or receivable (para. 11). Further, AASB 1004 requires that:

Income arising from the contribution of an asset to the entity shall be recognised when, and only when, all the following conditions have been satisfied:

- (a) the entity obtains control of the contribution or the right to receive the contribution;
- (b) it is probable that the economic benefits comprising the contribution will flow to the entity; and
- (c) the amount of the contribution can be measured reliably. (para. 12)

A contribution occurs when an entity receives an asset, including the right to receive cash or other forms of asset without directly giving approximately equal value to the other party or parties to the transfer; that is, when there is a non-reciprocal transfer. Contributions would, for example, include donated assets. (para. 13)

...

Liabilities Forgiven

The gross amount of a liability forgiven by a credit provider shall be recognised by the borrower as income. (para. 16)

In relation to local governments, government departments, GGSs and Whole of Governments, contributions, other than contributions by owners, are recognised as income when the transferee local government, government department, GGS or whole of government obtains control over them, irrespective of whether restrictions or conditions are imposed on the use of the contributions. (AASB 1004, para. 20). Control over the amounts arises when the transferee can benefit from the funds transferred to it and deny or regulate the access of others to those benefits (AASB 1004, para. 27).