



<b>To:</b>	<b>AASB members</b>	<b>Date:</b>	24 May 2011
<b>From:</b>	<b>Kala Kandiah and Nikole Gyles</b>	<b>Agenda Item:</b>	14.1
<b>Subject:</b>	<b>Leases project and application issues for Not-for-Profit and Public Sector Entities</b>	<b>File:</b>	

## Action

1. Receive a verbal update on the tentative decisions made by the IASB and the FASB in the joint May 2011 meetings on the *Leases* project.
2. Consider whether not-for-profit (NFP) and public sector modifications should be made to the Australian Accounting Standard that is expected to incorporate the IFRS on *Leases* and whether consequential amendments need to be made to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*.
3. Note that there is insufficient information at this stage to make decisions on Tier 2 reduced disclosures.

## Related documents:

Links to March and April 2011 AASB Board papers providing earlier updates on the IASB's *Leases* project:

[http://www.aasb.gov.au/admin/file/content102/c3/Mar\\_2011\\_AP\\_10.1\\_Leases\\_project\\_update.pdf](http://www.aasb.gov.au/admin/file/content102/c3/Mar_2011_AP_10.1_Leases_project_update.pdf)

[http://www.aasb.gov.au/admin/file/content102/c3/Apr\\_2011\\_AP\\_12.3\\_Leases\\_project\\_update.pdf](http://www.aasb.gov.au/admin/file/content102/c3/Apr_2011_AP_12.3_Leases_project_update.pdf)

See also agenda item 19.3: AASB letter to the IASB on the *Leases* project

## AASB Staff Recommendations<sup>1</sup>

Based on recent deliberations of the IASB, it is apparent that there is a fair degree of uncertainty as to what the final Standard on *Leases* might contain. Despite that, we think it is timely for the AASB to undertake preliminary consideration of NFP and public sector issues.

### 1. Outcome of *Process for modifying IFRSs for PBE/NFP entities*

We have considered the matters outlined in *Process for modifying IFRSs for PBE/NFP Entities* and **recommend making no modifications** to the Australian Accounting Standard that is expected to incorporate the IFRS on *Leases* for application by Australian NFP entities, on the basis that:

- (a) the nature of leasing arrangements entered into by Australian NFP entities are not sufficiently different from the leasing arrangements entered into by Australian for-profit entities to warrant specific guidance or modification for NFP entities;
- (b) it would not be disproportionately costly for NFP entities to comply with the Australian Accounting Standard that will incorporate the IFRS on *Leases* when compared to for-profit entities; and
- (c) AASB 117 *Leases* currently does not have any modifications for application by Australian NFP entities.

### 2. Implications for AASB 1049

#### i. Examples of GAAP options

A principle in AASB 1049 is that an option in GAAP that aligns with GFS should be adopted (paragraph 14 of AASB 1049). In March 2011, the IASB and the FASB tentatively decided that lessees and lessors would have a choice of either recognising or not recognising lease assets or lease liabilities for short-term leases in a class of underlying asset. However, in the May 2011 meeting, some IASB and FASB members indicated that they were not in favour of the optional treatment for short-term leases and the Boards decided to discuss short-term leases in a future meeting. If the Standard on *Leases* includes optional treatment for short-term leases, **we recommend that it be added in paragraph 14 of AASB 1049 as an example of an optional treatment**. We acknowledge that the list of examples in paragraph 14 of AASB 1049 is not meant to be

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<sup>1</sup> Staff had regard to respondents' comments in Appendix A in making the recommendations.

exhaustive, but we consider it would be helpful for public sector entities to have the optional treatment for short-term leases listed in paragraph 14 of AASB 1049 as such leasing transactions are quite prevalent in the public sector.

We are not aware of any other optional accounting treatments expected to arise out of the *Leases* project.

ii. Examples of GAAP and GFS differences (paragraph 42(a) of AASB 1049)

Based on the May 2011 tentative decisions made by the IASB in the *Leases* project, lessees would recognise right-of-use assets and lease liabilities for all leases (i.e. finance and operating leases). The expense recognition pattern for leases that are currently classified as operating leases may change from straight-line rental expense to the recognition of a higher expense in early periods due to interest expense and amortisation, depending on whether the IASB decides on a single or dual model for lessee accounting in the IFRS for *Leases*. If the Standard requires lessees to recognise right-of-use assets and lease liabilities for all leases, this would result in differences between GAAP and GFS as the ABS GFS Manual is aligned to AASB 117 and consequently does not recognise right-of-use assets and lease liabilities for operating leases. These differences are likely to cause differences in measurements of key fiscal aggregates and therefore **we recommend the differences be added in paragraph 42(a) of AASB 1049 as an example of differences that require disclosures of reconciliations and explanations of the differences**. We consider that it is common for public sector entities to enter into arrangements as lessees in operating leases (for example leases of office equipment, buildings and motor vehicles).

We suggest that it is not necessary to amend Illustrative Examples A and B of AASB 1049 as the cost involved in making any amendments would not be commensurate with the benefit of making the amendments, particularly if the differences are already included as examples in paragraph 42(a) of AASB 1049.

iii. Other implications for AASB 1049

We do not consider there to be any other amendments necessary to AASB 1049 as any other differences that may arise between GAAP and GFS due to the adoption of the *Leases* Standard are not expected to be significant.

**Question to Board members:**

Do you agree with staff's recommendations?

**Background**

The IASB and the FASB have undertaken a joint project to develop a Standard on *Leases*, an original objective of which was that all assets and liabilities arising under lease contracts are recognised in the statement of financial position (balance sheet).

In August 2010, the AASB issued ED 202R *Leases*, which incorporated the IASB's ED/2010/9 *Leases*. The comment period for IASB's ED 2010/6 closed on 15 December 2010 and over 760 comment letters were received (the comment period for AASB ED 202R closed on 12 November 2010 and attracted 16 comment letters). The IASB and FASB began redeliberations on the *Leases* project in January 2011 and an IFRS on *Leases* is expected to be issued in Q4 of 2011.

The AASB has recently written to the IASB on some of the tentative decisions made in the *Leases* project (refer to agenda item 19.3). Board members will receive a verbal update on the IASB and the FASB's deliberations on the *Leases* project in the joint May 2011 meetings.

**Tier 2 disclosures**

In November 2010 the AASB issued a Tier 2 supplement to ED 202R for comment by 31 January 2011. Staff have read the submissions received but are unable to make any recommendations to the Board at this stage as the IASB and FASB have not yet finalised the disclosure requirements for the IFRS. Once the IFRS is sufficiently progressed, we intend liaising with the AASB RDR subcommittee to develop Tier 2 requirements.

## Appendix A: NFP and public sector issues raised by Australian constituents in response to ED 202R *Leases*

### 1. Issue: GAAP/GFS harmonisation

Five (ACAG #1, Dept of Finance and Deregulation#2, FinPro #6, HoTARAC #8 and CPA, ICAA and NIA #9) responses expressed a view on the issue above.

Four of the responses (ACAG #1, Dept of Finance and Deregulation#2, HoTARAC #8 and CPA, ICAA and NIA #9) considered that the proposals in the ED would increase the GAAP/GFS divergence as lease accounting under GFS is currently aligned to AASB 117 and this is unlikely to change in the near future.

One of the responses (HoTARAC #7) cited some possible GAAP/GFS divergence arising from the ED's proposals as outlined below:

- in relation to transactions, lessees would recognise amortisation and interest expense under GAAP while having to report lease rental expenses under GFS.
- in relation to other economic flows, lessees would recognise revaluations and reassessments under GAAP but not under GFS.  
differences in cash surplus/(deficit) would increase due to the differing treatment of finance (ie capitalised) leases under GAAP and GFS.
- the value of a lessee government's net debt would increase, assuming that the liability to make lease payments would be treated similarly to a finance lease liability.
- lessees would have to recognise more items (eg revaluations and reassessments) thereby increasing the risk of misclassification as between transactions and other economic flows.
- GFS uses the term amortisation in relation to non-produced assets (eg land, subsoil assets and certain intangible assets) whereas the ED uses it in relation to right-of-use assets. It is unclear whether a right-of-use asset would ever be recognised under GFS and, if it was, whether it would be regarded as non-produced and therefore subject to amortisation under GFS.

*Staff response: We think our recommendations in section 2 of the memo adequately deal with the GAAP/GFS divergences that might arise.*

### 2. Issue: impact on debt/borrowing levels

Two responses (DG & AB Maxwell #4, FinPro #6) expressed concern that the inclusion of operating lease payments as liabilities/borrowings may result in increased borrowing amounts that exceed permitted/approved debt levels.

One of the responses (FinPro #6) considered that the increased debt levels would be perceived as reduced ability to service the debt even though no new commitments are introduced and the pattern of cash flows does not change. This may require the Local Government Act (Vic) 1989 to be amended to provide direction as to the inclusion of leases as borrowings. The Australian Loan Council, which approves a Council's borrowings, may also need to reconsider its assessment criteria for approving a Council's borrowings.

*Staff response: This concern is not unique to the public sector.*

### 3. Issue: transactions with unique attributes and relevance to the public sector

One response (ACAG #1) noted that some transactions may have unique attributes with particular relevance to the public sector (for example sale and leaseback transactions, Crown leases and public private partnerships), which may warrant application guidance in accounting for them.

*Staff response:*

***Sale and leaseback:*** AASB 117 does not include application guidance on accounting for sale and leaseback transactions in the public sector. IPSAS 13 Leases is also consistent with AASB 117 and does not have any application guidance specific to the public sector on sale and leaseback transactions. As such, we do not consider application guidance specific to the public sector on sale and leaseback transactions is necessary.

***Crown leases*** may be unique to the public sector in that they may not be at commercial rates and may, instead, only earn peppercorn rentals for the lessor. We note that public sector entities currently account for these arrangements under AASB 117, which does not include any application guidance for the public sector in accounting for these types of leases. We also note that IPSAS 13 does not include any application guidance specific to the public sector on accounting for leases that are not at commercial rates. Before we make any recommendations, we would like to discuss this issue further with constituents from the public sector. Specifically, we would like to understand the nature of the Crown leases and what the implications might be if these leases need to be recognised on the balance sheet of the lessee under the new Standard on Leases. We have commenced follow-up conversations with ACAG, the respondent who raised the issue.

***Public private partnerships:*** We note that there is currently no accounting standard that provides application guidance for public sector entities in accounting for public private partnerships (i.e. service concession arrangements) and the IPSASB has a current project on Service Concession Arrangements: Grantor. However, it is not clear when the IPSASB will issue a Standard on Service Concession Arrangements: Grantor. We do not consider it appropriate to include application guidance for public sector entities in accounting for public private partnerships in the Leases standard as public private partnerships usually consist of a broad set of agreements between public sector and private sector entities to construct, own, operate and/or transfer assets and a lease may only be one element of the agreements. Further, we do not think the Leases standard should pre-empt the outcome of the AASB's future work on service concession arrangements.

## 4. Issue: complexity and costs in complying with requirements of the ED

One response (DG & AB Maxwell #4) suggested that Local Government may not have details of the original terms and conditions for many Crown reserves under its control and compliance with a new Standard on *Leases* by Local Government will be "patchy", as the necessary information is accumulated.

Another response (CPA, ICAA and NIA #9) considered that the proposed requirements of the ED would add significant complexity and costs for non-publicly accountable entities, over and above that which would be incurred by an entity that is able to use the *IFRS for SMEs*.

*Staff response: Complexity and costs incurred in complying with (including transitioning to) a new Standard on Leases is not considered to be disproportionately high for public sector entities when compared to private sector entities. The benefits of complying with a 'transaction-neutral' new Standard on Leases would more than outweigh the costs of complying with the Standard. Disclosure relief for Tier 2 entities would be available under RDR, which is to be considered in due course.*

None of the responses to the ED were aware of any regulatory issues or other issues specific to the Australian environment that may affect NFP entities.