Australian Government
Australian Accounting Standards Board

# Staff Paper

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| **Project:** | **Leases** | **Meeting** | AASB December 2015 (M149) |
| **Topic:** | **Not-for-Profit considerations** | **Agenda Item:** | 3.2 |
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## Introduction and objective of this paper

1 The objective of this paper is to:

(a) update the Board on staff analysis of not-for-profit (NFP) specific issues previously raised in relation to the IASB's leases proposals; and

(b) seek Board decisions relating to:

(i) NFP lessee accounting;

(ii) NFP lessor accounting; and

(iii) any potential amendments to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*.

2 This paper is structured as follows:

(a) NFP lessees – below-market leases (paragraphs 8-18);

(b) NFP lessors – below-market leases (paragraphs 19-22); and

(c) potential GAAP/GFS differences (paragraphs 23-32).

## Summary of AASB staff recommendations

3 The staff recommend the following:

(a) consider a consequential amendment to AASB [16] as part of the redeliberations of ED 260 *Income of Not-for-Profit Entities* for below-market leases entered into by NFP lessees;

(b) not to develop additional guidance for NFP lessees regarding the application of AASB 117 *Leases* and AASB 1004 *Contributions* given this issue is addressed in the upcoming AASB 10XX *Income of Not-for-Profit Entities*; and

(c) not to develop additional guidance or amendments to AASB 1049 relating to differences between AASB [16] and Government Finance Statistics (GFS).

## Background

4 IFRS [16] is expected to have a single accounting model for lessees, similar to the approach in the International Accounting Standards Board's (IASB's) Exposure Draft ED/2010/9 *Leases*[1]. AASB staff reviewed responses received to AASB ED 202R *Leases*[2] (which incorporated IASB ED/2010/9) and found that constituents did not raise any NFP-specific issues in relation to the proposed lessee accounting model.

5 However, in July 2011, the Board noted a potential interpretation issue in relation to the interaction of AASB 117 and AASB 1004 for below-market finance leases of NFP lessees. Below-market leases are particularly prevalent in the NFP sector where lessors might provide a "peppercorn lease" to an NFP lessee whereby the fair value of the underlying leased asset is higher than the future minimum lease payments.

6 In September 2011, as the IASB was considering the "receivable and residual" approach for lessors, the Board noted that a lessor entering into a below-market finance lease would have to recognise the loss on entry to the lease as an impairment loss under the model. The IASB has since abandoned the "receivable and residual" model for lessors. Lessor accounting in IFRS [16] is expected to be similar to the lessor accounting in IAS 17.

7 Other than the above issues, no other NFP-specific issues have been raised with the Board, or have been identified in feedback received.

## Accounting for below-market finance leases of NFP lessees

<u>Overview</u>

8 In July 2011[3] the Board noted an issue for NFP entities that enter into below-market finance leases as a lessee. The issue arose out of the AASB 117 requirement to recognise finance lease assets at the lower of the fair value of the leased asset or the present value of the minimum future lease payments.

9 As noted in paragraph5, peppercorn leases are for assets that have a fair value that is usually far in excess of the present value of the future minimum lease payments. Consequently, under the AASB 117 requirements, the lessee would recognise assets and liabilities at the lower amount of the present value of the future minimum lease payments.

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1 [IASB Exposure Draft ED/2010/9 *Leases*]

2 [AASB ED 202R *Leases* comment page]

3 Copies of the Board paper are available by contacting AASB *Leases* project staff (kkandiah@aasb.gov.au).

10 However, NFP entities are also subject to AASB 1004 that requires contributions of assets to be measured at the fair value of the contributed asset with a corresponding amount recognised as income in the statement of financial performance.[4]

11 The issue discussed by the Board was the order in which the AASB 117 and AASB 1004 requirements could be applied. Three alternatives were discussed by the Board:

(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 nil.[5] 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;

(b) The requirements of AASB 1004 prevail over the requirements of AASB 117 – the contribution is accounted for as a grant of an asset. That is, lessees apply the recognition and measurement requirements of AASB 1004; or

(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, 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).

12 After considering AASB staff analysis of the above the Board decided to defer further consideration of the issue pending the outcome of the AASB's *Income of Not-for-Profit Entities* project.

AASB ED 260 *Income of Not-for-Profit Entities*

13 In April 2015 the AASB issued ED 260 that exposes a potential replacement for AASB 1004. ED 260 proposes the following consequential amendment to AASB 117 for NFP entities that would override the general finance lease asset and liability measurement requirements in AASB 117 with those of paragraphs 25-30 of Part B of ED 260[6] in cases where a NFP lessee enters into a below-market lease. This amendment would address the issue described in paragraphs 8 to 12 of this paper in relation to AASB 117:

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4 Please see Appendix A to this paper for relevant extracts from AASB 117 and AASB 1004.

5 Assuming there are no nominal amounts payable.

6 AASB ED 260 *Income of Not-for-Profit Entities*

**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 25-30 of AASB 10XX *Income of Not-for-Profit Entities*. AASB 10XX requires that, in such a lease, the lease asset and lease liability are initially measured at the fair value of the lease property at the inception of the lease.**

IFRS [16] *Leases*

14 IFRS [16] is not expected to contain any application guidance in relation to below-market leases. Accordingly, the measurement conflict described in paragraphs 8 to 12 of this paper would continue to exist with the introduction of IFRS [16] in Australia as AASB [16].

Staff Recommendation

15 As noted in paragraph 13, ED 260 proposes a consequential amendment arising from the issuance of AASB 10XX to AASB 117 that does address the measurement conflict. Staff therefore recommend that the same consequential amendment also be made to AASB [16] as a consequence of issuing AASB 10XX.

16 AASB staff consider that this approach would not require further due process as mirroring the consequential amendment to AASB 117 in AASB [16] is mechanical in nature and can be finalised through the Board's redeliberations on ED 260. Therefore, no further outreach would be required beyond that already conducted in ED 260.

*Assessment against IFRS modification criteria*

17 Consistent with the AASB staff recommendation to finalise the consequential amendment through redeliberations on ED 260, the Board will consider an analysis of the IFRS modification criteria as part of that process.

*Timeframe for introduction of requirements*

18 AASB staff note that until such time that AASB 10XX is issued the measurement conflict between AASB 1004 and AASB 117, and AASB [16], will continue to exist. Given that AASB 10XX is expected to be issued before the effective date of AASB [16], which would likely be 1 January 2019 (based on IASB's tentative decision in October 2015), AASB staff do not recommend the Board taking action on this issue before that time.[7]

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7 AASB staff note that if an entity early adopts AASB [16] prior to AASB 10XX the entity would not be able to avail itself of the below-market lessee guidance in the AASB 10XX consequential amendments and would be faced with the interpretation issues described in paragraph 11. However, this NFP issue is not caused by the issuance of AASB [16] and for the reason described in paragraph 18 AASB staff do not recommend the Board take any action.

**Question 1 to Board members**

Do Board members agree with staff recommendations to:

(a) include a consequential amendment in AASB 10XX for AASB [16] relating to measurement requirements for NFP lessees?

(b) not make NFP-lessee measurement amendments to AASB 117 and AASB [16] prior to the mandatory application date of AASB 10XX?

**Accounting for below-market finance leases of NFP lessors**

19 In September 2011 the Board noted an issue with lessor accounting as the IASB was considering the "receivable and residual' approach for lessors and its impact on below-market leases of lessors.

20 The "receivable and residual" approach would have required a lessor to recognise a receivable for the future minimum lease payments and a residual asset that was essentially calculated as the difference between the fair value of the underlying leased asset and the present value of the future minimum lease payments to be received.

21 Under the approach, a lessor would not have been able to recognise a loss upon entering a below-market lease under any circumstance. On the contrary, the lessor would have had to impair the residual asset and instead recognise an impairment loss on day-1. AASB staff argued that this did not faithfully represent the economics of the transaction.

22 In July 2014 the IASB decided not to proceed with the 'receivable and residual' approach and to substantially carry forward the current lessor accounting requirements in IAS 17 to IFRS 16 (refer to paragraph 8 of Staff Paper 3B of IASB July 2014 meeting[8]). Accordingly, the introduction of IFRS [16] in Australia is not expected to give rise to any additional NFP-specific issues for lessors and there is no amendment or further action required.

**Question 2 to Board members**

Do Board members agree that no amendment or further action is required in relation to below-market leases for NFP lessors?

**GAAP/GFS differences**

23 Paragraph 38 of *AASB Policies and Processes* states:

> When developing Standards for application by public sector entities the AASB considers differences between the requirements of the Standards and the basis of preparing information required by Government Finance Statistics (GFS), with a view to removing those differences where appropriate…

8 IASB Agenda Paper 3B (July 2014)

24 AASB staff have consulted with Australian Bureau of Statistics staff and other public sector stakeholders concerning any GFS implications of IFRS [16].

25 At a high level, both GFS and AASB 117 distinguish leases between operating and finance leases based on whether there is a transfer of risks and rewards incidental to ownership of the underlying leased asset. Consequently, lease accounting requirements under AASB 117 are generally aligned with those of GFS requirements.

26 The new lessee accounting model in IFRS [16] removes the finance/operating lease distinction for lessees by introducing a single model of recognising 'right of use' assets and lease liabilities. This new model introduces differences between GFS and Australian Accounting Standards, particularly in recognition, measurement and classification of leases.

27 AASB staff therefore considered these differences in the context of an amendment to AASB 1049 *Whole of Government and General Government Sector Financial Reporting*, noting paragraph BC37 of AASB 1049 that states:

> The Board considered whether GAAP or GFS principles should prevail for financial reporting purposes. The Board concluded that GAAP definition, recognition and measurement principles should be applied in accordance with other Australian Accounting Standards, unless otherwise specified, to accommodate GFS principles…

28 The above decision forms the basis of paragraph 10 in AASB 1049 that notes there would only be limited significant exceptions where AASB 1049 diverges from the definition, recognition, measurement, classification, presentation and disclosure requirements specified in other applicable Australian Accounting Standards.

<u>Staff recommendation</u>

29 AASB staff note that any difference in definition, recognition, measurement and classification between GAAP and GFS would be disclosed via a reconciliation note with an explanation of the difference as required by AASB 1049 paragraph 41(a). Therefore, AASB staff do not recommend introducing a recognition and measurement exception in AASB 1049 as a consequence of issuing IFRS [16] as AASB [16] in Australia.

30 AASB staff also considered whether the Illustrative Examples in AASB 1049 that show a reconciliation and explanation of key GAAP/GFS fiscal aggregate differences (as required by paragraph 41(a) of AASB 1049) should be amended to incorporate a reconciliation example of the difference between AASB [16] and GFS. AASB staff note that the Illustrative Examples already provide numerous examples of GAAP and GFS differences.

31 Notwithstanding the above, AASB staff note that a review of AASB 1049 could be undertaken in the future as a result of a review of the Australian GFS manual (which is currently in progress) or a review of the reporting framework. An illustration of the differences between AASB [16] and GFS in the AASB 1049 could be considered at that time.

32 On balance, AASB staff do not recommend the Board amend the Illustrative Examples in AASB 1049 as a consequence of issuing AASB [16] at this stage.

**Question 3 to Board members**

Do Board members agree with the staff analysis and recommendations made in paragraphs 29 and 32 to:

(a) not introduce a recognition and measurement exception in AASB 1049?

(b) not amend the Illustrative Examples?

**Appendix A**

*Relevant extract from AASB 117* Leases

**20 At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property <u>or, if lower, the present value of the minimum lease payments,</u> each determined at the inception of the lease…** [emphasis added]

*Relevant extracts from AASB 1004* Contributions

Contributions are defined 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.

**Measurement of Contributions**

**11 Income shall be measured at the fair value (see AASB 13 *Fair Value Measurement*) of the contributions received of receivable.**

**Recognition of Contributions of Assets**

**12 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 contributions will flow to the entity; and**

**(c) the amount of the contributions can be measured reliably.**

13 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. Contributions that are income exclude *contributions by owners*.