

Submission to the Australian Accounting Standards Board (AASB)

To whom it may concern,

We at LGiQ are a firm of local government specialists dedicated to empowering local government organisations with targeted mentoring and innovative accounting support. Our work is primarily with regional and rural councils whose experiences underpin much of our feedback.

In preparing this submission, we have also consulted with the South Australian Local Government Financial Management Group (SALGFMG) which represents finance professionals across the sector by providing resources, support and ongoing professional development.

This submission responds to the AASB request for feedback on:

1. The ongoing costs of applying AASB 16 and auditing and regulating its application; and
2. Whether AASB 16 results in financial statements that are more useful for decision makers than financial statements prepared under the previous Standard AASB 117 Leases?

1. Ongoing Costs of Compliance with AASB 16

Under section 127 of the *Local Government Act 1999* South Australian councils must prepare financial statements and notes in accordance with the standards prescribed by the regulations and other statements or documentation relating to the financial affairs of the council. Regulation 13 requires compliance with the **Model Financial Statements (MFS)**. The MFS prescribes guidance and recommended formats for all South Australian councils including flow diagrams, examples and guidance on accounting interpretations to assist councils when preparing their financial statements. Despite this comprehensive framework, the application of AASB 16 remains extremely challenging for councils. We find most finance professionals struggle with the calculations given the number of assumptions required to be made in the absence of readily accessible and available information on leases, especially when they have agreements that have not been structured as a lease. This issue is even more problematic in the regional and rural sector who struggle to find skilled finance staff and who have difficulty in meeting deadlines for statutory financial reporting with increasing workloads. They are required to make determinations on whether a lease exists, the lease term, interest rate implicit in the lease all of which takes time for calculations which ironically despite all their effort results in information the users of financial statements find difficult to understand.

Gathering contracts for analysis can require considerable effort and often require collaboration with other functional areas such as finance, procurement, property and IT. Some of the contracts can be very lengthy and hence the analysis may require considerable time to evaluate and digest. In Local Government this particularly occurs in arrangements where there were difficult judgements in the past or those which were not legally structured as a lease but involve “substantial” use of a single asset. This extends to waste contracts, power agreements, access to stormwater systems and property contracts all of which are often complex. Councils therefore often have to seek outside expertise from accounting firms to help them with the calculations and determination as to whether a lease exists or not. Very often these accounting firms have been known to charge per lease which can be very costly especially for a council with a larger portfolio of leases. There is also the need for the reassessment of leases on a yearly basis and the requirement to determine revised discount rates when remeasuring lease liabilities. Accounting for remeasurements

involves a lot of resources and often manual work that cannot be automated. This all comes at a cost and when you are a small regional council who is struggling financially and with staff resources to complete end of year statements the budget to fund this work often comes at the expense of funding services to the community and/or other competing work priorities.

A particularly significant challenge lies in determining the correct lease term under AASB 16. The length of the lease affects not only the size of the right-of-use asset and lease liability but also whether the short-term lease exemption can be applied. Finally, AASB16 contains additional application guidance on how to deal with periods covered by options to extend or terminate a lease. While this detailed guidance can be helpful, it also means there is more to consider when determining the lease term. There can be considerable judgement in determining whether it is 'reasonably certain' that an entity would exercise its extension option or not exercise its termination option. Unfortunately to influence disclosure requirements councils may decide to either not include any lease extensions or show all lease extensions resulting in an inconsistent and uneven approach by the sector which reduces comparability. This is exactly at odds with what AASB16 was designed to address. In determining the amount of lease liability councils will need to discount future lease payments using either (a) the interest rate implicit in the lease (if it can be readily determined) or (b) the lessee's incremental borrowing rate. In many cases, the interest rate implicit in the lease will not be readily determinable nor is there the required data to calculate it and therefore Councils often will need to come up with an appropriate incremental borrowing rate.

The more judgment required and greater need for manual entries to support adherence to the standard the greater the cost to implement for a council and the even greater risk of potential misstatement. We have instances of calculations for council organisations and subsidiaries that have been reviewed by external auditors or external providers for lease calculations which subsequently have been found to be incorrect and the AASB16 calculations have materially misstated the operating results. In some instances this has required a reinstatement of prior year financial statements. Calculations are often done manually, and Excel spreadsheets are used due to system limitations, which also comes with its own risk, as the proper tools for lease calculations are difficult and costly to obtain. Therefore for South Australian local councils, implementing AASB 16 has introduced several challenges, both technical and operational. Below is a summary of these major challenges, all of which come at a significant cost for compliance.

Identifying all lease arrangements - Local councils often have numerous, decentralized departments or business units that enter into lease or lease-like arrangements

Challenges :

- Difficulty identifying informal or embedded leases as employees managing lease registers are not specialised in the finance and accounting area.
- Incomplete lease registers across departments.
- Long-standing arrangements not formally documented.
- Lack of understanding and awareness of the financial implications by decentralised departments when committing the council to a contract that potentially may have an embedded lease
- Lack of guidance on what is determined to be a low-value asset (for example, various external audit firms have a different approach to what is considered "low value" and this creates inconsistency across the sector for comparability.

Determining the lease term - AASB 16 requires entities to determine the reasonably certain lease term, including options to extend or terminate

Challenges:

- Councils often enter into leases with rolling or short-term arrangements that are renewed informally.
- Judgement is required to assess lease extension options, particularly for Crown land or community buildings.

Discount rate determination - Under AASB 16, the lessee must apply the incremental borrowing rate (IBR) if the interest rate implicit in the lease cannot be readily determined

Challenges :

- Councils may not have a readily determinable IBR and more problematic as there is often no interest rate implicit in the lease especially with “old” documentation and very long term contracts.
- Often there is a need to estimate or model an appropriate rate, which can be complex and subjective.
- Council employees were given some industry guidance in 2025 for first time on options to use for incremental borrowing rates due to a lack of external borrowing options and benchmarks but there is still confusion by accounting staff.

Valuation of Right of Use (ROU) assets - Councils must recognise a right-of-use asset and corresponding lease liability for most leases.

Challenges :

- Determining appropriate asset values for long-term land leases or peppercorn (low-cost) leases, noting there is a temporary exemption currently for peppercorn leases
- Difficulty in applying fair value assessments where consideration is nominal (common with intergovernmental agreements or community use leases).

Subsequent measurement

Challenges :

- Determining if there was a lease modification (*a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease*)
- Incorrectly recognising a lease modification when there has only been a CPI increase in lease payments
- Challenges of the subsequent measurements of ROUA
- Lack of derecognition of ROUA and lease liabilities

System and Data management

Challenges :

- Legacy systems not designed for lease accounting.
- Manual tracking increases risk of error.
- Need for new software or significant spreadsheet-based workarounds.

Training and resourcing

AASB 16 is technical and significantly different from previous lease accounting standards.

Challenges:

Lack of internal accounting expertise on lease accounting.

- Resource constraints in smaller councils
- Different interpretation by Audit firms when providing advice given judgements required
- Ongoing training needed for finance and operational staff.

Audit and Compliance

Local councils are subject to external audit, compliant with the Model Financial statements and accounting standards and which is mandated in Local Government Act 1999.

Challenges:

- Auditors require consistent application and detailed supporting evidence and each external auditing firm can be inconsistent in how it assesses the information provided by a council.
- Risk of qualified audit opinions if lease data is incomplete or inconsistent.
- Increased disclosure requirements in financial statements.

2. Are financial statements more useful to users of local government statutory reporting as a result of AASB16?

Financial reporting by councils provides users with information to assist their decision-making and demonstrates effective stewardship and accountability. Councils are normally accountable to those who provide them with resources and to those who depend on them for the services or goods they provide. In addition, and like other tiers of government, councils are also subject to a high level of community interest and accountability. The financial reporting by councils provides information on how they have discharged their accountability obligations for the management of the public monies and assets entrusted to them and the delivery of services or goods to stakeholders in compliance with relevant legislation.

Councils control significant physical assets, the majority of which have no market value. Many of these assets are long-life assets that are subject to significant changes in value over the period the council holds

them. As a result, and to ensure financial information is relevant to users of the financial statements, physical assets, such as infrastructure (roads, water, sewerage, storm water drains, bridges) and buildings are measured and presented at their fair value. Under this approach, assets are re-measured periodically to reflect changes in their current value, with the resulting change generally being reflected in an asset revaluation reserve. The result is a balance sheet that better reflects the current replacement cost of assets and the operating statement measures more accurately the consumption of those assets via depreciation.

Financial sustainability in South Australian local government involves councils maintaining long-term financial health to deliver services and manage infrastructure without excessive rate increases or service cuts. This requires sound asset management, responsible debt management, and effective financial planning. Long-term financial plans that forecast future revenue, expenses, and infrastructure needs help councils evaluate their financial sustainability using several key financial ratios.

These ratios are industry specific. They let users know that each generation is paying for the consumption of resources, that community assets are being renewed and replaced compared with what is need to cost effectively maintain service levels and that the level of indebtedness is manageable and can be funded without compromising the councils ability to deliver services.

Decision makes and users of financial statements therefore primarily want financial information that helps them to understand the financial sustainability of the council's operation and have confidence that the systems and processes in place are working effectively to ensure that the tax collected, namely rates is being used effectively and efficiently to deliver council services.

Regarding leases, this makes the actual lease payments in the annual operating budget the most useful numbers for understanding the real costs of the council and for practical purposes like setting rates, managing services, and budgeting. It is these costs that decision makers and users of financial information and in particular council members, are interested in and understand.

Councillors, elected by their communities are often not sophisticated in their understanding of finance. They often lack basic financial skills and acumen and therefore overly complex financial statements information especially on items like leases which create significant distortions in the statements are difficult for them to understand. AASB16 introduces a level of complexity and subjectivity that does not add value to their decision making.

Intergenerational equity is a key principle especially in ensuring rates increases are relatively 'stable' over time. Therefore front-loaded expenses created as a result of lease accounting entries are seen as confusing and potentially distorting reported financial results which makes it harder for users to understand. This is why finance staff in their management and financial reporting over the year often do not complete the calculation for right of use assets until the end of year process and all reporting throughout the year and against budget is based on the actual lease payments. The accounting entries for AASB16 effectively have become a year end adjustment to meet compliance for accounting standards as opposed to information useful for decision making.

In an ideal world although AASB 16 Leases could be considered generally helpful to local government users of statutory financial reporting its usefulness comes with some caveats depending on the specific context, the financial literacy of the user base which is often low , and the way the information is communicated which is arguably challenging with a sector facing significant challenges in attracting and retaining skilled professionals.

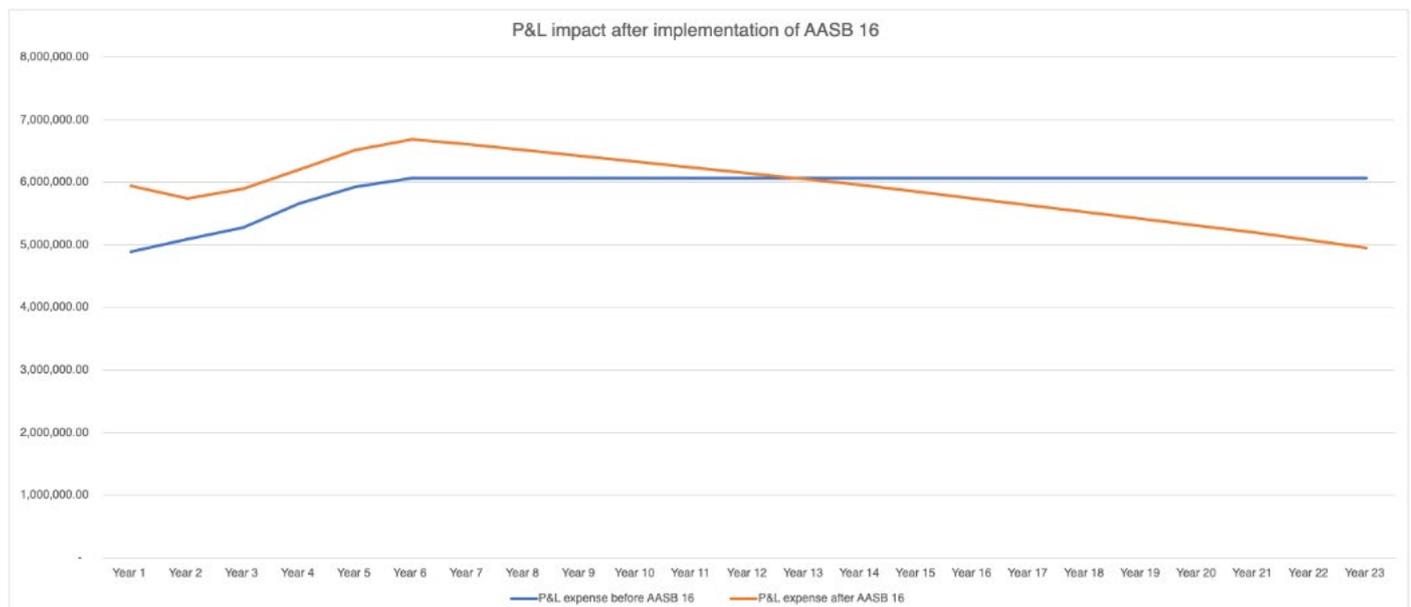
An additional issue is that bringing lease liabilities onto the balance sheet can create the perception of increased debt. This often leads to misconceptions about a council’s financial sustainability and may trigger political or public concern, even though there is no actual change in the underlying economic substance. Councils often meet the technical definition of control on paper when determining if a lease and ROU asset is recognised, but economic control is weaker than with owned assets — they can’t sell, modify, or sublease many leased assets without restrictions.

So councils "control" it enough for accounting purposes, but it’s not the same as owning it as for other assets on our balance sheet.

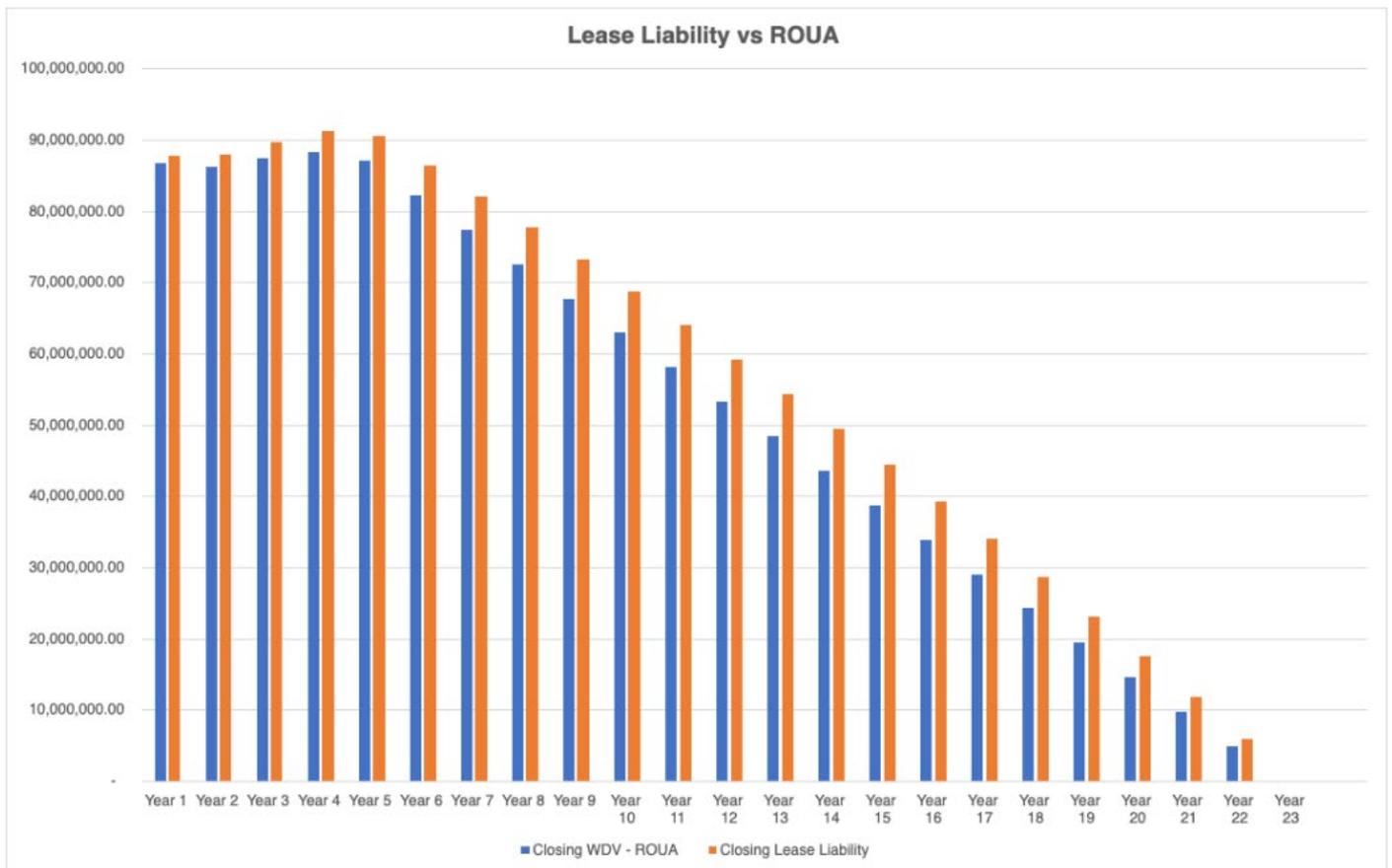
These issues faced by local government are illustrated with the following example from a regional council. The entries created by recognising a right of use asset due to its arrangement for the purchase of power via a power purchase agreement distort the operating results of the council and the level of indebtedness due to this long term agreement.

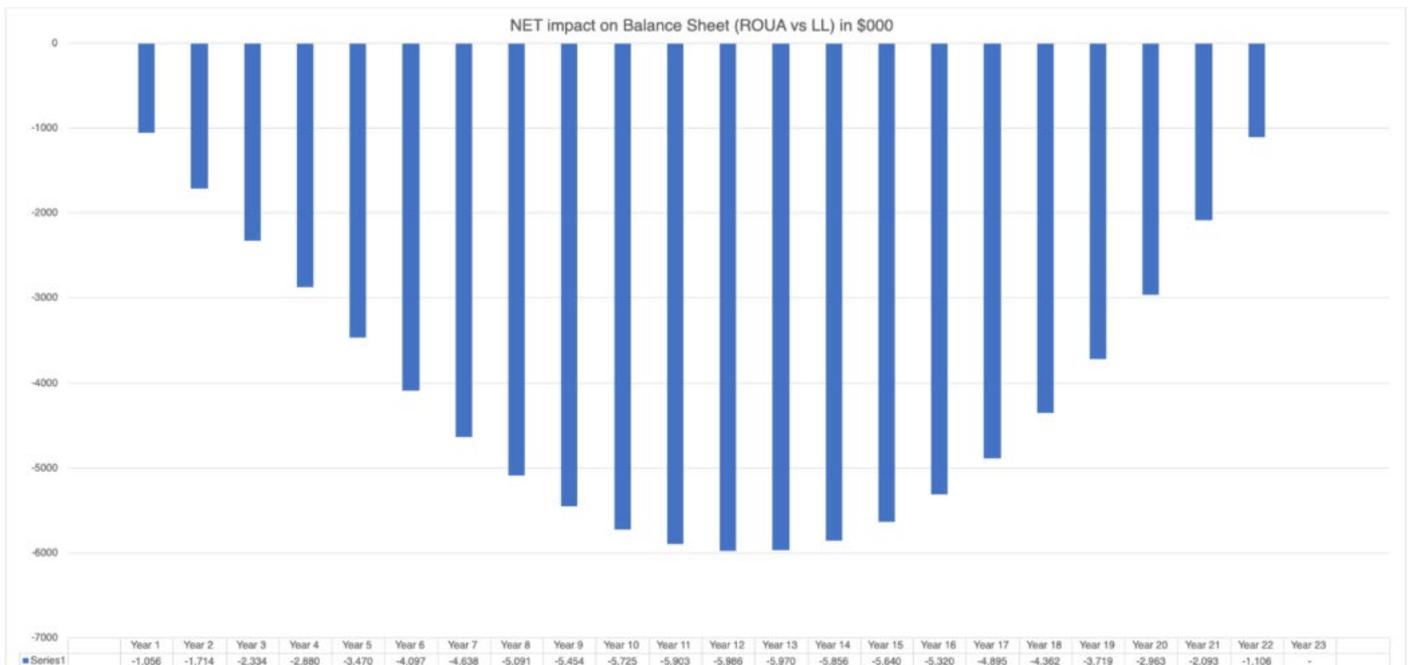
With the introduction of AASB16 the distortion on the income statement over time shows a higher impact on the operating position over the initial 10 years as opposed to the later years. This, for a council looking for “rate stability” over time does not help users of financial statements. Councils prepare long-term financial plans in compliance with legislation over a 10 year period. Users of financial information and in particular councillors now see the council with higher operating deficits due to the introduction of ASB16.

Technically, as a council seeks to report an operating surplus this would translate to increases in rates to ensure ratepayers are “paying for the consumption of resources” from each generation. Contrastingly in a subsequent long-term financial plan and in later years of the contract the impact on the operating position improves and that generation effectively will be required to pay less. Prior to AASB16 changes each generation was effectively contributing the same amount annually.



The same can be said of the net impact on the balance sheet. This “distortion” impacts the perceived level of indebtedness of the council over time and the interpretation by users of the financial statements regarding a level of increased debt. There were already concerns over this council’s financial sustainability but the recognition of the right of use asset in compliance with AASB16 triggered greater concerns and reputational risk. This has resulted in the council reporting its financial position excluding the ROU asset treatment and compliance with the AASB16 accounting standard is done merely for compliance with accounting standards and the MFS as opposed to providing meaningful information for users





We strongly believe despite its intent, AASB16 leases for the local government sector is not providing more meaningful information to users of financial statements to enhance decision making, We believe compliance has become costly and introduced a level of complexity given the significant judgments required. AASB16 usefulness to decision makers appears to be industry-specific and more tailored to users of financial statements looking to make investment decisions. For the local government sector our experience and feedback from finance professionals shows it does not add value or provide its users with better information to assess the council’s financial sustainability and accountability over resource provision. To address that the standard as a minimum would need to minimise distortions created to the operating statement and balance sheet especially for longer leases. The requirement for judgement and subjectivity in determining whether there indeed is an imbedded lease, to decisions regarding the interest rate if it is not readily determined from the agreement and to the lease term also need to be simplified. Any changes to the standard need have regard to industry specific impacts of AASB16 accounting entries and how the typical user of financial information interprets this information for decision making.

We welcome the opportunity to discuss any aspect of our submission and supportive of the AASB endeavours to address AASB16 and its application.

Kind Regards,

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