

Carmen Ridley
Board Member
Australian Accounting Standard Board

Cc: Jasmine Osborne, Senior Policy Officer – Finance, Office of Local Government NSW

RE: AASB ED 286 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities* – Tenterfield Shire Council's feedback

Dear Carmen,

We believe that accounting for the right-of-use assets under peppercorn leases in the local government is not straight forward. This is due to specifics of the local government sector which manages a lot of assets under different legal arrangements for the benefit of the community. Therefore, we would like to submit our feedback on the AASB ED 286 (Exposure Draft) as a contribution toward resolving the problems we might face later after initial application of AASB 16 and AASB 1058.

In Part I of this letter we provide some understanding of the subject. In Part II we give our responses on matter 1 and matter 3 from the specific matters for comments section in the Exposure Draft.

We are happy to discuss further if this will be required.

Igor Ivannikov MPhil (UNE), FCCA, CA
Local Government Financial Consultant
E: iivannikov100@gmail.com
M: 0412 932 174

Paul Della,
Manager Finance & Technology
Tenterfield Shire Council
p.della@tenterfield.nsw.gov.au

Part I - Background

Definition of peppercorn lease

Exposure Draft clarifies that the term "... *peppercorn lease* is generally used to describe a lease that has nil or nominal lease payments. However [in this exposure draft] ... the term is used to include leases with lease payments that are more than nominal but significantly below market value principally to enable the entity to further its objectives". Does this mean that the "nominal" lease is different to the lease at "significantly below market value"? If yes, how to determine this?

We assume that this clarification was made to separate the nominal lease on the ground that it is in substance a **grant** of an asset for use and manage for a defined period of time. If this is the case then the accounting treatment should be as per the current AASB 1004 or upcoming AASB 1058. That means measurement of an asset at initial recognition at fair value with the corresponding income through profit and loss at the date of recognition (the lease liability component will be negligible and can be ignored).

Tenterfield Shire Council (Council) has a School of Arts building which has been leased to the council for management, care and control 20 years ago. The terms of that agreement are for 50 years at \$1 annual lease payment. This building has been recognised as an asset and been valued at fair value along with other buildings within the class. The value of the building is significant.

If our understanding is correct then the School of Arts lease is an example of "nominal" lease payments and is not covered by this Exposure Draft.

Council has another example of a lease of a building with the \$260 monthly payment leased from a state agency for management and control. Will that lease be considered as "nominal" or "significantly below market value"? If we assume that the second option relevant then the Exposure Draft proposals apply.

Reason for peppercorn leases in Local Government NSW

Under peppercorn lease arrangement a council as a lessee manages, controls and cares of the lease assets with the title being held by the lessor. The lessor still requires nominal (or significantly less market value) lease payments to emphasise the fact that it is the legal owner. This, however, does not exempt councils from recognition and subsequent measurement at fair value of those assets on the basis of control concept under Conceptual Framework.

The School of Arts lease allows for option for extension for another 50 years. Considering significant benefit of the property to the community, it is expected that the lease will be extended. We believe that this is common to all other councils as all the assets under peppercorn lease are managed by the councils for the benefits of the community for the long term.

Restrictions

We understand that the Exposure Draft was issued as a response to Not-for-Profit entities concerns about restrictions of the assets under peppercorn leases and difficulties of valuing those restrictions. However, councils in NSW have always had "restricted assets" which have been required to be valued: community land, rural fire services assets, community buildings, etc. This created a lot of discussions and tensions between councils, auditors and valuers as there is no clear understanding how to value those restrictions. This makes valuation highly judgemental and does not contribute to the fairness of the statements. But, still, we are required to value assets at fair value. Therefore, we do not understand, why would the fact that the asset is under the peppercorn lease would be a factor for deferring the requirement to recognise the asset at fair value at initial recognition.

Right-of-use assets

Referring back to the example of the School of Arts. Currently it is in our books under the buildings class of assets. It is also included in our buildings assets management plan and subject to renewals and maintenance programs. With the new AASB 16 this should be reclassified to the right-of-use assets. The text of the standard implicitly states that this is an intangible asset.

From the community perspectives it does not matter how to call it: "asset" or a "right-of-use asset". All those items are understood and managed equally. Community would expect to have similar recognition and valuation approaches as well. From the community perspective this does not matter whether the asset is legally owned by

the council or is controlled under peppercorn lease. In both cases community's perception is that council manages both types of assets and keeps control over them. For example, if council owns a community hall and leases the courthouse, then community would expect to see both of them in the council's accounts under similar recognition and measurement principles.

We can still classify School of Arts as right-of-use assets separately to the normal assets but the approach to recognition and measurement should be similar. If this will be different then it will make our financial statements unfair.

Part II - Exposure Draft questions

Question 1

Do you agree with the proposed temporary option for not-for-profit entities to not measure right-of-use assets at initial recognition at fair value for leases with significantly below-market terms and conditions principally to enable the entity to further its objectives ('peppercorn leases')?

Council response:

We would prefer permanent option not to measure right-of-use assets at initial recognition at fair value. It is not because of the inability to measure restrictions but because we will be able to avoid significant unrealised income from recognition. This is the one-off paper based income which does not reflect the operations of the council. Furthermore, we stand for the **subsequent measurement at fair value** with the effect through asset revaluation reserve within equity.

Question 3

Additional disclosure requirements are set out in the proposed paragraphs Aus59.1 and Aus59.2 of AASB 16 for application to peppercorn leases where the right-of-use assets are measured at cost rather than at fair value. In conjunction with the other disclosure requirements in AASB 16, would these additional disclosures provide adequate information for users to understand the effects on the financial position, financial performance and

Council response:

We do not believe that original as well as extra disclosures proposed by the Exposure Draft will be useful to the users of our financial statements. As mentioned above the assets managed by the council under peppercorn leases are long-term with high level of certainty of extension or long-term use. This is due to the specialised nature of the assets which are held for the benefit of the community. This makes the right-of-use assets similar in nature to other community assets owned by the council. We believe that for these assets disclosure in the Accounting Policy Note and separate classification as "right-of-use assets" on the accounts would be more than enough.