Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Private Sector Financial Reporting Framework**	**Meeting:**	M184
Topic:	**Tier 3 – Leases**	**Agenda Item:**	7.3
		Date:	26 October 2021
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Objective of this paper

1 The objective of this staff paper is for the Board to **decide** its preliminary views on Tier 3 reporting requirements for a not-for-profit (NFP) private sector entity's leases other than concessionary leases[1] for inclusion as part of a discussion paper (DP).

Background and reasons for bringing this paper to the Board

2 At its 4 August 2021 meeting, the Board decided to consider the classification, recognition and measurement requirements concerning leases for NFP private sector entities at a future meeting. Addressing leases as part of a DP recognises the complexity of the accounting requirements in AASB 16 *Leases* and on expectation that it is common for a smaller NFP private sector entity to be a lessee. Developing preliminary views in this regard will help the Board obtain feedback on whether its proposed views should be further developed as part of a future Exposure Draft.

3 Note, staff have not addressed related lease disclosures in any detail as part of this paper. Staff think this is contingent on the Board's preliminary view on Tier 3 lease recognition and measurement accounting policies and in acknowledgement of the discussion paper stage of the Board project. However, staff have assumed that some disclosure about an entity's lease arrangements would be warranted regardless of the Board's decision on lease recognition and measurement policy; e.g. a general description of the entity's significant leasing arrangements.

4 The Not-for-Profit Private Sector Financial Reporting Framework Project Summary provides an overview of the Board's tentative decisions to date in respect of the project.

1 Consideration of the treatment of concessionary leases is excluded from the scope of this paper in order to first focus Board attention on leases occurring on arm's-length terms between parties. Also, the Board is considering the accounting for concessionary leases under Tier 1 and Tier 2 reporting requirements as part of Agenda Item 11 at this meeting (refer Agenda Paper 11.2). Pending the Board's decision in relation to that paper, staff will bring a paper to a future Board meeting to consider any Tier 3 impact.

Structure of this paper

5 This paper is structured as follows:

(a) summary of staff recommendations (paragraphs 6 – 7);

Current accounting requirements and whether there is a reason for the Board to address

(b) current requirements under Australian Accounting Standards (paragraphs 8 – 15);

(c) summary of approaches taken by selected other jurisdictions (paragraphs 16 – 20);

(d) feedback from Australian stakeholders (paragraphs 21 – 26);

(e) findings from academic research and other literature (paragraphs 27 – 31);

(f) findings from staff review of a sample of financial statements (paragraphs 32 – 35);

Considering options for simplification and staff analysis

(g) options for simplification (paragraphs 36 – 41);

(i) recognition of leases (Table 1);

(ii) measurement of leases (Table 2);

(h) evaluation of options against the Tier 3 principles (paragraph 42);

Staff recommendations

(i) recognition of leases (paragraphs 43 – 46); and

(j) measurement of leases (paragraph 47).

Summary of staff recommendations

6 Staff recommend that the Tier 3 reporting requirements for leases (other than concessionary leases) should require a lessee (lessor) to:

(a) recognise only the lease expense (income) associated with the leasing arrangement, supplemented by disclosure of information about the entity's lease commitments; and

(b) measure that lease expense (income) 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.

7 No right-of-use (ROU) asset or corresponding lease liability is recognised. The lease does not need to be further classified.

Current requirements under Australian Accounting Standards

AASB 16 Leases – high-level summary

8 AASB 16 specifies non-symmetrical recognition requirements for lessees and lessors. There are no NFP private sector-specific requirements, other than for concessionary leases.[2]

9 **Lessees** are required to recognise a right-of-use asset and lease liability at the commencement date of the lease, other than for short-term leases and leases of low-value assets. For these types of leases, the lease payments associated with the leasing arrangement are recognised as

2 AASB 16 includes Aus paragraphs to address the accounting for concessionary lease arrangements including additional disclosures if the lease asset is initially recognised at cost, to scope out leases in a service concession arrangement, and to scope in in-substance leases (other than leases of intellectual property) of NFP public sector licensees.

an expense on either a straight-line basis over the lease term or another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

10 In the case of leases other than those of a short-term nature and for low-value assets, the lessee is required to:

(a) initially measure the right-of-use asset at cost, and subsequently measure it by applying a cost model (or other measurement model permitted under the Australian Accounting Standard applicable to the underlying asset); and

(b) initially measure the lease liability at the present value of the lease payments that are not paid at the commencement date and subsequently adjust it for interest accretion and lease payments. Whether or not a variable lease payment is included in the measurement of the lease liability depends on the specific term. The carrying amount of the lease liability is adjusted as necessary to reflect changes to the lease payments, lease modifications and revised in-substance fixed lease payments.

11 **Lessors** are required to classify a lease as either an operating lease or a finance lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise, it is classified as an operating lease. Lessors have different recognition and measurement requirements depending on the classification of the lease. Broadly:

(a) Finance lease: A lessor derecognises the asset under a finance lease at the commencement date of the lease. A lease receivable is recognised instead, initially measured at an amount equal to the net investment in the lease, and subsequently adjusted for rents received and interest accretion. Finance income is recognised over the lease term for accretion of interest associated with that lease receivable.

(b) Operating lease: A lessor continues to account for the asset under lease in accordance with the specific Australian Accounting Standard applying to that asset. Lease payments receivable are recognised as income on a straight-line basis, or another systematic basis where this is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

12 Any lease incentives received by a lessee are reflected by the lessee as a reduction in the cost of its right-of-use asset and the fixed lease payments forming part of the measurement of its lease liability. Lease incentives are recognised by the lessor as a reduction to the fixed payments forming part of the measurement of the net investment in the lease.

13 Any initial direct costs incurred by a lessee are recognised as part of the cost of the right-of-use asset. Initial direct costs incurred by a lessor in a finance lease are, in most circumstances, included in its initial measurement of the net investment in the lease; reducing the amount of income the lessor recognises over the lease term. Initial direct costs incurred by a lessor in an operating lease are added to the carrying amount of the underlying asset and recognised as an expense over the lease term on the same basis as the lease income.

AASB 1060 General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities – Tier 2 disclosures

14 In addition to a general description of the entity's significant leasing arrangements and other information:

(a) lessees, and lessors in a lease classified as an operating lease, complying with AASB 1060 are required to disclose the total of the future lease payments at the end of the reporting period by specified time-banded period;

(b) a lessor in a lease classified as a finance lease that complies with AASB 1060 must disclose:

(i) a reconciliation between the gross investment in the lease at the end of the reporting period and the present value of lease payments receivable at the end of the reporting period; and

(ii) their gross investment in the lease and the present value of lease payments receivable at the end of the reporting period, by specified time-banded period.

15 The time band disclosures above are not required of entities preparing Tier 1 general purpose financial statements that comply with AASB 16 in its entirety.

Summary of approaches taken by selected other jurisdictions

16 Unlike AASB 16, several of the jurisdictions analysed for the purposes of this staff paper[3] (IFRS for SMEs, UK FRS 102, UK FRS 105, UK Charities SORP, Singapore CAS, HK SME-FRF & SME-FRS) require <u>both</u> lessees and lessors to classify a lease as either a finance lease or operating lease, using a risk-and-rewards model (i.e. similar to the superseded AASB 117 *Leases*). Broadly:

(a) a lessee in a finance lease recognises a lease asset and lease liability. The lease asset is initially measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. The lease liability is initially measured at the present value of the minimum lease payments, and subsequently adjusted for rents received and interest accretion. The treatment of certain variable lease payments varies from that specified by AASB 16 – consequently, the resultant recognised amount might differ from that determined under AASB 16;

(b) a lessee in an operating lease does not recognise a lease asset and lease liability. The lessee recognises its lease payments as an expense over the lease term on a straight-line basis, unless another systematic basis is more representative of the pattern of the lessee's benefit. Any lease incentives are similarly recognised over the lease term;

(c) a lessor accounts for the lease in the same manner as AASB 16;

(d) lease incentives are recognised by lessees in an operating lease as a reduction in the expense incurred over the lease term on a straight-line basis. Lease incentives are recognised by lessors in an operating lease as a reduction in the income recognised over

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3 For the purposes of this staff paper, the NFP lease requirements for the following jurisdictions were considered:

(a) International Financial Reporting Standard for Small and Medium-sized Entities (*IFRS for SMEs*);

(b) New Zealand Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit) (NZ PBE SFR – A (NFP))

(c) Financial Reporting Standard 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (UK FRS 102);

(d) Financial Reporting Standard 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* (UK FRS 105);

(e) Canada Accounting Standards for Not-for-Profit Organisations (Canada ASNFPO);

(f) Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (UK Charities SORP);

(g) Singapore Charities Accounting Standard (Singapore CAS);

(h) Hong Kong Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (HK SME-FRF & SME-FRS); and

(i) Financial Accounting Standards Board Accounting Standards Codification 842 (FASB ASC 842).

the lease term on a straight-line basis (note: *IFRS for SMEs* does not specify requirements for the treatment of lease incentives for lessees or lessors); and

(e) initial direct costs are treated in the same manner as AASB 16.

17 In contrast to AASB 16 and other jurisdictions, New Zealand's PBE SFR – A (NFP) does not require:

(a) the classification of leases according to the substance of the transaction (i.e. all leases are treated the same); nor

(b) a lessee to recognise assets under a lease. Similarly, there are no specific 'lease' requirements for a lessor for the assets that it has leased out.

Instead, the requirements applicable to NZ Tier 3 entities simply require lessees to recognise lease expense when the cost is incurred. Lessors are required to record lease receipts as income on a straight-line basis over the term of the agreement unless another systematic basis is representative of the time pattern of the user's benefit.

18 Also, in contrast to AASB 16 and other jurisdictions, the Canada ASNFPO and US ASC 842 specify a different classification of leases for lessees and lessors. Despite the different classification categories, the recognition and measurement requirements that apply under US ASC 842 are broadly in-line with those specified by IFRS 16.[4] The Canada ASNPFO leasing requirements regarding recognition and measurement for lessees and lessors are largely consistent with those in the superseded AASB 117 and the majority of other jurisdictions (see paragraph 16).

IASB Review of IFRS for SMEs

19 Staff note that the IASB is currently undertaking a second comprehensive review of its *IFRS for SMEs Standard*. As part of its project, the IASB sought feedback on whether IFRS 16 requirements, with simplifications, should be introduced. In addition to the mixed feedback received from respondents to the approach suggested in its Request for Information, when recently discussing possible approaches the update could take, its advisory body, the SME Implementation Group (SMEIG), had mixed views as to whether the Standard should be updated to reflect the accounting specified by IFRS 16 *Leases*, with simplifications. Specifically:

(a) some SMEIG members considered that applying IFRS 16 would not be burdensome; while

(b) other members supported maintaining the existing *IFRS for SMEs* recognition and measurement requirements, but to improve the disclosures required of operating leases entered into. These members were of the view that such an approach would meet the needs of users of the financial statements, tailor for the costs and recognise SME capabilities, and be true to the objective of the *IFRS for SMEs*.

A third approach discussed was to extend, for lessees, the accounting for finance leases currently specified by the *IFRS for SMEs* to all leases (i.e. bring all leases on to the statement of financial position but possibly with slightly different requirements to IFRS 16).

20 No IASB decisions relating to the *IFRS for SMEs* update for leases have been made at the time of writing this paper.

4 However, US ASC 842 requires lessees to recognise interest and amortisation expense only for finance leases, while only a single lease expense is recognised for operating leases, typically on a straight-line basis.

Feedback from Australian stakeholders

21 As part of the targeted outreach conducted by staff in 2020, staff received feedback that stakeholders supported the Board developing 'a simpler balance sheet'. Amongst other aspects, staff understood this to extend to stakeholder support for simpler recognition and measurement requirements. In addition, at the AASB NFP Project Advisory Panel meeting on 18 May 2021,[5] panel members provided the following initial feedback in relation to possible Tier 3 accounting simplifications for leases:

(a) that NFP preparers would prefer to recognise the periodic lease expense in profit or loss. Some panel members noted that Tier 3 NFP preparers and users generally do not understand the outcomes of applying AASB 16 (and faced difficulty with application). Members questioned whether the recognition of operating leases "on-balance sheet" (as required by AASB 16) was helpful for users of Tier 3 financial statements;

(b) that measurement of the lease liability could be simplified by allowing a lessee to measure the right-of-use asset at the nominal value of the minimum lease payments; and

(c) that identification of an appropriate interest rate is challenging as NFP entities do not generally borrow. Panel members considered the Board should develop proposals for simplification of the reporting requirements in this regard.[6]

22 The AASB NFP Project Advisory Panel discussed leases in more detail at its 18 October 2021 meeting. At this meeting, in contrast to the feedback from the earlier meeting, several panel members expressed a clear preference for the Board to develop requirements that mirror AASB 16, with simplifications. Only one panel member indicated (reserved) support for not recognising any leases on-balance sheet. One further member supported requirements that reflect a AASB 117 approach, or even simpler accounting.

23 Some members observed that users of AASB 16 accounting may not understand fully the accounting specified by AASB 16 or that it may create complexity for acquittal reporting. However, reasons given in support of a AASB 16 approach included:

(a) caution against diverging from the approach considered by the IASB for small-and-medium sized entities;

(b) protection of the integrity of the balance sheet, considering that the AASB (and IASB) have, under the *Conceptual Framework for Financial Reporting*, determined that it is appropriate to recognise a liability for leases. A member noted practical wind-up issues that have arisen in the past as a consequence of not recognising such liability for at least the non-cancellable portion of a lease; and

(c) concern at future transition costs for entities that might in the future apply Tier 2 or Tier 1 reporting requirements.

24 The possible form AASB 16 simplifications could take was not discussed at any length. However, AASB 16 requirements regarding the lease term and applicable discount rate were raised as areas of complexity. Other areas for simplification included whether the use of

5 Refer Agenda paper 3.4 *Not-for-Profit Project Advisory Panel minutes from 18 May 2021 meeting* from the 20-21 June 2021 AASB meeting.

6 Panel members also observed that the Board should revisit the accounting for concessionary leases, including whether a lease asset should be recognised at a nominal amount or at fair value (resulting in a donation difference to be recognised). As noted in footnote 1, the Board is considering the accounting for concessionary leases under Tier 1 and Tier 2 reporting requirements in Agenda Paper 11.2. Pending the Board's decision in relation to that paper, staff will bring a paper to a future Board meeting to consider any Tier 3 impact.

nominal values should be permitted and whether the Board should extend or clarify the AASB 16 exemptions for low-value and short-term leases. A Board member who attended the panel meeting observed that the Board could develop simplification requirements that differed from those that the IASB might develop as part of its review of the *IFRS for SMEs*.

25 In addition, during the ACNC Sector and Advisor Forums held during October 2021, staff received mixed feedback on potential Tier 3 accounting simplifications for leases. One view asserted that on-balance sheet recognition of operating leases contributes to user confusion in understanding the financial statements. Another participant was concerned at the cost to entities of diverging from a AASB 16 approach, noting that some entities have previously invested time and money into implementing AASB 16. Changing the requirements from AASB 16 would be a waste of the entity's investment. A preparer participant shared their view that AASB 16 should not be applicable to medium-sized charities, given that the Standard has been "painful" for large charities, requiring a relatively significant cost for the comparably little-to-no benefit and skewed entity reporting positions. Several participants agreed that disclosures would be crucial should Tier 3 reporting requirements remove lease assets and lease liabilities from the balance sheet.

26 Staff have also received informal feedback from partners of a Large National Networks audit firm reflecting some support for the Board permitting smaller Australian NFP private sector lessees to recognise lease expense as the cost is incurred, rather than developing an approach consistent with superseded AASB 117.

Findings from academic research and other literature

27 *Implementing AASB 16 Leases: Are Preparers Ready?* (Davern, M., Gyles, N., Hanlon, D. & Shah, F., 2019)[7] provides a snapshot of the process of implementation of AASB 16 *Leases* by preparers. The findings of this report suggest that, although entities had made relatively good progress in implementing the Standard and were largely in agreement with the benefits of on-balance sheet recognition of leases, there were a number of challenges faced as a result of the greater complexity in AASB 16 requirements. Specifically, based on the results of a survey, preparers indicated that:

(a) the significant additional data required to be captured, and the establishment of systems to generate such data, were key complexities associated with the implementation of the new Standard; and

(b) the most challenging specific aspects of AASB 16 include the identification of leases, determination of an appropriate discount rate and determination of the lease term.

Overall, the findings of the report suggested that there are a number of inherent challenges associated with the implementation of AASB 16, which may be especially costly for smaller entities, including NFPs.

28 Staff are aware of an Australian research study currently being conducted on users information needs of NFP general purpose financial statements.[8] Though the study is yet to be finalised and published, staff understand that it is expected to communicate the research participants' view that:

(a) having comparability between like entities is important. Factors identified as impairing comparability included having accounting policy choices and subjectivity in applying accounting requirements; and

7 Published by CPA Australia, 2019.

8 This research study will be presented at the AASB November 2021 Virtual Research Forum.

(b) users are unlikely to read the notes to the financial statements.

Concerning leases for NFP entities, the preliminary findings of this research indicate that AASB 16 is uniformly identified as overly complex and of limited value in a NFP context. Furthermore, the study highlights concerns that the complexity of AASB 16 may reduce the impact of the overall financial report.

29 Staff are additionally aware of an Australian research study currently being conducted which aims to assess the impact of AASB 15 and AASB 16 on the NFP sector. Though the study is yet to be finalised and published, staff understand that it is expected to communicate research participants' views that:

(a) the challenges associated with the implementation of AASB 16 have been specifically high among NFP entities;

(b) the effort that went into implementing AASB 16 and then explaining it to the members of NFP entities was very difficult, particularly in relation to the on-balance sheet recognition of leased assets and liabilities;

(c) NFP entities had difficulty in finding the right team or professional to prepare accounts in compliance with AASB 16 without considerable errors; and

(d) there are concerns that the value AASB 16 brings to end-users in the NFP sector may not justify the significant increase in costs associated with compliance.

30 Staff additionally note that a survey was conducted by the CAANZ in September 2020[9] that gauged members' views on the impact of the recently implemented new accounting standards, including IFRS 16. Whilst the survey was not specific to NFP entities, the findings of this survey suggest that, although IFRS 16 has improved the quality and comparability of financial information, it has also imposed significant additional costs on stakeholders, including:

(a) greater complexity for preparers, potentially jeopardising the ability to prepare reports in a timely fashion; and

(b) reduced understandability for users of financial statements.

Callouts in the publication reporting on the survey included the following:

"IFRS 15 & 16 have significantly increased internal work loads and doesn't translate to increased value from a business perspective" (preparer feedback)

"More consideration needs to be given to the users of financial statements, including the non-financial people. The removal of "rent" on property leases doesn't make sense to non financial people and it is impossible to explain in a way that makes sense." (user feedback)

"IFRS 16 is too broad in [its] application and I can understand the likes of users of large equipment and aircraft through leases needing to disclose this and account for this as prescribed but I see no benefit at all in application to property rental\leases." (preparer feedback)

31 Staff have not identified any further academic research, AASB research or other literature that provides useful input to the staff analysis, including findings providing support or otherwise for the reporting requirements for a NFP private sector entity's lease arrangements.[10] Staff will continue to consider whether there is other academic literature relevant to the topic.

9 See the 2020 Chartered Accountants IFRS Survey, available on the CAANZ website.

10 The IFR4NPO Consultation Paper discusses the accounting for concessionary leases, but that is outside the scope of this paper.

Findings from staff review of a sample of financial statements

32 Staff reviewed a random non-representative sample (20) of the 2020 financial statements of entities with reported revenues between $500,000 – $3 million to gain an understanding of the prevalence of the use of leases by entities of this size.[11] The financial statements reviewed included both those described as general purpose financial statements and those described as special purpose financial statements. The staff findings are summarised below:

Observation (out of a sample size of 20 financial reports)	**No.**
Entity is a lessee	15
Entity asserts compliance with AASB 16	9
Entity recognises rental expense for assets that do not appear to be leased in a short-term lease or be of low value in nature, or asserts compliance with AASB 117	6
Entity leases premises	15
Entity does not recognise a right-of-use asset in relation to the leased premises (including those acquired in a concessionary lease)	10
Entity described the lease of premises as a concessionary leases	2
Entity's assets include identifiable capitalised leasehold improvements	7
Entity's liabilities include a make good provision	1
Entity is a lessor[12]	2
Entity does not appear to be either a lessee or lessor	4
Unable to establish whether entity is party to a lease arrangement	1

33 Other than premises, other leased assets in the sampled entities included vehicles, photocopiers and telecommunication equipment. In addition, several financial statements referred to "assets leased in short-term or leases of low value" without identifying the nature of these assets. From our sample, the only underlying asset that was leased out (entity as lessor) was premises.

34 The financial statements reviewed generally communicated information about the type of asset under lease, but in most cases did not include any detail about the length of the entity's lease contracts. Consequently, the future periods in which the entity is committed to making lease payments is not conveyed to users.

35 The staff review suggests that smaller NFP private sector entities are likely to lease assets (i.e. it is a common transaction), and possibly, more typically:

(a) in operating lease type arrangements;

(b) for assets that are not AASB 16 "low value" assets; and

(c) for lease terms that are not considered "short-term".

11 The sample set is the same as that considered in the September 2021 staff paper on Tier 3 reporting requirements for changes in accounting policies, accounting estimates and errors.

12 Both lessors in the sample are also lessees.

Options for simplification

36 With reference to the flowchart in Agenda Paper 7.1 (Appendix A) [13] for this meeting on approaches to simplification, staff have identified the following options for recognition (and related classification and measurement) simplification for Tier 3 reporting requirements:[14]

(a) Option 1: lessees and lessors to apply AASB 16 recognition (and related classification and measurement) requirements, with simplifications. As reflective of the project stage, the 'actual' simplifications need not be determined at this time.[15]

(b) Option 2: lessees and lessors to recognise lease payments as an expense or income.

Staff have analysed Option 1 and Option 2 in Table 1 below. The staff analysis takes into consideration current practice in Australia and international jurisdictions, feedback received from stakeholders, and the findings summarised in paragraphs 27 to 35 above.

37 Further, under Option 2, the periodic rental expense (income) could be measured on:

(a) a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit; or

(b) at the amount of the periodic payment made (i.e. cost). Under the latter approach, rather than being 'smoothed', any initial direct costs will be recognised as incurred and the benefit of an upfront lease incentive will be recognised in the period of receipt (e.g. a rental holiday will be reflected by a nil expense during the rental holiday period).

Staff have analysed the possible measurement criteria options in Table 2 below.

Other possible options for simplification

38 Staff observe that there are other possible simplification alternatives that the Board could consider, including specifying AASB 117-type accounting requirements or a version of Option 2 that requires leases to be classified into different categories so as to allow for different

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13 The primary objective of Tier 3 reporting requirements is to develop simplified requirements for financial reporting that meet the needs of users for smaller NFP entities. The flowchart outlines the approach staff will take when developing simplification options against this objective and the agreed principles when forming the staff recommendation on the Tier 3 reporting requirements.

14 In suggesting these Approaches, staff had regard to the Board's approach to simplification as agreed at its August 2021 meeting. Approach 1 and Approach 2 demonstrate simplification in areas of:

(a) recognition and measurement (criteria are less subject to judgement and/or easier to apply);

(b) interpretation (requirements are easier to interpret, as less subject to management discretion); and

(c) understandability (requirements result in reporting outcomes that can be easily understood or explained to users).

15 However, for reference, examples to simplify IFRS 16 for small-and-medium sized entities contemplated by the IASB in its *Request for Information: Comprehensive Review of the IFRS for SMEs Standard* were:

(a) permitting the option to use a discount rate by reference to market yields on high-quality corporate bonds if the interest rate implicit in the lease and the lessee's incremental borrowing rate cannot be readily determined;

(b) changing the definition of 'lease term' to 'the non-cancellable period for which an entity is required to comply with the lease'. Any subsequent extension to the lease term then would be accounted for as a new lease;

(c) simplifying requirements for subsequent measurement and reassessment of the lease liability by requiring a lease to be remeasured in the event of a substantive change in the term of the contract. The effect of any other change would be reflected in the income statement in the period of the change;

(d) retaining the IFRS for SMEs finance lease disclosures; and

(e) simplifying the language of the Standard.

disclosure requirements to be specified. Considering the incremental value of other possible approaches for the staff analysis and recommendations, staff have not further analysed other possible alternatives.

39 Although staff acknowledge that an accounting treatment consistent with that of the former AASB 117 would facilitate comparability with similar-sized NFP entities operating in other jurisdictions and ensure that lease transactions which result in the substantial transfer of risks and rewards incidental to ownership of the asset involved are recognised on-balance sheet (and therefore considered by users in their economic decision making), staff have not put forward such an approach for the following reasons:

(a) this approach could be regarded as a backward step, as both Australia and the IASB have moved away from the AASB 117 'two model' accounting approach;[16]

(b) such an approach is arguably no more understandable or helpful to users than the accounting required by AASB 16;

(c) having different accounting models for operating vs. finance leases may result in economically similar transactions being accounted for in different ways, and consequently, information asymmetry; and

(d) the AASB 117 ‘risk and rewards’ model can be similarly complex to apply and can be subject to structuring to achieve a desired accounting result.

40 The following tables analyse the options to recognition criteria (and related classification and measurements) mooted above:

16 Staff note that compared to AASB 16, the AASB 117 accounting model is regarded as being less consistent with the *Conceptual Framework for Financial Reporting*.

Table 1*: Summary of possible options and analysis for Tier 3 – recognition*

Possible option for Tier 3 – Recognition criteria	Support for the Option	Arguments against the Option
Option 1: Lessors and lessees to apply AASB 16 recognition (and related classification and measurement) requirements, with simplifications Lessees recognise lease assets (right-of-use asset) and lease liabilities for all leases unless a short-term or low-value exemption applies. Lessors recognise a lease receivable for finance leases and finance income over the lease term, based on a pattern that reflects a constant periodic rate of return on its net investment in the lease. Lessors recognise lease payments from operating leases as income on a straight-line basis, or if more representative, another systematic basis.	• Greater transparency and comparability around NFP entities' financial position and financial leverage. • More faithful representation of the entity's assets and liabilities. Under the *Conceptual Framework for Financial Reporting*, the AASB (and IASB) have determined that it is appropriate to recognise a liability for leases to ensure the integrity of the balance sheet. • Leases appear to be a common and possibly material transaction for smaller NFP entities and, therefore, users benefit from more complete information on them to inform their decision making. • Allows for easier consolidation of the entity into a parent entity preparing Tier 1 or Tier 2 financial statements. • The financial reporting obligations of some NFP private sector entities are dependent on their size. In some cases, the size threshold test is dependent on the quantum of the entity's assets.[17] As such, maintaining largely consistent recognition and measurement requirements for leased assets helps avoid confusion in determining the entity's financial reporting obligations.	• Some feedback suggests that accounting practitioners are concerned that the recognition of leases on the balance sheet by a lessee may not be understood by users of Tier 3 financial statements, and consequently, is not helpful/useful. • Unnecessarily complex and potentially impractical for smaller entities to apply, especially where the entity is both a lessee and lessor.[19] • May impose disproportionate costs (e.g. valuation costs, education costs, effort required) on preparers, as leases are more likely to be material to the financial statements of smaller entities (and consequently the accounting requirements cannot be departed from on materiality grounds). • The underlying implementation issues and their associated costs may not be fully known prior to completion of the Post-Implementation Review of IFRS 16. As AASB 16 is a relatively new Standard, there might be standard-setting costs incurred to maintain equivalent Tier 3 accounting requirements for consistency with AASB 16 when amendments are made to AASB 16. Otherwise, there will be complexity through (non-simplification) inconsistency between the requirements applying to Tier 3 entities and other entities.[20]

17 For example, the governing state legislation requires a cooperative to be classified as small or large depending on whether the entity meets at least two of set threshold criteria on revenue, gross assets, and employee numbers.

19 Staff note that in addition to the asymmetrical accounting requirements, the supplementary material accompanying the 37-page AASB 16 includes 41 pages of IFRS 16 Illustrative Examples and 5 related IFRS IC agenda decisions.

20 Staff note that there are currently 4 active IFRS 16 related projects on the IFRS Foundation's work program, and 10 IFRS 16-related completed projects since issue of the IFRS Standard.

Possible option for Tier 3 – Recognition criteria	Support for the Option	Arguments against the Option
(Similar to the approach mooted by the IASB in its *Request for Information: Comprehensive Review of the IFRS for SMEs Standard*)	• Arguably more consistent with the existing AASB 16 requirements and the approach considered by the IASB to update the IFRS for SMEs Standard. • Avoids costs of introducing substantially different accounting requirements from AASB 16 in this regard, including costs of: o educating preparers; o transitioning to other reporting tiers (i.e. Tier 1 or Tier 2); and o maintaining a different set of requirements to those for other reporting tiers. • Depending on the simplifications adopted, could provide a good balance of benefits vs. costs, as it may require only some, but not all, lease arrangements to be brought on to the balance sheet. • The accounting requirements specified by some other jurisdictions[18] provide support for the argument that the same accounting model for leases should apply to smaller entities.	• The relevance of information of a lessee recognising assets typically leased by NFP entities for a period shorter than its useful life (e.g. premises) and the corresponding liability is less significant to users compared to other aspects of the financial statements (and could be supplemented by disclosures). • For lessees, this approach impedes the comparability of the financial statements compared to that of a similar-sized entity in another jurisdiction. • Lessees may make operational decisions that are not necessarily in their best interests to take advantage of the short-term exemption from on-balance sheet recognition of a lease. • Less consistent with the Board's agreed Tier 3 principles, as management are less likely to actively manage leases at this level in smaller entities, especially for standard leases of office space or motor vehicles. • IFRS 16 was developed with larger entities in mind. Consequently, requiring it be applied to smaller entities may inadvertently result in the AASB interpreting IFRS (e.g. through extension of understanding of 'low value' or other developed guidance).
Option 2: Lessees and lessors to recognise lease payments as an expense or income Entities treat all leases in a manner akin to that currently required for	• Significantly simplified requirements compared to the existing AASB 16 and superseded AASB 117, which is in keeping with the Board's objective for this project. • Arguably could provide more useful information, as some feedback suggests that accounting treatments that differ from AASB 16 may improve user understandability of NFP entities'	• The non-recognition of a lease asset and lease liability may represent a loss of important information for users that might not be fully alleviated through lease disclosures, especially for leases that involve use of the lease asset for most of its useful

18 For example, UK FRS 105, which applies to 'micro entities' requires entities to apply the same lease accounting model as UK FRS 102, which applies to its larger (but not publicly accountable) entities. Similarly, HK SME-FRF & SME-FRS requires entities to apply similar lease accounting as that specified by *Hong Kong Financial Reporting Standard for Private Entities*, which applies to entities larger than those entitled to apply HK SME-FRF & SME-FRS.

Possible option for Tier 3 – Recognition criteria	Support for the Option	Arguments against the Option
leases classified as an 'operating lease' (i.e. leases are off-balance sheet, and no right-of-use asset or corresponding lease liability is recognised). Instead, an expense or income is recognised for the periodic lease payment. The recognition treatment is supplemented by disclosure of information about the entity's lease commitments. The lease does not need to be further classified. Measurement is considered in Table 2. (Similar to the approach adopted by NZ PBE SFR – A (NFP))	financial statements, and therefore the usefulness of those financial statements. The preliminary feedback suggests users generally do not understand the outcomes of applying AASB 16. • Imposes fewer costs on preparers compared to Option 1, including reduced costs of: ○ preparation (by eliminating the need to determine the amounts of lease-related assets and liabilities, and any related depreciation and unwind of discount); ○ the transition from SPFS to GPFS (by more closely mirroring the current accounting applied by part of the smaller NFP entity population); ○ education (by significantly simplifying requirements); and ○ ongoing maintenance. • Reduces complexity for preparers by eliminating the judgement required to determine whether a lease entered into by an NFP entity is an operating lease or a finance lease. • The 'riskiness' of 'misrepresenting' the assets and liabilities held by not recognising leases on-balance sheet is likely to be low as the (albeit limited) staff research suggests that the majority of NFP entities are unlikely to 'use up' their predominant underlying asset (as leases are typically for premises). • Facilitates trans-Tasman comparability, as this approach harmonises with New Zealand Tier 3 recognition requirements. • Enhances comparability between Tier 3 entities by requiring the same treatment for all types of leasing arrangements entered into.	life or for which the entity has a 'real' obligation imposed by early termination penalties.[21] • Could be viewed as less transparent as this approach fails to provide a 'complete' picture of the entity's underlying financial position, especially for assets for which there has been a substantial transfer of the risks and rewards incidental to ownership. • A 'backward step' for entities that have recently implemented AASB 16. • Will impact comparability against entities in different reporting tiers as this requirement would be unique to Tier 3. • A Tier 3 subsidiary may be required to identify the AASB 16 accounting for consolidation, resulting in a 'double cost' of preparation. • May lead to confusion when applying size threshold tests for determining an entity's financial reporting obligations. It may not be clear whether an entity determines assets by reference to AASB 16 requirements or to Tier 3 reporting requirements that do not require the recognition of leased assets on the balance sheet. Additional costs may be incurred to amend legislation for clarity. • Having different accounting requirements makes it more difficult for auditors and preparers to move between different sized entities. • Less consistent with Tier 2 accounting principles compared to Option 1. • Respondent feedback to the IASB Request for Information suggests SMEs are not likely to use leasing to avoid showing financial liabilities on the balance sheet, but merely just to

21 Staff note that some jurisdictions require lessees smaller than those contemplated by the Board to recognise lease assets and lease liabilities for their finance leases.

Possible option for Tier 3 – Recognition criteria	Support for the Option	Arguments against the Option
	• Recognition approach is symmetrical between the lessee and lessor, reducing complexity for preparers and users. • Likely to be more consistent with how management internally monitors their lease impact compared to Option 1. • It appears to be unlikely that there are many, if any, lessors that enter into a leasing arrangement that would be classified as a 'finance lease', therefore, it is questionable whether having two accounting models for lessors is unnecessarily creating complexity for preparers (via the inclusion in a future Standard of requirements that might not commonly apply).	obtain access to a financing option, complementary to traditional bank loans.

41 As noted in paragraph 37 above, staff think that under Option 2 there is an opportunity for simplification with respect to the measurement criteria for the periodic lease expense/income. Table 2 below analyses the two options considered by staff:

Table 2 ***Summary of possible options for measurement of leases under Option 2***

Possible option for Tier 3 – Measurement criteria	Support for the Option	Arguments against the Option
Option 2A: Measure lease expense/income 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 Similar to the approach adopted for operating leases by the following: • IFRS for SMEs • UK FRS 102 / 105	• Provides useful economic information for users by reflecting the lessee's usage of the leased asset consistently over the lease term to capture the consumption of the underlying benefits associated with the asset. • Enables NFP preparers to identify and utilise the measurement basis most representative of the time pattern of the benefits associated with the leased asset. • While more complicated than Option 2B, the requirement is relatively straightforward to apply. In many cases, for shorter-term leases and smaller lessees who are less likely to be able to obtain non-standard terms, the result under Option 2B and	• May be unnecessarily complex for some smaller preparers within the range contemplated by the Board, even though the result is arguably more faithfully representative of the entity's 'expense' for a period.

Possible option for Tier 3 – Measurement criteria	Support for the Option	Arguments against the Option
• Singapore CAS • HK SME-FRF & SME-FRS and the accounting by NZ PBE SFR – A (NFP) for lessors.	this approach is likely to be the same (i.e. preparer costs under this approach may not be significantly greater compared to Option 2B). • Consistent with operating lease measurement for lessors specified by AASB 16 and the superseded AASB 117.	
Option 2B: Measure lease expense/income at the amount of the periodic payment made to the lessor Similar to the approach adopted by NZ PBE SFR – A (NFP) for lessees.	• Simple to apply – no interpretation ambiguity. • Reduces the cost of preparation of the financial statements (as the rental expense will simply be the periodic rental payments to the lessor). • In many cases, as the result under Option 2A and this approach is likely to be the same, this approach removes the apparent complexity in the accounting requirement. • Arguably provides users with relevant information, as the benefits of a rental holiday or other lease incentive, if any, is reflected in the period the benefit is provided. While not as faithfully representative of the entity's lease contract in its entirety, this information may be sufficient for users of Tier 3 financial statements.	• The timing of lease payments may not necessarily represent the time pattern of the lessee's consumption of the value of the leased asset. • Will impact the comparability of financial statements against entities in other reporting tiers, and possibly create consolidation issues, as this requirement would be applicable only to entities applying Tier 3 reporting requirements. • Less consistent with existing accounting requirements and may be seen as a step backwards for entities that currently comply with AASB 16 recognition and measurement policies.

Evaluation of options against the Tier 3 principles

42 With reference to the flowchart in Agenda Paper 7.1 (Appendix A) for this meeting, in addition to the analysis in the tables above, staff also analysed each of the proposed options against the tentative Tier 3 principles previously agreed to by Board members. Staff consider that the proposed options are broadly equally aligned with the Tier 3 principles, with the exception of those listed below:

Principle	**Discussion**
Accounting requirements do not impose disproportionate costs on preparers when compared to the benefits of the information	Even with simplifications to AASB 16 (such as those discussed as part of the IASB's *IFRS for SMEs* Review project), Option 1 is more likely to impose greater costs on preparers compared to Option 2 as leases are more likely to be material to the financial statements of smaller entities (and consequently, the more complex accounting requirements must be met and need to be understood).
Consistency with the accounting principles specified by Tier 2: Australian Accounting Standards – Simplified Disclosures is desirable, but might not always be warranted, since Tier 3 requirements are being developed as a proportionate response to the costs incurred by certain entities whilst still meeting the needs of users of the financial statements for this cohort of entities	Even with simplifications to AASB 16 (such as those discussed as part of the IASB's *IFRS for SMEs* Review project), Option 1 is arguably more consistent with the Tier 2 accounting requirements for leases, while Option 2 *prima facie* significantly departs from the Tier 2 requirements (although the accounting outcomes may be similar, depending on the asset leased). However, the benefits to users of adopting Option 1 may not outweigh its costs in the form of increased complexity imposed on both preparers and users of NFP entities' financial statements as staff's research to date (including stakeholder feedback received) suggests that users do not understand or find helpful the on-balance recognition of leases. Additionally, Option 2A is consistent with the Tier 2 measurement requirements for lessors with operating leases, while Option 2B is inconsistent with the Tier 2 measurement requirements. However, neither Option 2A nor 2B is expected to impose disproportionate costs on preparers of NFP entities' financial statements.

Staff recommendations

Recognition of leases (and related classification and measurement)

43 On balance, staff support Option 2. That is, that the proposed Tier 3 reporting requirements should require lessees and lessors to recognise lease payments as an expense or income. Staff consider that requiring a lessee and lessor to recognise only lease expense (income) is an appropriate proportionate response in recognition of the smaller size of Tier 3 entities and their resource constraints when considered against AASB 16-type requirements which even

larger entities may find challenging to apply. Staff were persuaded to their view by the following considerations:

(a) while AASB 16 is more consistent with the *Conceptual Framework for Financial Reporting*, requiring AASB 16 treatment, even with simplification, will impose more complex requirements on smaller lessees compared to their international counterparts for little additional useful information to users. Besides the costs of understanding and applying AASB 16 recognition and measurement requirements, staff note the underlying predominant asset held under lease by Tier 3 NFP entities (premises) would generally not be recognised on-balance sheet by international counterparts who adopt policies akin to AASB 117 or simply recognise the lease rentals when incurred. The non-recognition of leases on the balance sheet will significantly level the playing field for Australian reporters through simplification of the leasing requirements for NFP preparers while providing relevant information to users who have previously indicated that they do not understand the financial statement outcomes of applying AASB 16;

(b) introducing requirements that could significantly shift the gross asset position of entities in a manner that imposes more financial reporting obligations on the entity is inconsistent with red tape reduction. This is manageable but will involve costs of either clarifying or changing the affected legislation. Staff do not currently have a good understanding of how many entities are likely to be impacted by such a change but note that the number may not be large as, other than property, many of the lease assets held by Tier 3 NFP entities (e.g. photocopier and telephony) are likely to be of the ilk contemplated by the IASB as being of 'low value' and consequently, as permitted under the AASB 16 exception, treated in a similar manner as in Option 2. Staff note that Option 1 is likely to put the Board into the position of having to interpret “low value” for smaller entities; and

(c) the compliance costs for lessee-preparers for the majority of Tier 3 entities are unlikely to outweigh the benefits to users of its financial statements of having the on-balance sheet information accorded under Option 1, especially when the leased asset in question is property (the predominant asset held under lease by Tier 3 NFP entities, as suggested by the sample financial statements considered).

44 Staff note that the Board has previously observed that an entity of the Tier 3 size contemplated by the Board should be able to prepare Tier 1 or Tier 2 general purpose financial statements if it elects to do so. Consequently, any Tier 3 subsidiary entities needing to consolidate may determine to prepare such financial statements instead.[22]

45 Staff note the concern that allowing entities to effectively continue a current special purpose financial statement accounting policy for leases could be regarded as the Board not doing enough to raise the quality of the financial statements. However, on consideration of the types of assets leased, and having regard to the ‘net’ financial statement impact of on-balance sheet lease recognition, staff consider that the accounting under either approach will provide similar results. In staff’s view, fulsome disclosure of an entity’s lease commitments provides users with more understandable and hence more useful information, compared to its lease recognition and measurement policies. Also, staff note that the quality of entity reporting overall will be improved as the project outcomes are expected to include more entities being

22 At its 8-9 September 2021 meeting, the Board decided to seek feedback as part of the discussion paper whether to allow an entity preparing Tier 3 financial statements to opt-up to the accounting policies permitted under Tier 1 or Tier 2 reporting requirements for the topics covered by Tier 3 requirements. The Board decided not to form a preliminary view in this regard for the purposes of the discussion paper.

required to apply the same accounting policy to their leasing arrangements – improving the comparability of the financial statements of different entities.

46 Staff additionally note that the IASB is currently in the process of contemplating how to align the *IFRS for SMEs* Standard with IFRS 16, including possible simplifications (consistent with Option 1 put forward in this staff paper). While the IASB has tentatively decided to develop proposed amendments using IFRS as the starting point, it has not yet made any decisions on leases. An exposure draft is not expected before the second half of 2022.[23] As such, staff consider that there is a degree of uncertainty around the benefits versus costs of this approach, whereby, despite potential simplifications, AASB 16 may be too complex and challenging for users and preparers to understand and apply. Furthermore, as the IASB is yet to determine the simplifications to IFRS 16 for application by small-to-medium sized entities, any simplifications adopted in Australia in the meantime may not necessarily be consistent with that of the IASB in the future. Finally, there is not a specific need for alignment with the IASB in this regard as the *IFRS for SMEs* Standard has not been adopted in Australia.

Question for Board members

Q1 Do Board members support, for the discussion paper, the staff recommendation that Tier 3 reporting requirements for leases (other than concessionary leases) should require a lessee (lessor) to recognise only lease expense (income), supplemented by disclosure of information about the entity's lease commitments (Option 1)?

If not, what approach do Board members support?

Measurement of leases (only relevant if Option 2 is supported)

47 On balance, staff support Option 2A, being to require entities to measure the lease expense/income 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. While recognising an expense/income equivalent to the actual lease payment/receivable may be closer to how the entity manages the arrangement (i.e. Option 2B), staff support Option 2A because staff consider that any additional costs of this approach would be, for a majority of entities, unlikely to exceed the benefits to users of having information that more accurately depicts the cost to the lessee (benefit to the lessor) of the consumption of the economic benefits associated with the asset.

Question for Board members

Q2 Do Board members support, for the discussion paper, the staff recommendation that Tier 3 reporting requirements for leases (other than concessionary leases) should require a lessee (lessor) to measure the lease expense (income) on a straight-line basis over the term of the lease unless another systematic basis is more representative of the time pattern of the user's benefit (Option 2A)?

If not, what approach do Board members support?

23 See Agenda Paper 4A, SME Implementation Group meeting 9 September 2021, available on the IASB website.