Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Income of Not-for-Profit Entities**	**Meeting:**	M168 (November 2018)
Topic:	**Relief for NFP lessees from fair valuing ROU assets in peppercorn leases**	**Agenda Item:**	8.1
Contact(s):	Patricia Au 03 9617 7621 pau@aasb.gov.au Meina Rose 03 9617 7622 mrose@aasb.gov.au Kala Kandiah 03 9617 7626 kkandiah@aasb.gov.au	**Project Priority:** **Decision-Making:** **Project Status:**	High High Pre-Ballot Draft

Objective of this paper

1 In this paper, staff ask the Board to decide:

- whether relief from fair valuing right-of-use (ROU) assets in peppercorn leases of private sector NFP lessees is warranted under the circumstances outlined in paragraphs 16–28;
- whether similar relief should be extended to public sector NFP lessees; and
- if appropriate, approve one of the four pre-ballot drafts in Agenda Papers 8.2–8.5.

Reason for the Board to consider this issue at this meeting

2 NFP lessees would be required to measure a ROU asset arising from their ‘peppercorn leases’ at fair value when AASB 1058 *Income of Not-for-Profit Entities* and AASB 16 *Leases* become effective from 1 January 2019. The decisions that the Board will make at this meeting will determine whether NFP lessees would need to apply this requirement when the Standards become effective.

3 At present, many NFP lessees do not recognise leased assets from peppercorn leases in accordance with AASB 117 *Leases*, and AASB staff have received feedback that many NFP preparers are having difficulties determining the fair value of the ROU assets arising from these leases to comply with the requirements in AASB 16.

4 The financial reporting thresholds of NFP private sector entities are likely to be revised as a result of the ACNC Legislative Review recommendations, and it is possible that the Board might consider introducing a third tier of financial reporting requirements in the future with simplified recognition and measurement requirements for entities at the lower level of the reporting threshold (agenda item 10 of this meeting will be discussing this matter). If this happens, some of the NFP private

sector entities that would need to apply AASB 16 from next year and fair value their peppercorn leases may in the future be exempted from these requirements.

5 The NFP public sector entities have similar issues as the NFP private sector in relation to fair valuing ROU assets in peppercorn leases. It was also noted that the majority of peppercorn leases are leases of assets with restrictions. The valuation of assets with restrictions, including valuation of ROU assets with restrictions, has been raised as a major issue to be addressed in the *Fair Value Measurement for Public Sector Entities* project, as there is currently diversity in how these restrictions are considered in arriving at the fair value of public sector assets, which are generally held for delivery of service to the public and not to generate cash flows.

6 The Board has directed staff to prioritise developing examples in the form of frequently asked questions (FAQs) to help entities in the NFP sector (private and public sector) apply the requirements in AASB 16 to initially fair value ROU assets in peppercorn leases. Staff are in the process of gathering feedback on the issues that need to be addressed in these FAQs. However, staff's preliminary observation is that the issues related to fair valuing ROU assets with restrictions might not be something that could be addressed through the publication of FAQs as it is likely to require more research and consultation and possibly some specific guidance. This would need to be developed as part of the broader *Fair Value Measurement for Public Sector Entities* project.

Summary of staff recommendations

7 For NFP private sector lessees, staff recommend temporarily relieving them from initially measuring ROU assets arising from <u>all</u> (existing and new) peppercorn leases at fair value until such time that the future reporting thresholds and reporting requirements for NFP private sector entities are finalised or somewhat bedded down. This would prevent these entities from having to incur costs and changes in systems and processes to comply with the requirements in AASB 16 to initially fair value ROU assets when it is possible that most of these entities might not be required to apply these requirements in the future (refer to paragraphs 16–28 for more details).

8 For NFP public sector entities, given the prevalence of the issues relating to the valuation of restricted assets in the public sector, staff recommend that similar relief be extended to them until such time that examples and/or guidance have been developed to assist these entities in measuring ROU assets with restrictions as part of the *Fair Value Measurement for Public Sector Entities* project (refer to paragraphs 29–37 for more details).

9 Staff note that disclosures about the terms and conditions of peppercorn leases may provide sufficient information to users about the financial impact of peppercorn leases (refer to paragraphs 20–21 for more details).

Questions to the Board:

Q1: Does the Board agree to provide temporary relief for private sector NFP lessees from initially measuring ROU assets in peppercorn leases at fair value until such time that the future reporting thresholds and reporting requirements for these entities are finalised or somewhat bedded down, and until further guidance has been developed to assist NFP entities in measuring ROU assets in peppercorn leases at fair value? [at paragraphs 25–28]

Q2: Does the Board agree to extend the temporary relief to NFP public sector entities until further guidance has been developed to assist NFP entities in applying AASB 16 and AASB 13 *Fair Value Measurement* requirements to measure ROU assets in peppercorn leases at fair value? [at paragraphs 36–37]

Q3: Does the Board agree with the Staff recommendation to temporarily relieve NFP lessees from initially measuring ROU assets arising from all (existing and new) peppercorn leases at fair value until such time that the future reporting thresholds and reporting requirements for private sector NFP entities are finalised or somewhat bedded down and until further guidance has been developed to assist NFP entities in measuring ROU assets in peppercorn leases at fair value? [Refer to Agenda Paper 8.2 and paragraphs 38–40]

Q4: Does the Board agree with staff's proposed next steps to expose a Fatal Flaw Review version of the proposed Amending Standard for public comments with a short comment period of 21 days? [at paragraphs 43–45]

Structure of this paper

10 This staff paper is set out as follows:

(a) Background (paragraphs 11–15)

(b) Why provide temporary relief from the requirement to fair value ROU assets in peppercorn leases for NFP private sector lessees (paragraphs 16–19)

(c) Disclosures of peppercorn leases (paragraphs 20–21)

(d) Pros and cons of providing temporary relief from fair valuing ROU assets in peppercorn leases to NFP private sector lessees (paragraphs 22–28)

(e) Should similar relief be extended to NFP public sector lessees (paragraphs 29–32)

(f) Pros and cons of providing temporary relief from fair valuing ROU assets in peppercorn leases to NFP public sector lessees (paragraphs 33–37)

(g) Extent of relief (paragraphs 38–40)

(h) Pre-Ballot drafts of proposed Amending Standard (paragraphs 41–42)

(i) Next steps (paragraphs 43–45)

(j) Appendix A: Practical challenges faced by NFP lessees and previous decisions made by the Board

(k) Appendix B: AASB 16 transitional requirements for NFP entities [for reference only]

(l) Appendix C: Extracts from Basis for Conclusions for AASB 1058 [for reference only]

Attachments

Agenda Paper 8.2	Pre-ballot draft of Amending Standard – Alternative 1A (complete Standard)
Agenda Paper 8.3	Pre-ballot draft of Amending Standard – Alternative 1B (amendment section)
Agenda Paper 8.4	Pre-ballot draft of Amending Standard – Alternative 2A (amendment section)
Agenda Paper 8.5	Pre-ballot draft of Amending Standard – Alternative 2B (amendment section)

Background

11 AASB 1058 *Income of Not-for-Profit Entities* and AASB 16 *Leases* are effective for annual reporting periods beginning on or after 1 January 2019. AASB 1058 made amendments to AASB 16, which require NFP lessees to recognise a right-of-use (ROU) asset that is initially measured at fair value for a lease that has significantly below-market terms and conditions principally to enable the entity to further its objectives. The amendments to AASB 16 are presented in Appendix B to this paper, in the context of the relevant AASB paragraphs.

12 For ease of reference, in this paper, leases that have "significantly below-market terms and conditions principally to enable the entity to further its objectives" are referred to as "peppercorn leases". Staff note that the term "peppercorn lease" is generally used to describe a lease that has nil or nominal amount of rent payment; however, for the purpose of this paper, the staff's proposals also apply to leases with more than a nominal amount of rent, but where the lease payments are significantly below market value principally to enable the entity to further its objectives.

13 At present, many NFP lessees do not recognise leased assets and lease liabilities from peppercorn leases. This is because, assuming minimum lease payments are negligible, under AASB 117 *Leases*:

- a lessee under an operating lease does not recognise a leased asset or a lease liability; and
- no material asset or liability would be recognised by the lessee under a finance lease as the present value of minimum lease payments is negligible[1].

14 Stakeholders[2] from both NFP private sector and NFP public sector have expressed concerns that valuing previously unrecognised peppercorn leases on adoption of AASB 16 would be a costly exercise. In addition many NFP entities in both the private and public sector are having difficulties determining the fair value of the ROU assets in peppercorn leases, for example due to restrictions related to the leases or the underlying assets and the specialised nature of the underlying assets (refer to Appendix A for more details of the practical issues faced by NFP entities in applying this requirement).

15 Staff are in the process of gathering feedback on this matter to develop examples in the form of frequently asked questions (FAQs) to help NFP entities with the requirements in AASB 16 and AASB 13 *Fair Value Measurement* to measure ROU assets in peppercorn leases at fair value. Staff are also monitoring the IPSASB's *Public Sector Measurement* project, which is expected to consider fair value measurement issues as well.

[1] AASB 117 paragraph 20 requires a lessee, at commencement of the lease term, to recognise a finance lease asset and an equivalent lease liability measured at the lower of the fair value of the leased asset and the present value of the minimum lease payments.

[2] Stakeholders include preparers in the NFP private sector, accounting firms with NFP private sector clients, the AASB's Fair Value Project Advisory Panel, and ACAG's Financial Reporting and Accounting Committee.

Why provide temporary relief from the requirement to fair value ROU assets in peppercorn leases for NFP private sector lessees

16 As mentioned above, AASB 16 and AASB 1058 come into effect from 1 January 2019 and AASB staff have heard from a number of NFP private sector preparers and accounting firms with NFP private sector clients, through various outreach events with the sector, that many entities in this sector are having difficulties in determining the fair value of the ROU assets in peppercorn leases (refer to Appendix A for details of the practical issues faced by these entities).

17 If the reporting thresholds for the NFP private sector entities are revised in the future following the ACNC Legislative Review recommendations, and if the Board introduces a third tier of financial reporting requirements with simplified recognition and measurement requirements for entities at the lower level of the reporting threshold (agenda item 10 of this meeting will be discussing this matter), a significant number of private sector NFP entities that are currently required to comply with the recognition and measurement requirements in AASB 1058 and AASB 16 from 1 January 2019 might be exempted from those requirements in the future due to their size.

18 Staff consider that it would not be appropriate to require these entities to have to go through the process of fair valuing their ROU assets in peppercorn leases, incurring costs and making changes to their processes and systems, if many of these entities might not have to apply these requirements in the future.

19 Based on the above, staff think that there is merit in providing temporary relief to NFP private sector lessees from measuring ROU assets in peppercorn leases at fair value until the future financial reporting thresholds and financial reporting requirements for NFP private sector entities are finalised (or near final), and until further guidance has been developed to assist NFP entities with the requirements in AASB 16 and AASB 13 to fair value ROU assets in peppercorn leases.

Disclosures of peppercorn leases

20 AASB 1058 paragraph 23 requires preparers to disclose sufficient information to enable users of financial statements to understand the effects of transactions, such as peppercorn leases, where an entity acquires an asset for consideration that is significantly less than fair value principally to enable the entity to further its objectives on the financial position, financial performance and cash flows of the entity. In AASB 1058 paragraph 37 the Board encouraged preparers to make disclosures about the restrictions imposed on the use of assets.

21 Staff are of the view that temporarily not requiring NFP private sector lessees to initially measure ROU assets at fair value but maintaining the requirement to disclose information about peppercorn leases under paragraphs 23–37 of AASB 1058 could provide sufficient information to users of financial statements until such time that the relief recommended by staff in paragraph 19 above is revisited/removed. This is because to satisfy the requirements in AASB 1058 paragraph 23 entities would need to disclose as a minimum, the description of the leased asset, the terms and conditions of the lease and the associated cash flows.

Pros and cons of providing temporary relief from fair valuing ROU assets in peppercorn leases to NFP private sector lessees

22 Staff have considered the following pros and cons of providing temporary relief to NFP private sector lessees from valuing ROU assets arising from peppercorn leases at fair value. Staff are of the view that the pros outweigh the cons.

23 Arguments for providing temporary relief:

- Avoid undue costs and effort in complying with AASB 16's requirements to fair value ROU assets in peppercorn leases for NFP private sector entities that might be exempted from the requirements in the future due to possible changes in the reporting thresholds and reporting requirements for these entities.
- Reduce the cost of adopting AASB 16 and AASB 1058 for private sector NFP lessees until the future reporting thresholds and reporting requirements for these entities are finalised, which may increase NFP entities' uptake of preparing general purpose financial statements (GPFS).
- May prevent entities from changing to special purpose financial statements (SPFS) to avoid having to apply the requirements in AASB 16 to fair value ROU assets in peppercorn leases, even though arguably they should still comply with all recognition and measurement requirements of the Standards in order to give a true and fair view. This may also reduce the resistance against removing SPFS from the financial reporting framework for this sector.

24 Arguments against providing temporary relief:

- Private sector NFP entities that would be required to apply the AASB 16 requirements and fair value ROU assets in peppercorn leases at a later date, after any changes to the reporting thresholds and reporting requirements have been finalised, might find it more difficult to obtain the relevant information about their existing leases, due to the further lapse of time. It could arguably be more costly for them to apply the requirements compared to now.

Staff recommendation 1

25 Paragraph 28(d) of the *AASB's Not-for-Profit Entity Standard-Setting Framework* states that a justifiable circumstance for making NFP modifications to IFRS Standards include "undue cost or effort of preparing and disclosing information outweigh the benefits."

26 Staff are of the view that the costs and effort in determining the fair value of ROU assets in peppercorn leases outweigh the benefits in the NFP private sector, particularly when a significant number of entities in this sector are likely to be exempted from this requirement in the future when the reporting thresholds and reporting requirements are revised. As mentioned in paragraphs 20–21 above, staff are of the view that maintaining the requirement to disclose information about peppercorn leases under paragraphs 23–37 of AASB 1058 could provide sufficient information to users of financial statements until such time that the relief recommended by staff in this paper is revisited/removed.

27 Staff also consider, given the prevalence and magnitude of the issues raised by the entities in the NFP sector, that more standard setting work needs to done to address the difficulties highlighted by entities in this sector (as per paragraph 24(d) and 24(g) of the *AASB's Not-for-Profit Entity Standard-Setting Framework*), as part of the broader *Fair Value Measurement for Public Sector Entities project*.

28 Therefore, staff recommend granting temporary relief for NFP private sector lessees from the requirement to measure ROU assets in peppercorn leases at fair value until such time that the future reporting thresholds and reporting requirements for these entities are finalised or somewhat bedded down, and until further guidance has been developed to assist NFP entities in implementing the requirements.

Question to the Board:

Q1: Does the Board agree to provide temporary relief for private sector NFP lessees from initially measuring ROU assets in peppercorn leases at fair value until such time that the future reporting thresholds and reporting requirements for these entities are finalised or somewhat bedded down, and until further guidance has been developed to assist NFP entities to initially fair value ROU assets in peppercorn leases?

(Staff analysis of the extent of the relief is discussed below)

Should similar relief be extended to NFP public sector lessees

29 Staff have received informal feedback from the Financial Reporting and Auditing Committee (FRAC), a sub group of the Australasian Council of Auditors General (ACAG), as well as from the Fair Value Project Advisory Panel that NFP public sector lessees are encountering difficulties in applying the requirements of AASB 13 in determining the fair value of non-financial assets, particularly assets with restrictions and specialised assets. As a consequence, these entities are also having difficulties fair valuing the right-of-use of these restricted assets. Further details of these practical issues are set out in Appendix A.

30 Staff note that the Board has directed staff to prioritise developing examples in the form of frequently asked questions (FAQs) to help entities in the NFP sector (private and public sector) apply the requirements in AASB 16 to initially fair value ROU assets in peppercorn leases. Staff is in the process of gathering feedback on the issues that need to be addressed in the FAQs. However, staff's preliminary observation is that the issues related to fair valuing ROU assets with restrictions might not be something that could be addressed through the publication of FAQs. It is likely to require more research, consultation and possibly some specific guidance, which would need to be developed as part of the broader *Fair Value Measurement for Public Sector Entities* project.

31 In accordance with the *AASB's Not-for-Profit Entity Standard-Setting Framework* (paragraph 24(d) and 24(g)), given the magnitude and prevalence of restricted assets in peppercorn lease arrangements in the public sector and the difficulties expressed by constituents in this sector in fair valuing these ROU assets, staff consider there is merit in also granting temporary relief to NFP public sector entities from fair valuing ROU assets in peppercorn leases until staff have progressed further in the *Fair Value Measurement for Public Sector Entities* project and further guidance is developed to assist NFP entities in applying the requirements in AASB 16 and AASB 13 to fair value ROU assets in peppercorn leases.

32 Staff note that the IPSASB has a *Public Sector Measurement* project, and an exposure draft relating to public sector measurement is expected to be released in the near future. This might provide guidance on fair valuing public sector assets, including valuing assets with restrictions, assets held for public service and specialised assets. Staff will continue monitoring the developments in this project and consider how this may assist with the AASB's *Fair Value Measurement for Public Sector Entities* project.

Pros and cons of providing temporary relief from fair valuing ROU assets in peppercorn leases to NFP public sector lessees

33 Staff have considered the following pros and cons of providing temporary relief to NFP public sector lessees from fair valuing ROU assets in peppercorn leases. Staff are of the view that the pros outweigh the cons.

34 Arguments for providing temporary relief:

- Providing the relief until such time that further guidance is developed as part of the *Fair Value Measurement for Public Sector Entities* project, would help avoid:
    - diversity in practice on how ROU assets are initially fair valued; and
    - undue costs and effort incurred by preparers trying to get their auditors and valuers on the same page in relation to valuing these assets;
- If the Board agrees with Staff recommendation 1 above to temporarily relieve NFP private sector entities from fair valuing ROU assets in peppercorn leases, extending the relief to NFP public sector entities will result in more comparable financial statements between the two sectors.

35 Arguments against providing temporary relief:

- The longer the lapse of time, this might increase the difficulty for entities to obtain the relevant information about their existing peppercorn leases. It may then be more costly for entities to apply the requirements compared to now.

Staff recommendation 2

36 Based on the above, staff recommend temporarily relieving NFP public sector entities from initially measuring ROU assets in peppercorn leases at fair value until further guidance has been developed to assist NFP entities in applying AASB 16 and AASB 13 requirements to initially fair value ROU assets in peppercorn leases.

37 Similar to the NFP private sector entities, staff are of the view that maintaining the requirement to disclose information about peppercorn leases under paragraphs 23–37 of AASB 1058 (as mentioned in paragraphs 20–21 of this paper) could provide sufficient information to users of financial statements until such time that the relief recommended by staff in this paper is revisited/removed.

Question to the Board:

Q2: Does the Board agree to extend the temporary relief to NFP public sector entities until further guidance has been developed to assist NFP entities in applying AASB 16 and AASB 13 requirements to initially fair value ROU assets in peppercorn leases?

(Staff analysis of the extent of the relief is discussed below)

Extent of relief

38 Staff considered two alternatives for providing temporary relief to NFP lessees from initially measuring ROU assets at fair value arising from peppercorn leases until such time that the future reporting thresholds and reporting requirements for NFP private sector entities are finalised or somewhat bedded down, and until further guidance has been developed to assist NFP entities in initially fair valuing ROU assets in peppercorn leases:

- Alternative 1 – Temporarily relieve NFP lessees from initially measuring ROU assets arising from all peppercorn leases at fair value (that is, temporarily exempt NFP lessees from applying the Australian amendments in AASB 16 arising from AASB 1058); or

- Alternative 2 – Temporarily relieve NFP lessees from initially measuring ROU assets arising from existing peppercorn leases, entered into prior to the initial application of AASB 16, at fair value. This would allow NFP lessees to apply the Australian amendments in AASB 16 arising from AASB 1058 prospectively from the date of initial application of AASB 16, requiring them to initially measure at fair value ROU assets arising only from new peppercorn leases entered into after AASB 16 becomes effective.

39 Staff's assessment of the advantages and disadvantages of the two alternatives are outlined in the table below.

Alternative	Advantages	Disadvantages
Alternative 1 Temporarily relieve NFP lessees from initially measuring ROU assets arising from all peppercorn leases at fair value	*Advantages for all NFP lessees:* • Addresses stakeholders' concerns about determining the fair value of ROU assets arising from existing and new peppercorn leases. • Reduced costs and effort in determining fair value of ROU assets in peppercorn leases, until further guidance on AASB 16 and AASB 13 has been developed to assist NFP entities measure ROU assets in peppercorn leases at fair value. *Advantages for NFP private sector lessees:* • Avoid having private sector NFP lessees at the lower thresholds incurring costs and making changes to their systems and processes to initially measure any ROU assets at fair value when they might be exempted from this requirement in future as a result of future changes to their reporting requirements. • Reduces resistance to preparing GPFS as a result of having to apply AASB 16, until such time that the future reporting thresholds and reporting requirements for these entities are finalised.	*Disadvantages for all NFP lessees:* • When the temporary relief is removed, there might be some backtracking by those entities that would need to comply with this requirement in AASB 16 in the future, including some large private sector NFP entities, and it would become more difficult for these entities to get the information for their leases the longer the time lag before they apply the requirements.

Alternative	Advantages	Disadvantages
Alternative 2 Temporarily relieve NFP lessees from initially measuring ROU assets arising from <u>existing</u> peppercorn leases, entered into prior to the initial application of AASB 16, at fair value	*Advantages for all NFP lessees:* • Addresses stakeholders' key concern about determining fair value of ROU assets in existing peppercorn leases. • New peppercorn leases will be measured at fair value, which would reflect the economic substance of new peppercorn leases in the financial statements. *Advantages for NFP private sector lessees:* • Would reduce the amount of work that would need to be done by those entities that would need to apply AASB 16 when the future reporting thresholds and reporting requirements for NFP private sector entities are finalised.	*Disadvantages for all NFP lessees:* • Financial statements would not be comparable and users might find it confusing that new and existing peppercorn leases are accounted for differently. It might create more confusion in the future, when the relief is revisited/removed, when those peppercorn leases entered into prior to FY2019 are remeasured to fair value. *Disadvantages for NFP private sector lessees:* • NFP private sector entities at the lower reporting thresholds would incur costs in setting up systems and processes to measure the fair value of new peppercorn leases when they may not be required to apply these requirements in the future.

Staff recommendation 3

40 Staff consider Alternative 1 would be a better approach to provide temporarily relief from the requirements in AASB 16 to initially fair value ROU assets in peppercorn leases as it would avoid NFP private sector entities incurring costs to implement systems and processes to comply with the requirements when a significant number of these entities might be exempted from them in the future. It would also reduce costs and effort in determining fair value of ROU assets in all peppercorn leases, until further guidance on AASB 16 and AASB 13 has been developed to assist NFP entities measure ROU assets in peppercorn leases at fair value. In addition, it would be less confusing for users of financial statements as all peppercorn leases of NFP lessees will be measured/remeasured under the same method, thus creating more comparable financial statements than if Alternative 2 was applied.

Question to the Board:

Q3: Does the Board agree with Staff recommendation of adopting Alternative 1 to temporarily relieve NFP lessees from initially measuring ROU assets arising from <u>all</u> (existing and new) peppercorn leases at fair value until such time that the future reporting thresholds and reporting requirements for NFP private sector entities are finalised or somewhat bedded down and until further guidance has been developed to assist NFP entities in initially measuring ROU assets in peppercorn leases at fair value?

Pre-Ballot Drafts of proposed Amending Standard

41 Staff have prepared four versions of pre-Ballot Draft Amending Standards, as follows:

- Alternative 1A – Relieve NFP entities in both the private sector and the public sector from initially measuring ROU assets arising from all peppercorn leases at fair value (see Agenda Paper 8.2).
- Alternative 1B – Relieve NFP entities in the private sector only from initially measuring ROU assets arising from all peppercorn leases at fair value (see Agenda Paper 8.3).
- Alternative 2A – Relieve NFP entities in both the private sector and the public sector from initially measuring ROU assets arising from existing peppercorn leases, entered into prior to the initial application of AASB 16, at fair value (see Agenda Paper 8.4).
- Alternative 2B – Relieve NFP entities in the private sector only from initially measuring ROU assets arising from existing peppercorn leases, entered into prior to the initial application of AASB 16, at fair value (see Agenda Paper 8.5).

42 Staff are seeking Board approval of one of the versions of pre-ballot Draft Amending Standard provided to the Board, subject to Board's decision in Question 1, Question 2 and Question 3 above.

Next steps

43 AASB 1058 and AASB 16 are effective for annual reporting periods beginning on or after 1 January 2019. If the Board agrees with Staff recommendations 1 and 2 – to provide temporary relief for NFP lessees in the private sector and the public sector from initially measuring ROU asset in peppercorn leases at fair value – an Amending Standard would need to be released prior to 1 January 2019, being the effective date of these Standards.

44 Staff propose exposing a Fatal Flaw Review version of the Amending Standard for public comments, with a short comment period of 21 days. The short comment period is justified as the proposal is to provide temporary relief rather than introducing new requirements.

45 The table below provides a draft timeframe of the due process.

Date/meeting	Task
13 November 2018 (Board meeting)	Approve Ballot Draft Fatal Flaw
14 November 2018	Issue Fatal Flaw for comments with 21 days comment period (comments due 5 December 2018)
5–12 December 2018	Staff to collate comments and prepare ballot draft Amending Standard
12–19 December 2018	Board to consider comments on Fatal Flaw and vote on ballot draft Amending Standard out-of-session
20 December 2018	Final Standard issued

Question to the Board:

Q4: If the Board approves one of the four versions of pre-ballot Draft Amending Standard in paragraph 41, the timing to finalise the Standard before the end of 2018 would be tight. Does the Board agree with staff's proposed next steps in paragraphs 43–45 to expose a Fatal Flaw Review version of the proposed Amending Standard for public comments with a short comment period of 21 days?

Appendix A: Practical challenges faced by NFP lessees and previous decisions made by the Board

This Appendix outlines the practical challenges NFP lessees are facing and previous decisions made by the Board regarding the transitional provisions of peppercorn leases.

Practical challenges faced by NFP lessees

Restrictions imposed on the use of the lease asset could make it difficult to identify the fair value of the ROU asset

46 Often peppercorn leases have restrictions imposed on the use of the lease asset (such as a leased building must be used to operate a school) which could make it difficult to accurately determine the fair value of the ROU asset without engaging a professional valuation expert.

47 Short-cut methods, such as market rentals applicable to similar assets in the same or neighbouring region but that do not have restrictions on use, are considered by some to be an inappropriate proxy for the fair value of the ROU asset. If short-cut methods are used to determine the fair value of ROU assets, some consider that the resulting financial information may not necessarily be comparable between entities.

48 Restrictions in use do not only pose challenges to the valuation of ROU assets, but also in determining the fair value of assets that are owned by the entity. At the December 2017 Board meeting[3], the Board noted feedback from the Fair Value Project Advisory Panel that highlighted a few areas where public sector entities are having issues applying the requirements in AASB 13. 'Restrictions on assets' was determined to be one of the most important issues that needs to be addressed in the *Fair Value Measurement for Public Sector Entities* project.

49 Even though public sector entities have been applying the fair value/revaluation model in recognising their non-financial assets for many years, staff are aware that there is currently significant diversity in practice on how restrictions are treated in the valuation of such assets. For example, there are different views on:

- how the 'highest and best use' concept is applied to assets that are used to provide community services;
- the types of costs to be factored into the 'current replacement cost' calculation;
- the factors to consider when determining discount rates;
- whether there are 'market participants' for assets with restrictions in use; and
- how to determine the relevant market participants for assets with restrictions.

The same issues apply to the valuation of ROU assets that are associated with leases of restricted assets under peppercorn leases.

[3] December 2017 Board meeting (M161) Action Alert.

Long-term peppercorn leases and leasing of specialised assets

50 Some NFP lessees have long-term peppercorn leases (eg 99 year leases) and leasing of specialised assets which are not common in the for-profit sector. These entities have difficulty determining the fair value of the ROU assets associated with these leases without the use of valuation experts, which could be quite costly. In addition, there is diversity in views on the valuation approach for these assets.

Private sector NFP lessees not having the skills and financial capabilities to determine fair value of ROU assets

51 Many private sector NFP lessees do not have the skills and financial capabilities to determine the fair value of the right of use of an asset arising from peppercorn leases. This becomes even more prevalent for smaller organisations that rely to a large extent on volunteers. Staff note that all charities with annual revenue of more than $250,000 will have to apply the new fair value measurement requirements from 1 January 2019 (unless the ACNC thresholds are amended by then, which is unlikely).

52 Even though the Board noted that AASB 1058 does not require the use of valuation experts (AASB 1058 paragraph BC29(c)), it has been brought to staff's attention that in many cases auditors might seek input from valuation experts to obtain sufficient appropriate audit evidence to determine whether management's estimate of the fair value of the ROU asset is reasonable (ASA 540 paragraph 6).

Previous decisions made by the Board

53 The Board had previously considered whether to grandfather peppercorn leases for NFP entities when finalising AASB 1058. An extract from the Basis for Conclusions for AASB 1058 in relation to this decision is contained in Appendix C for the Board's information.

54 The Board decided to relieve NFP entities from revisiting the accounting that previously applied on initial recognition of assets acquired at nil or nominal amount or significantly less than fair value[4]. However, the Board decided not to provide such transition relief to assets acquired in peppercorn leases. The Board made this decision having considered the following:

- the Board was concerned that the financial position of a NFP entity may be misrepresented, and about the lack of comparability between entities regarding peppercorn leases entered into before and after adoption of AASB 1058[5];

- the Board expected an entity to have undertaken fewer transactions involving leases and that the terms and conditions of these transactions to be clearly identifiable, compared to acquisitions of other assets at a discount to fair value[6];

- a lessee may not have recognised an amount in its statement of financial position in respect of the ROU asset in an operating lease[7]. This is in contrast to other assets acquired for significantly less than fair value which are already recognised (generally at cost on initial recognition) in the statement of financial position. The Board further noted that there is

[4] AASB 1058 paragraph BC147.
[5] AASB 1058 paragraph BC153.
[6] AASB 1058 paragraph BC149.
[7] AASB 1058 paragraph BC149.

unlikely to be any deferred income to recognise in future periods in accordance with AASB 1058 in relation to these assets[8];

- the Board acknowledged there will be increased costs associated with measuring ROU assets at fair value arising from peppercorn leases. However, the Board noted that AASB 1058 only requires measuring ROU assets at fair value at initial application, and not on an ongoing basis, and that the use of valuation experts is not mandatory. The Board was of the view that the identified benefits exceeded the cost of the revised requirements, as these requirements better reflect the value transferred to the lessee[9].

[8] AASB 1058 paragraph BC147.
[9] AASB 1058 paragraphs BC28 and BC29(c).

Appendix B: AASB 16 transitional requirements for NFP entities

This appendix contains paragraphs of AASB 16 stating the transitional requirements, including amendments arising from AASB 1058 as outlined in Appendix D "Amendments to other Standards" of AASB 1058.

AASB 1058 amended AASB 16 Leases (February 2016) – Paragraph Aus25.1 and, in Appendix C, paragraphs AusC5.1, AusC5.2, AusC8.1 and AusC11.1 are added to AASB 16, as included below.

Initial measurement of the right-of-use asset

23 At the commencement date, a lessee shall measure the right-of-use asset at cost.

24 The cost of the right-of-use asset shall comprise:

(a) the amount of the initial measurement of the lease liability, as described in paragraph 26;
(b) any lease payments made at or before the commencement date, less any lease incentives received;
(c) any initial direct costs incurred by the lessee; and
(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

25 A lessee shall recognise the costs described in paragraph 24(d) as part of the cost of the right-of-use asset when it incurs an obligation for those costs. A lessee applies AASB 102 *Inventories* to costs that are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories during that period. The obligations for such costs accounted for applying this Standard or AASB 102 are recognised and measured applying AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*.

Aus25.1 Notwithstanding paragraphs 23–25, where the lessee is a not-for-profit entity and the lease has significantly below-market terms and conditions principally to enable the entity to further its objectives, the right-of-use asset shall initially be measured at fair value in accordance with AASB 13 *Fair Value Measurement*. AASB 1058 *Income of Not-for-Profit Entities* addresses the recognition of related amounts.

Transition – Lessees

C5 A lessee shall apply this Standard to its leases either:

(a) retrospectively to each prior reporting period presented applying AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
(b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application in accordance with paragraphs C7–C13.

AusC5.1 Not-for-profit entities applying this Standard retrospectively in accordance with paragraph C5(a) to leases that at inception had significantly below-market terms and conditions principally to enable the entity to further its objectives shall:

(a) measure the right-of-use asset at fair value;
(b) measure the lease liability in accordance with this Standard; and
(c) recognise any related items in accordance with paragraph 9 of AASB 1058 *Income of Not-for-Profit Entities*.

Any income arising shall be recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of the earliest prior period presented.

AusC5.2 Notwithstanding paragraph AusC5.1, not-for-profit entities that adopted AASB 1058 in an earlier reporting period are not required to remeasure the fair value of the right-of-use asset arising from leases that (1) at inception had significantly below-market terms and conditions principally to enable the entity to further its objectives and (2) were previously classified as finance leases applying AASB 117. Instead, the entity shall transition those leases in accordance with paragraph C11, regardless of which transition option in paragraph C5 is applied.

C6 A lessee shall apply the election described in paragraph C5 consistently to all of its leases in which it is a lessee.

C7 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall not restate comparative information. Instead, the lessee shall recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

Transition – Leases previously classified as operating leases

C8 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall:

(a) recognise a lease liability at the date of initial application for leases previously classified as an operating lease applying AASB 117. The lessee shall measure that lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.

(b) recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying AASB 117. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:

(i) its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.

(c) apply AASB 136 *Impairment of Assets* to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient in paragraph C10(b).

AusC8.1 Not-for-profit entities applying this Standard retrospectively in accordance with paragraph C5(b) to leases that (1) at inception had significantly below-market terms and conditions principally to enable the entity to further its objectives and (2) were previously classified as operating leases applying AASB 117 shall:

(a) notwithstanding paragraph C8(b), measure the right-of-use asset at fair value at the date of initial application of this Standard;

(b) measure the lease liability in accordance with paragraph C8(a); and

(c) recognise any related items in accordance with paragraph 9 of AASB 1058.

Any income arising shall be recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of this Standard.

C9 Notwithstanding the requirements in paragraph C8, for leases previously classified as operating leases applying AASB 117, a lessee:

(a) is not required to make any adjustments on transition for leases for which the underlying asset is of low value (as described in paragraphs B3–B8) that will be accounted for applying paragraph 6. The lessee shall account for those leases applying this Standard from the date of initial application.

(b) is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in AASB 140 Investment Property. The lessee shall account for the right-of-use asset and the lease liability arising from those leases applying AASB 140 and this Standard from the date of initial application.

(c) shall measure the right-of-use asset at fair value at the date of initial application for leases previously accounted for as operating leases applying AASB 117 and that will be accounted for as investment property using the fair value model in AASB 140 from the date of initial application. The lessee shall account for the right-of-use asset and the lease liability arising from those leases applying AASB 140 and this Standard from the date of initial application.

C10 A lessee may use one or more of the following practical expedients when applying this Standard retrospectively in accordance with paragraph C5(b) to leases previously classified as operating leases applying AASB 117. A lessee is permitted to apply these practical expedients on a lease-by-lease basis:

(a) a lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

(b) a lessee may rely on its assessment of whether leases are onerous applying AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to performing an impairment review. If a lessee chooses this practical expedient, the lessee shall adjust the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application.

(c) a lessee may elect not to apply the requirements in paragraph C8 to leases for which the lease term ends within 12 months of the date of initial application. In this case, a lessee shall:

  (i) account for those leases in the same way as short-term leases as described in paragraph 6; and

  (ii) include the cost associated with those leases within the disclosure of short-term lease expense in the annual reporting period that includes the date of initial application.

(d) a lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

(e) a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

Transition – Leases previously classified as finance leases

C11 If a lessee elects to apply this Standard in accordance with paragraph C5(b), for leases that were classified as finance leases applying AASB 117, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying AASB 117. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this Standard from the date of initial application.

AusC11.1 Subject to paragraph AusC5.2 and notwithstanding paragraph C11, not-for-profit entities applying this Standard retrospectively in accordance with paragraph C5(b) to leases that (1) at inception had significantly below-market terms and conditions principally to enable the entity to further its objectives and (2) were previously classified as finance leases applying AASB 117 shall:

(a) measure the right-of-use asset at fair value at the date of initial application of this Standard;
(b) measure the lease liability in accordance with this Standard; and
(c) recognise any related items in accordance with paragraph 9 of AASB 1058.

Any income arising shall be recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of this Standard.

Appendix C: Extracts from Basis for Conclusions for AASB 1058

This appendix contains extracts from the Basis for Conclusions in AASB 1058 that explain the previous decisions made by the Board regarding peppercorn leases.

The Board decided to grandfather assets, other than lease assets, acquired at nil or nominal amount prior to initial application of AASB 1058

BC145 In ED 260, the Board proposed requiring an asset that has been acquired for consideration that is below market but that is more than nominal to be measured at fair value. The Board decided to finalise the proposal in issuing this Standard (other than with respect to inventory). However, the Board observed that an entity would not have previously applied AASB 1004 to these transactions, nor recognised any income on the transaction as the asset acquired will generally have been measured at the amount of the consideration transferred. Accordingly, in the absence of any transitional provisions, a not-for-profit entity will be required to apply the requirements of AASB 1058 retrospectively to such transactions, including determining the fair value (or, in respect of inventory, current replacement cost) of the asset on acquisition.

BC146 In its redeliberations, the Board considered that the costs of applying AASB 1058 retrospectively to all such assets would exceed the benefits of doing so, having regard to the need for an entity to identify and value such assets still existing at reporting date. Accordingly, the Board determined some form of transitional relief to be appropriate. The Board decided to consider transitional provisions for leases made on significantly below-market terms and conditions separately from any transitional provisions for other assets…

The Board decided not to grandfather peppercorn leases entered into prior to initial application of AASB 1058

BC147 With respect to assets other than lease assets, the Board decided not to require a not-for-profit entity to revisit the accounting that previously applied on initial recognition of these assets. The Board made this decision having regard to costs involved in identifying and measuring the various assets held on adoption of this Standard that may have been acquired at an amount that was more than nil or nominal, but significantly less than fair value, and the associated discount to fair value. The Board considered these costs to outweigh the benefits of retrospective application of the Standard, as these assets are already recognised (generally at cost on initial recognition) in the statement of financial position, and noting that there is unlikely to be any deferred income to recognise in future periods in accordance with this Standard.

BC149 The Board decided that the transitional relief for other assets need not be aligned with transitional relief for leases. In making this decision, the Board considered:

(a) the quantum of transactions involving a lease. The Board observed it expects an entity to have undertaken fewer transactions involving leases, and that the terms and conditions of these transactions to be clearly identifiable, compared to acquisitions of other assets at a discount to fair value; and

(b) that a lessee may not necessarily have recognised an amount in its statement of financial position in respect of the right-to-use asset in an operating lease.

The Board considered that fair value measurement only required at initial application and the use of valuation expert is not mandatory

BC28 Following the consultation period, and after considering constituent comments received, the Board decided to proceed with issuing revised principles for the recognition and measurement of income of not-for-profit entities largely as exposed. The Board considered the identified benefits of the revised requirements to exceed the costs of the revised requirements.

BC29(c) The Board observed some of the costs of the new requirements to be:

> … increased costs associated with the requirement to measure more assets at fair value (or current replacement cost, in relation to inventories) at initial recognition. The Board observed that while the consequential amendments made by this Standard will require more assets to be recognised and measured at fair value, these requirements better reflect the value transferred to the entity. The Board noted this Standard does not require assets (including assets obtained in a 'peppercorn' lease where a nominal amount is made as payment to the lessor) to be measured at fair value on an ongoing basis, but only on initial recognition (or in some instances, on transition to this Standard). Further, the Standard does not require the valuations to be conducted by a professional valuation expert. In addition, the Board noted the Standard does not require assets in the form of donated inventory to be recognised and measured at current replacement cost where the item donated is not material…

Board's decision on transition relief

BC150 The Board decided to consider transitional relief for leases on significantly below-market terms and conditions separately from transitional relief for other assets. The Board made this decision having regard to:

(c) the diversity in accounting for such leases under previous requirements (see paragraph BC6 (above);

(d) the potential significance of leases made on such terms to the financial position of a not-for-profit entity; and

(e) the prevalence of below-market leases in the not-for-profit sector.

BC151 The Board considered whether to:

(a) require retrospective application of this Standard, without any relief on initial application;

(b) permit a not-for-profit lessee to continue its existing accounting for such leases, in a similar manner to the relief specified for other transactions; or

(c) permit a not-for-profit lessee access to a similar level of relief on initial application of this Standard as is available to a for-profit entity on adoption of AASB 16.

BC152 The Board decided that it should, at a minimum, permit a not-for-profit lessee access to a similar level of relief on initial application of this Standard as is available to a for-profit entity on adoption of AASB 16. However, having regard to its decisions on the measurement of assets acquired in a lease, the Board concluded it would be appropriate to modify the transitional provisions set out in AASB 16 to require the lease asset, on initial adoption of this Standard, to be measured at its fair value rather than by reference to the lease liability.

BC153 In its discussion, the Board decided not to permit a not-for-profit lessee to continue its existing accounting for such leases, in a similar manner to the relief specified for other transactions. The Board made this decision having regard to its concern the financial position of a not-for-profit entity may be misrepresented, and the lack of comparability between entities if such leases were entered into before and after adoption of this Standard.