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Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
Collins St West Victoria 8007
AUSTRALIA

Dear Ms Peach

Exposure Draft 286—Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities (NFP)

I am pleased to make this submission on ED286.

I have over 30 years experience in accounting advisory functions of large accounting and auditing firms across a wide range of clients, industries and issues in the for-profit, not-for-profit, private, and public sectors. My clients across the business and government environments have included listed companies, unlisted and private companies, charitable and not-for-profit organisations, commonwealth, state and local government departments and agencies in the public sector, and government owned corporations (government business enterprises).

Overall, I believe that the amendments should become permanent for not-for-profit private sector and public sector entities. I do not believe that the information relating to valuing what were operating leases provides useful information to users. Consequently, I believe that valuations should not be mandatory even if the valuation issues are resolved.

The attachment to this letter addresses the AASB's matters for comment within the ED.

I also include a summary of valuation issues I have encountered in relation to peppercorn leases.

Yours faithfully

David Hardidge

AASB specific matters for comment

The AASB is inviting specific comments on the following:

- 1. Do you agree with the proposed temporary option for not-for-profit entities to not measure right-of-use assets at initial recognition at fair value for leases with significantly below-market terms and conditions principally to enable the entity to further its objectives ('peppercorn leases')? This option would permit not-for-profit entities to measure such right-of-use assets at initial recognition at cost instead of fair value. The AASB will reassess the option when further guidance has been developed to assist not-for-profit entities in fair valuing such right-of-use assets and the financial reporting requirements for not-for-profit private sector entities have been finalised. If you disagree, please provide reasons.**

As I respond in question 2, I believe that the option should become permanent for not-for-profit entities in both the private and public sectors.

If the AASB does not implement a permanent option, I support the proposed temporary option.

I also believe that the option should be available on a lease-by-lease basis, rather than an "all or nothing" approach. In my experience, some entities fair value finance lease assets under the current standards, and that approach should continue.

I note that such leases are subject to similar valuation issues relating to restrictions and conditions, though the comparable asset is similar to an owned asset, than the operating assets to be capitalised under AASB 16.

- 2. If you disagree with providing a temporary option, do you consider that not-for-profit entities should be permitted to measure right-of-use assets at initial recognition at either fair value or cost for peppercorn leases entered into prior to the initial application of AASB 16? In your view, should such a permanent option be provided for not-for-profit entities in the private sector, the public sector, or both sectors? Please provide your reasons.**

As noted above I suggest that the AASB make the changes a permanent option. In my experience, there has been little or no interest from users and preparers of NFP financial statements for this information.

Current discussions on valuation approaches indicate that valuations will require the obtaining of information outside the accounting system and management reporting. This indicates that the information is not used on a day to day basis by the NFP entity.

Furthermore, the effect of the initial recognition of the peppercorn lease, and ongoing reduction of results for the depreciation of the right-of-use asset is likely to cause confusion amongst users of these statements.

- 3. Additional disclosure requirements are set out in the proposed paragraphs Aus59.1 and Aus59.2 of AASB 16 for application to peppercorn leases where the right-of-use assets are measured at cost rather than at fair value. In conjunction with the other disclosure requirements in AASB 16, would these additional disclosures provide adequate information for users to understand the effects on the financial position, financial performance and cash flows of the entity arising from such peppercorn leases? If not, what additional disclosures would be appropriate?**

I believe the disclosure conditions should be redrafted as I expect confusion in trying to apply materiality when the value is unknown.

- 4. Whether the AASB's Not-for-Profit Entity Standard Setting Framework has been applied appropriately in developing the proposals in this ED?**

I agree that the AASB has appropriately applied the AASB's *Not-for-Profit Entity Standard Setting Framework*.

I urge the AASB to reflect on how these proposals were originally introduced, as it would appear that based on preparer and user feedback, the information is not wanted, leading to the implication that the AASB did not originally follow the standard setting framework. In particular, the requirement to fair value operating leases was not included in the original ED260 proposals, I for one objected to this requirement in my submission on the fatal flaw version of ED260, where I also raised implementation issues.

- 5. Whether there are any regulatory issues or other issues arising from the Australian environment that may affect the implementation of the proposals, including the Government Financial Statistics (GFS) implications?**

I believe that the proposals may have adverse implications for the Government Finance Statistics.

I understand that generally the right-of-use asset arising from the capitalisation of operating leases under AASB 16 is not a GFS asset. Consequently, the GFS Manual does not require the valuation of such assets.

I further understand that the GFS Manual recognises finance leases under AASB 117, and that these leases are fair valued under AASB 116 and AASB 1049. Consequently, the intended consequences of the AASB's "all or nothing" adoption of the measurement proposals would have adverse consequences, unless my suggested lease-by-lease exemption is permitted.

Specifically, an organisation would be prevented from adopting the “all or nothing” exemption, as AASB 1049 would require the valuation of the AASB 117 finance leases at fair value. Adoption of my suggestion would allow the organisation to continue to value the AASB 117 finance leases at fair value as a separate class to the newly capitalised operating leases under AASB 16.

6. Whether, overall, the proposals would result in the financial statements that would be useful to users?

My experience is that there is little or no interest from users for valuations. I believe that redrafted disclosures will be sufficient for users.

7. Whether the proposals are in the best interests of the Australian economy?

I believe that the proposals will reduce costs to NFP entities, with little, if any, reduction of useful information. Therefore, I believe that the proposals are in the best interests of the Australian economy.

8. Cost and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative?

My experience is that in many situations, NFP entities would need to engage external advisers and / or valuers to comply with the original requirements. As noted above, I do not believe that this expenditure generates sufficient benefits with improved financial information.

Furthermore, given the uncertainty, and diversity of views in valuing peppercorn leases, the usefulness of any valuations is reduced and lacks comparability.

Other comments

I also suggest that AASB uses a term such as “concessionary leases”, rather than multiple references to the wordy and confusing “right-of-use assets at initial recognition, for leases with significantly below-market terms and conditions”.

Valuation issues

I have previously provided the following valuation issues to AASB staff.

What is the market participant?

What is the market participant for a peppercorn lease to a not-for-profit entity?

In relation to land, do you use commercial market rates that would be paid by a for-profit entity, even though the peppercorn rental arrangements would not

be made available to a for-profit entity, or do you use the rent that a not-for-profit entity could afford to pay which is usually not very much? Do you consider some sort of deprival value notion, i.e., that if the not-for-profit had to pay commercial rates, it would not continue to operate, or alternatively, it will only operate and provide services if paying a peppercorn lease rental?

Additional complications arise when having to consider the nature of restrictions and conditions on peppercorn leases or assets of a specialised nature.

Some peppercorn leases are deliberately set at nil, because if they were set at a higher rate, then the NFP lessee would have to raise prices to recover the lease cost, or use valuable funding for lease rentals instead of providing services.

Fair value for lease with early termination rights

What is the fair value of a right-to-use asset under a 99 year lease when the lessor has the right to terminate the lease with no penalty on two years notice?

A market participant (i.e. not a related party) would not assume a 99 year term. Specifically, they would only value the right as being for two years use, or potentially with some risk adjusted premium on the understanding that the lessor would not terminate the lease immediately.

Lessors do kick out lessees, even if previously friendly relationships, for example Monash University with Mimotopes and a special purpose centre:

<http://www.theaustralian.com.au/higher-education/monash-university-drives-out-mimotopes-cancer-firm/news-story/18fc769b6eb4ba96f7c95c746088b68e>

<http://www.abc.net.au/news/2017-03-30/monash-university-hand-mimotopes-centre- eviction-notice/8400094>

Contingent rent and fair value

What is the fair value of a peppercorn lease with contingent rent?

If the fair value is based on fixed rent, and then the lease liability for the minimum payments (possibly nil) are deducted, large upfront revenue would be recognised. Such accounting would not reflect the actual agreement, as the entity has not earned that revenue – as it will have to pay some of it in the future through future contingent rentals.

An example is rent of 10% of sale for a kiosk concession on crown land.

Another example is that the lessee pays rental equal to the cost of maintaining the building each year.

For example:

Queensland Performing Arts Trust 2017

Note 18 SERVICES AND ASSETS PROVIDED TO THE TRUST

Arts Queensland, through the Department of Premier and Cabinet, owns and maintains the Performing Arts Centre premises on behalf of the State of Queensland. The Trust is provided with the use of the building and items of fit out, including certain items of plant and equipment that are not performance related, by way of a service level agreement with the Corporate Administration Agency (CAA). As described in note 3(b) the Trust pays rent below fair value for the use of premises in the Cultural Precinct.

Finance leases

Queensland have something called DOGIT leases (Deeds of Grant in Trust). The land is held in trust for specific use (e.g. aboriginal communities), and is not freehold, and cannot be sold.

Some peppercorn leases are already on balance sheet. For example finance leases. This includes DOGIT land for aboriginal communities and DOGIT land for grammar schools and universities.

Examples of valuation

The DOGIT land for aboriginal communities is valued at a \$1, as it cannot be sold, or used for anything else. The same \$1 value is used whether or not the land is unimproved, or improved (e.g. graded in order to construct a house).

I am currently pursuing the following other valuation examples:

- DOGIT land held by grammar schools and universities, and the adjustments for restrictions and conditions applied
- The Queensland Performing Arts Trust recognises a contribution for rental received at below fair value – refer above for the amount of rent that they do pay. I am following up to determine how fair value was determined.

Queensland Performing Arts Trust 2017 (see above)

Note 3 Grants and Contributions

The Trust has received a contribution in the amount of \$7.660 million (2016: \$7.716 million) from Arts Queensland equal to the amount of rent below fair value charged by Arts Queensland for the use of the premises by the Trust in the Cultural Precinct.

I have seen references to fair value of peppercorn leases being determined by comparable market rentals. However, they have been compared to for-profit entities. As noted above, I have questioned whether this approach is appropriate if the rental is given for NFP purposes and the public benefit.

In addition to the examples I have already provided, other practical difficulties include:

- hospitals sharing facilities with medical research institutions on a collaborative basis.