AASB 16 *Leases* Subsequent Measurement of Right of Use Assets

AASB 16 *Leases* comes into effect in FY2019-20. This brings most leases, including those were previously recognised as operating expenses, on balance sheet as a right-of-use asset and lease liability. This Circular provides guidance on the subsequent measurement of the right of use assets, which are to be recorded at cost, subject to impairment.

This Circular applies to all NSW public sector agencies, including State Owned Corporations.

Application

This guidance is issued as a Treasurer's Direction under section 9 of the *Public Finance and Audit Act 1983* (the Act) and therefore applies to all entities that are required to prepare general purpose financial statements under the Act. Treasury may subsequently limit or vary application of this Direction pursuant to section 9(3) of the Act.

Background

Treasury has mandated right-of-use assets (ROUA) should be measured using the cost method under AASB 16, subsequent to initial recognition. This includes concessionary leases (i.e. leases that have significantly below-market terms and conditions principally to enable a not-for-profit entity to further its objectives).

Under the cost model, a lessee shall measure ROUA at cost:

(a) less any accumulated depreciation and any accumulated impairment losses; and

(b) adjusted for any remeasurement of the lease liability (AASB 16.30).

Agencies are required to assess at the end of each reporting date whether there are any indications of impairment in accordance with AASB 136 *Impairment of Assets* (AASB 136.9). **If any such indications exist, the entity shall estimate the recoverable amount of the ROUA**, i.e. the higher of the asset's fair value less costs of disposal; and its value in use (AASB 136.18).

If, and only if, the recoverable amount of a ROUA is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss, which should be recognised in profit or loss (AASB 136.59-60).

After the recognition of an impairment loss, the depreciation charge for the asset shall be adjusted in future periods based on the asset's revised carrying amount and its remaining useful life (AASB 136.63).

An entity shall assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset may no longer exist or may have decreased. **If any such indication exists, the entity shall estimate the recoverable amount of that asset (AASB 136.110)**. An impairment loss recognised in prior periods for a ROUA shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised (AASB 136.114). If this is the case, the carrying amount of the asset shall be increased to the lower of its recoverable amount and the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised for the asset in prior years (AASB 136.117). That increase is a reversal of an impairment loss.

Identifying Indications of Impairment

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the internal and external sources of information listed in para 12 of AASB 136.

Property leases managed by Property NSW

For property leases managed by Property NSW:

- Property NSW will assess whether there are general market indications of impairment (or indications of a reversal of impairment) in the property market. This will be based on identifying any observable market indications that values of property leases have significantly declined, e.g. a significant decline of market rents in general. Property NSW will share the outcome of their central assessment with agencies, including the market rent index movements and the potential impairment losses arising from the market rent index movement for each individual lease managed by Property NSW.

- Lessees are responsible for identifying and assessing other indications of impairment (or reversals of impairment), that are specific to individual ROUAs. For example, the leased space has become or is expected to become surplus on an ongoing basis, due to the change of the entity's service capacity requirements (note a short-term negative change is not considered to be an impairment indication).

- Lessees are responsible for assessing the aggregate impact of potential impairment losses arising from general market indications provided by Property NSW and potential impairment losses arising from other indications. If the aggregate impact is material to the lessee, the lessee entity should inform Property NSW to record the impairment loss (or reversal of impairment).

Leases not managed by Property NSW

For leases of property not managed by Property NSW or leases of other assets, the lessee agencies are responsible for identifying and assessing indications of impairment (or reversals of impairment) at the reporting date.

The following sections are only applicable if there are indications of impairment (or reversals of impairment).

Use of fair value to calculate impairments of ROUA

For many not-for-profit entities, ROUAs are held primarily for continuing use of their service capacity, instead of generating net cash inflows. The value in use of these assets may be significantly lower than their fair value. According to AASB 136.21, if there is no reason to believe that an asset's value in use materially exceeds its fair value less costs of disposal, the asset's fair value less costs of disposal may be used as its recoverable amount.

Treasury acknowledges obtaining external valuations for the fair value of ROUAs recognised under AASB 16 by lessees will increase costs for agencies and in some circumstances may provide little benefit. Therefore, in this guidance Treasury has provided practical expedients for when assets require an external valuation for the purpose of an impairment assessment, allowing in some instances for an asset's depreciated historical cost to be a proxy for its fair value. This is consistent with the current accounting policy in Total State Sector Accounts in Note 13 that states "Non-specialised assets with short useful lives are measured at depreciated historical cost, as an estimate for fair value".

AASB 16 transition considerations

On transition, the carrying value of most ROUAs is equal to the lease liability, because the modified retrospective approach in AASB16.C8(b)(ii) has been elected in accordance with TC18-05 *AASB 16 Leases Transition Elections.* The only exception is ROUAs that have accelerated depreciation. For ROUAs that have accelerated depreciation, the option in AASB16.C8(b)(i) may be used, that requires the ROUA to be measured at the transition date at its carrying amount as if the Standard had always been applied since the commencement date. Post transition, for new leases the initial measurement for ROUAs will generally be equal to the lease liability, plus any lease payments made at or before the commencement date, any initial direct costs and dismantling and removal costs, less any lease incentives received.

Treasury's view is this ROUA value of new leases post transition is an appropriate proxy for fair value upon initial recognition. This is consistent with how an acquired asset is currently measured.

Costs of disposal

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense (AASB 136.6). Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale/disposal (AASB 136.28).

It should be noted that costs of disposal related to ROUA are not necessarily immaterial. Entities should ensure to consider costs of disposal, when calculating the recoverable amount of an asset. This is particularly critical in a market where the transfer or termination of leases is difficult, either because of surplus in market supply in general, or onerous conditions specific to the lease agreement.

Practical Expedients by Asset Type

Note that impairment calculation is only required when there is an indication of impairment or reversal of impairment as stated in the "Background" section and "Indication of Impairment" section above. Therefore, the section below is only applicable when there is indication of impairment or reversal of impairment of a ROUA.

Property

- For leases less than five years or greater than five years, but substantially shorter than the asset's useful life (e.g. the lease term is 10 years while the useful life of the leased property is 60 years):
    - If there is an overall market indication of impairment of property leases related to general office accommodation, the fair value assessment will be based on indices published by Property NSW. This will apply to property leases of general office accommodation held by Property NSW or external lessors. For overall market indication related to property leases other than general office accommodation, the lessee entities shall seek the market indication relevant to the specific property.

- Where the impairment indications relate to non-market factors assessed by lessees, those lessee agencies should:
    - Determine the fair value and impairment of the ROUA based on the specific circumstances. For example, if the ROUA is impaired because of a physical damage of the underlying asset for which the lessee is responsible, the impairment of the asset could be measured based on the rectification costs to be incurred by the lessee.
    - For those property leases managed by Property NSW, report the impairment amount to Property NSW.
- For property leases greater than five years, where the lease tenure is closely aligned to the ROUA's useful life, the agency will be required to obtain an external valuation.
- The carrying amount of ROUAs arising from property leases as at 1 July 2019 is deemed to be their fair value.

Motor vehicles excluding specialised motor vehicles[1]

- General motor vehicles are usually expected to depreciate over their useful life without significant upward or downward movements in fair value. Therefore the depreciated historical cost of the corresponding ROUA is generally deemed as an acceptable surrogate for fair value, consistent with the requirement for the underlying assets in TPP 14-01 *Valuation of Physical Non-Current Assets at Fair Value.*
- However, agencies are still required to consider indications of impairment and will need to consider whether the depreciated historical cost has exceeded the recoverable amount of their motor vehicles. This may require additional analysis if motor vehicle leases are longer than a standard 3-5 years' term. This should include consideration of accelerated depreciation where appropriate, i.e. where a ROUA should incur higher depreciation earlier in its useful life.

Other assets

- It is expected in most instances, assets will depreciate over their useful life with minimal instances of an upward or downward movements in fair values. Thus, for leases of five years or less, agencies are not required to undertake a valuation either by management or externally to determine the fair value. The depreciated historical cost of the ROUA is generally deemed to be an acceptable surrogate for fair value, consistent with the requirement for the underlying assets in TPP 14-01.
- For leases greater than five years, but where the lease term is substantially shorter than the asset's useful life: management will be required to perform a formal management assessment of the fair value when an impairment assessment is needed. This is similar to the interim revaluation requirements for property, plant & equipment in TPP 14-01 *Valuation of Physical Non-Current Assets at Fair Value*. This valuation should include a condition assessment of the ROUA, including whether there is an expected material difference between the ROUA's current recorded value and its expected fair value. This is to be documented appropriately. Where fair value could be materially lower than the carrying amount eg due to market conditions, management is then to obtain data to support the market value – for example an external valuation.
- For leases greater than five years and where the ROUA tenure is closely aligned to the asset's useful life, the agency will be required to obtain external valuations to determine the fair value.

Appropriateness of the practical expedients

- Agencies should ensure they have reasonable documentation to demonstrate the appropriateness of using the practical expedients above, in their circumstances. However, if agencies have been applying and documenting similar practical expedients in applying TPP14-01 (e.g. the use of depreciated historical cost as an surrogate for fair value for non-specialised

[1] Specialised motor vehicles are considered those where a significant value of the asset is derived from the modifications or specifications made to the general motor vehicle asset. Management will need to exercise their judgement whether their motor vehicles would fall into this category.

assets with short useful lives in section 7.5 of TPP14-01) to their owned assets in the related asset class, there is no need for additional documentation.

Appendix A: Guidance for Valuation of Property Leases

PROPERTY NSW – ROUA FAIR VALUE ASSESSMENTS

Executive summary

Property New South Wales (PNSW) provides financial information to the NSW State Government (the Government) on a periodic basis. Such financial information requires certain adjustments to the carrying amount of assets and liabilities, including impairment adjustments. Since AASB 16 *Leases* is applicable to all agencies from 1 July 2019, right of use assets (ROUA) and a corresponding lease liability shall be recorded by all agencies. For the purposes of Government reporting, PNSW measures these ROUA using the cost model.

In accordance with AASB 136 *Impairment of Assets*, there is a requirement to perform an impairment assessment for ROUAs, where impairment indications exist. Fair Value measurements for ROUAs are needed to determine a ROUA's recoverable amount, when there is indication of impairment or reversal of impairment.

Although in theory, the fair value of a ROUA changes constantly over the lease term, there are certain points in time that the carrying amount is approximate to the fair value. PNSW has identified the following points in the life cycle of a lease in order to assess when an ROUA's carrying amount is close to its fair value and when a reassessment of fair value is needed:

- Initial recognition
- End of lease term
- At the time of a market rent reviews
- Between any two of the above points (eg between initial recognition and a market rent review)

For convenience, when a Fair Value assessment is undertaken (other than a re-assessment event) it would typically be done as part of the 31 March Early Close, unless there is significant movement between 31 March and 30 June. The process for determination of fair value under each of the above categories is summarised below:

- ROUA is initially recorded at an amount equivalent to the lease liability, which is a reasonable proxy of fair value given that AASB 16 uses a discounted cash flow model for measurement at initial recognition. Hence all ROUAs will be considered to be stated at fair value at the time of initial recognition / lease commencement.
- ROUAs will be reduced to nil at the end of the lease term. Given the nature of the interest in a leased asset, where the lessee holds no interest in the residual value, we know that the measurement of ROUAs at the end of the lease term will be nil and also equal to FV at that time.
- When a periodic market rent review occurs, the lease payments attributed to that lease will be reset to a "market" rate at that time. Therefore, where a remeasurement is undertaken as a result of a market rent review, the ROUA will therefore automatically be referencing measurement inputs that are considered to be market value. AASB 16 requires remeasurement of the ROUA where a lease is subject to market rent reviews or rentals change in accordance with an index or rate (eg CPI). The remeasurement methodology required by AASB 16 is considered by management to be consistent with the current replacement cost (CRC) method, which is an approach frequently used by not-for-profit entities to determine the value in use of assets.
- Where a market rent review has not occurred recently (i.e. in the last 12 months), whatever payment mechanism exists (whether that is a fixed payment or fixed increase, or CPI based increase) can only be described as a proxy for market, and will inevitably be different to the market movement in that period. In situations where a lease has not been subject to a recent market rent review, PNSW will establish a matrix of valuation indices based on market rent per square meter by geographic area that provide an appropriate

basis for determining an impairment adjustment factor, if applicable, at each relevant Government reporting date.

1. Background:

The new leasing standard (AASB 16) is effective for reporting periods beginning on or after 1 January 2019. For New South Wales Government agencies that is financial year ending 30 June 2020.

A "right of use" model replaces the "risks and rewards" model under AASB 16, that requires lessees to recognise nearly all leases on their balance sheet to reflect their right to use an asset for a period of time and the associated liability for payments. This change eliminates nearly all off balance sheet accounting for lessees. Although the impact on net assets will be relatively small, there will be an increase in total assets and total liabilities by the amount of right of use assets (ROUAs) and lease liabilities. There is an exemption for low value leases (Treasury determined these being leases of assets that are valued at $10,000 or under when new) or leases with a term up to 12 months, which are considered short term leases. For Property Leases this will include leases in “Holdover” status which are leases with no fixed term that extend on a month to month basis.

2. Purpose:

PNSW is required to measure all non-current ROUAs, where PNSW is the lessee, at cost in its financial statements, less any impairments where impairment indications exist. This information must also be reported to NSW Treasury for the whole-of-government Total State sector Accounts.

In addition, PNSW is required to provide information on subleases to NSW Government agencies, where PNSW is the lessor.

Both the right of use ROUAs on PNSW’s balance sheet, and those on individual agencies’ balance sheets (in respect of subleases) will need to be measured at cost. An impairment adjustment is required when carrying amount of an ROUA exceeds its recoverable amount, which is generally determined by its fair value less costs of disposal for not-for-profit entities. This paper sets out the principles that PNSW will follow to determine the fair value of those ROUAs.

The approach set out in this paper should be applied to all ROU property lease assets recorded on balance sheets of GSF Agencies (defined in the *Government Sector Finance Act 2018*), except property leases greater than five years where the ROUA tenure is closely aligned to the asset’s useful life (eg 52 Martin Place, Sydney – 124 years lease term).

3. Principles on Fair Value:

The definition of fair value in AASB 13 paragraph 9 is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. In the case of a leased property asset, the lessee of the ROUA is typically using that asset as part of its own operations, rather than as a cash-flow generating or income producing asset.

AASB 13 sets out three widely used valuation techniques to determine fair value, being the market approach, the cost approach and the income approach. For the purposes of this paper it has been determined that the approach that best maximises the use of relevant observable inputs for the Property leased asset class, is the cost approach.

AASB 13 paragraph B8 explains that “the cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)”. It is worth noting that in applying the cost approach, it is necessary to take into account the fact that in assessing the value of the asset there will be amounts that have not been paid (the remaining lease payments). Therefore, the fair value of a lease is best determined by assessing any difference in contractual cash flows of a lease and what the contractual cash flow profile would be if the lease were negotiated at market rates at the date of the valuation.

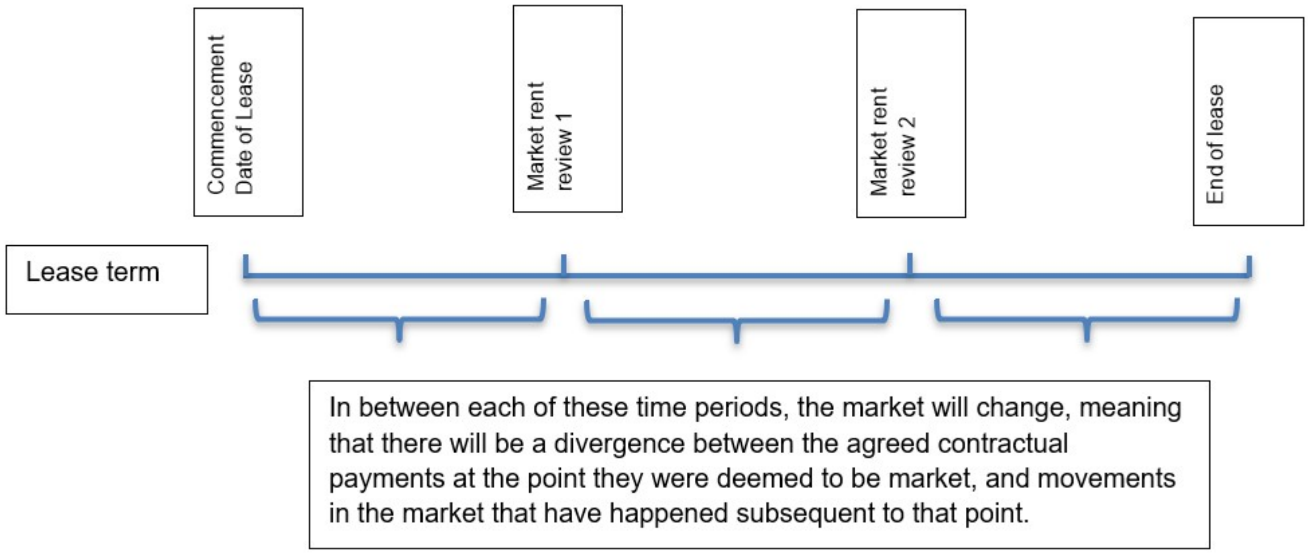
4. Accounting analysis:

For the purposes of determining an appropriate methodology for fair value measurement, we have considered the fair value impact at the following key points in the life cycle of the RoU:

- Initial recognition
- End of lease term
- At the time of market rent reviews
- Between any two of the above points (eg between initial recognition and a market rent review) ie an annual fair value re-measurement

These events are illustrated in the following example:

On the assumption that at each of these points in time in the lease term, there is an arm's length negotiation between the parties, the agreed rent at each of the following points in the lease are deemed to be "at market".



4.1 Initial recognition:

AASB 16 requires the ROUA to be measured initially at cost, which is determined by reference to the amount of the initial measurement of the lease liability, any lease payments made at or before the commencement (less any lease incentives received), any initial direct costs incurred and an estimate of make good expenses required at the end of the lease. The lease liability is initially measured at the present value of the lease payments, which in the case of PNSW, will generally be discounted at the lessee's incremental borrowing rate. Discount rates implicit in the lease should be used where these can be identified or can be calculated from the contracts. Lease payments include any fixed increase in cash flows agreed at the inception of the lease. However, in a situation where lease payments are variable subject to a rate or index or periodic rent reviews, AASB 16 requires the measurement of those future cash flows to be based on the payments at the commencement date of the lease.

At initial recognition it is reasonable to assume the lessee is paying a "market" rent, given it has been negotiated at arm's length. Therefore, the measurement of the ROUA at commencement of the lease will be based on the present value of future cash flows. Given that there is some constraint imposed by the standard on the cashflows that are included in that initial recognition (due to the fact that future increases due to changes in CPI or market rent reviews are excluded), it is reasonable to consider whether this is an appropriate representation of the Fair Value of the ROUAs. It is widely accepted that the initial recognition of an asset under the cost model is equivalent to fair value at inception, and it would be unusual to record a FV adjustment on initial recognition unless there was clear evidence of an above or below market feature of the lease. This is also consistent with the "Current Replacement Cost" (CRC) Fair Value methodology that would establish the initial cost of an asset as determined by the relevant accounting standards as a basis for the Fair Value measurement.

4.2 End of lease term:

It is self-evident to state that the value of the ROUA at the end of the lease term will be nil. The basis of any lease arrangement is that the lessee holds no residual interest in the asset beyond the contractual term of the lease because the asset will usually be returned to the lessor. This means that the FV is "known" at the end of the term and must be recorded at nil.

4.3 At the time of market rent reviews:

AASB 16 requires remeasurement of the ROUA and lease liability if there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example, a change to reflect changes in market rental rates following a market rent review. Hence an entity is required to remeasure the lease liability based on revised cash flows at the remeasurement date and adjust the ROUA.

Consistent with the situation at the initial recognition of a lease, at the time of a market rent review - what is known at that point is that the remaining lease payments for that lease will be reset to a rate agreed between the parties, and therefore considered to be "arm's length" and therefore at market. Given that AASB 16 will require a remeasurement of the ROUA at this time to reflect the revised contractual cashflows - this is akin to an indexation event that is required by the CRC valuation methodology in order to bring the asset value to "current cost". As a result, at each remeasurement date that arises due to a market rent review adjustment, the revised carrying amount of the ROUA will represent the "current replacement cost (CRC)".

CRC is a commonly used method to determine the value in use of the assets in not-for-profit entities, where the future economic benefits of an asset are not primarily dependent on the asset's ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits. CRC is defined as the current replacement cost of an asset less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset.

As mentioned earlier, a remeasurement of the ROUA could be triggered either by a change in index or rate or by market rent reviews. The remeasurement adjustment based on market rents would be a reasonable proxy of CRC and hence reflective of the fair value of the ROUA at the remeasurement date. However, an adjustment due to any other change of index (e.g., CPI) or a rate (e.g., LIBOR) will not always represent market rent and hence cannot be used as FV in the same way as proposed for a market rent review. As a CPI adjustment is only used as a way of determining an increase in rents based on broader economic conditions - it is not sufficiently equivalent to an alignment to a market rent. Therefore, these remeasurement events would still be subject to an additional adjustment to determine the fair value of the underlying ROUAs as set out in section 4.4 below.

4.4 Between market rent reviews

This section covers PNSW's approach to determine the fair value of the ROUA for the purposes of Government reporting, in a situation where the underlying lease is not subject to a recent market rent review and hence the ROUA is not stated at CRC. For these leases, the carrying amount of ROUA does not reflect market changes since the last market review date. Accordingly, when there is indication for impairment or reversal of impairment, PNSW will determine an adjustment index suitable for each relevant Government reporting date that bridges the gap between market rents. The adjustment index will reflect the changes to expected/forecasted market movements at different points in time.

Appropriate adjustment indexes will be developed that reflect the market movements for different geographic regions (by sub-market of metropolitan Sydney, such as Sydney CBD, North Sydney, Parramatta and etc). The percentage movement of the total forecasted rental per square metre for the remaining lease term is used to calculate the adjustment indexes.

At the end of each financial year (or 31 March), the carrying value of the ROUA will be adjusted to the recoverable amount (i.e. fair value less cost of disposal, unless value in use is higher) based on the adjustment indexes, if the carrying value of ROUA is materially higher than the recoverable amount.

4.5 Practical expedients of ROUA fair value assessment

The expedients below only apply to the assessment of overall market impairment indication for property leases only. Agencies are reminded to also consider any non-market indications of impairment specific to a particular property lease. e.g. surplus leased space.

- Leases for which the commencement date or the latest market rent review date is within the past 12 months

As discussed above, the carrying amount/revised carrying amount of ROUAs represent the current replacement cost as at the lease commencement date and the market rent review. Usually there are no significant changes in market rents within 12 months. Therefore, entities are not required to re-assess the fair value for leases whose commencement date or latest market rent review date is within the past 12 months, unless there is an indicator or a significant movement in market rents. The carrying amount of these ROUAs is deemed to be the fair value.

- Market movements in regional areas

The regional market is relatively small and the market rent data is not available. As a practical shortcut, CPI indices will be used as a basis for assessment for ROUAs in regional areas.

Appendix B Worked examples at Commencement Date

In these scenarios, the calculation represents the starting value of the ROUA and Lease Liability. As per the premise of this paper, even though the application of the leasing standard will result in a different calculation methodology for each of these leases, the ROUA value at inception will be considered to be equal to Fair Value.

Determining ROU Asset value at inception
Discount rate 5%

Scenario 1A - no change to payments

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
At lease inception	100	100	100	100	100	100	100	100	100	100
ROU Asset @ inception	$772.17									
Lease Liability @ inception	$772.17									

Scenario 1B - Fixed increases

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
At lease inception	100.0	103.0	106.1	109.3	112.6	115.9	119.4	123.0	126.7	130.5
ROU Asset @ inception	$874.76									
Lease Liability @ inception	$874.76									

Scenario 1C - CPI increases

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
At lease inception	100	100	100	100	100	100	100	100	100	100
ROU Asset @ inception	$772.17									
Lease Liability @ inception	$772.17									

Scenario 1D - Rent Free period incentive in Year 1

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
At lease inception	0	100	100	100	100	100	100	100	100	100
ROU Asset @ inception	$676.94									
Lease Liability @ inception	$676.94									

Scenario 1E - Fixed increase (3%) with a Market Rent Review in year 6, fixed increase (3%) for remainder of term.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
At lease inception	100.0	103.0	106.1	109.3	112.6	100.0	103.0	106.1	109.3	112.6
ROU Asset @ inception	$817.55									
Lease Liability @ inception	$817.55									

Scenario 1F - Fixed increase (3%) with a Market Rent Review in year 6 (with a floor being prior period rent), fixed increase (3%) for remainder of term.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
At lease inception	100.0	103.0	106.1	109.3	112.6	112.6	115.9	119.4	123.0	126.7
ROU Asset @ inception	$862.63									
Lease Liability @ inception	$862.63									