ACT ACCOUNTING POLICY

AAPP 107 - ACT Accounting Policy Paper on Make Good Provisions

FOR THE REPORTING PERIODS ENDING ON OR AFTER 30 June 2020

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1 INTRODUCTION

1.1 APPLICATION

1.1.1 PURPOSE

This ACT Accounting Policy is for: Accounting for Provisions for Make Good Clauses within a:

- ROUA Lease Agreement whereby the lessee is to restore or 'make good' a leased asset at the end of the lease term, or
- ACT Property Group (ACTPG) MOU or Rental Agreements that specifies that your agency will be responsible for make good costs.

This policy provides general guidance to aid ACT Government agencies on the appropriate recognition and measurement of make good obligations to dismantle, remove and restore items of right-of-use-asset (ROUA) and property, plant and equipment.

This policy is to be read in conjunction with the following:

- AASB 16 Leases;
- AASB 116 *Property, Plant and Equipment;*
- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets;* and
- AASB Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities.*

1.1.2 RELATIONSHIP TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

ACT Accounting Policies are to be read in conjunction with applicable Australian Accounting Standards. Australian Accounting Standards incorporate International Financial Reporting Standards issued by the International Accounting Standards Board, with the addition of paragraphs on the applicability of each standard in the Australian environment. This policy assists agencies to apply the requirements within Australian Accounting Standards to make good obligations requiring the dismantling, removal and/or restoration of items of property, plant and equipment.

There is, however, no intention that the ACT Accounting Policies will replicate the Accounting Standards. Consequently, agencies should ensure that they have a thorough understanding of the content of the standards before reading and applying relevant ACT Accounting Policies.

1.1.3 APPLICATION DATE

This ACT Accounting Policy applies to the reporting periods ending on or after 30 June 2020.

1.1.4 AGENCIES COVERED BY THIS POLICY

This policy applies to directorates and territory authorities.

1.1.5 BUDGETARY IMPLICATIONS

This policy does not address the issue of funding for make good obligations. Rather it seeks to guide agencies on the recognition and measurement of these obligations. Agencies should make sure that they are adequately providing for the effect of this potential outflow. In the relevant budget year when the actual costs need to be incurred, agencies may need to either seek additional funding through the budget process or determine other appropriate sources of funding. In some cases, an agency's obligation to fund make good clauses may be governed by a memorandum of understanding and agreed to by the agency upon the commencement of a lease. Therefore, an agency should refer to this agreement when determining the responsibilities of each party for making sure that any expected outflow is appropriately provided for and funded.

1.1.6 CONTACT

If you have any questions regarding the content or application of this ACT Accounting Policy, please do not hesitate to contact the Financial Reporting and Framework Branch for further clarification. Contact details are listed on the website www.treasury.act.gov.au/accounting.

2. BACKGROUND

ACT directorates and territory authorities may have obligations to dismantle, remove and restore items of property, plant and equipment. These obligations are often referred to as 'make good'. The most common example is contained within a building lease agreement, whereby the leasee agency is required, as per the contract, to restore the premises to its original condition at the conclusion of the lease. Also, ACTPG MOU/Agreements may also require make good.

Make good obligations are required to be recognised as a provision where the criteria, as mentioned in AASB 137.14 (and discussed below in paragraph 3.1), is met. In addition to this, in accordance with AASB 116.16(c) the initial estimate of the future cost of making good leasehold improvements forms part of the cost of the asset and is therefore required to be capitalised, depreciated and revalued in accordance with an agency's asset policies (see section 4.2).

Whereas, ACTPG MOU/Agreement make good does not form part of the asset (ACT Policy) however, the arrangements may still require make good and therefore a liability provision (see section 3.1.2).

3. MAKE GOOD – AASB 16: ROUA

AASB16 s9 (para B9-B33) provides that leases that represent a lessee's right to use an underlying asset for the lease term are a right-of-use asset (ROUA) on the Balance Sheet.

The right-of-use asset is measured as follows (AASB 16: 23-28):
Lease liability (Present value of lease payments + present value of expected payments at end of lease); + initial direct costs of lessee + prepaid lease payments + estimated costs to restore/dismantle or remove (AASB 137) – lease incentives received.

Therefore, for a right-of-use asset, the make good costs are included in the total cost of the right-of-use asset. Make good costs are AASB16 s24 (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.'

Along with recognition of make good costs in the initial cost of the ROU asset, when the lessee incurs an obligation for those costs. A provision will still need to be recognised in compliance with AASB 137.

3.1 APPLICATION EXAMPLES

3.1.1 AASB 16 ROUA AND MAKE GOOD

An agency enters into a new lease agreement to use a warehouse for 10 years with a company at a cost of $15,000 per year (not an ACTPG lease). Under the contract, with the company the agency is required to for example repaint the warehouse at the end of the lease term. This meets the criteria under AASB 16 s9 right-of-use asset and the cost to repaint relates to the right-of-use asset the warehouse as part of the restoration, and so the repainting cost is capitalised to the right-of-use-asset and a provision recognised in compliance with AASB 137.

3.1.2 NOT AN AASB 16 (ACT GOVERNMENT PROPERTY GROUP) ROUA AND MAKE GOOD

Under ACT Leasing policy agencies will NOT record ACTPG leases (relating to standard, non-specialised accommodation) as a right-of-use-asset on their balance sheet. Therefore, make good requirements are not part of an asset.

(Refer to ACT Accounting Policy -AASB16 Leases (including Transition) 30 June 2019 section 6.2 ”ACTPG therefore, has a substantive substitution rights (AASB 16.B14) over the accommodation and they are not considered to constitute a lease within the agreement. ACT Government agencies shall not account for a right-of-use asset or a lease liability for internal leases through ACT Property Group’’).

The ACT Government Office Accommodation Policy does not cover stand-alone purpose-built GRE such as clinical health facilities, schools, correctional facilities etc including non-office components of other specialist facilities, however, it applies to all other office accommodation.

- **ACTPG MOU/Agreement – to Make Good**

  However, if your MOU or rental agreement with ACTPG specifies that your agency will be responsible for make good costs then the make good is treated as a liability on the balance sheet.

  The current MOU agreement refers to agencies “*where the premises are subject to a “superior lease” which provides for a payment in lieu of make good…the directorate will be required to fund a make good liability unless budget finding is provided to ACTPG*.” In this circumstance a superior lease is defined *as any lease (other than an Executive Crown lease or a Crown Lease), sublease, under lease or license pursuant to which the Territory, represented by ACTPG, occupies the Premises.*

  If agencies have a new agreement commencing in 2019-20, below is a suggested journal for a provision from Make Good under an ACTPG rental agreement with respect of restoring the leased premises:

Dr	Rental agreement expense	XX
Cr	Provision for Make Good	XX

Refer to section 4.2 for the accounting treatment of Make Good required for dismantling and removing fit-out owned by the Agency.

4. MAKE GOOD - AASB 116 & 137

4.1 IS A PROVISION FOR MAKE GOOD REQUIRED?

A provision for make good is required to be recognised in accordance with AASB 137.14 when the following criteria are all met.

(a) An entity has a present obligation (legal or constructive) as a result of a past event.
(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
(c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, a provision should not be recognised. Agencies must review their lease agreements, memorandums of understanding and any other arrangements made, in relation to their tenancies, in order to determine whether the above criteria are satisfied.

4.1 Is a Provision for Make Good Required - continued

In accordance with AASB 137.36, the amount of the provision shall be the best estimate of the expenditure required to settle the present obligation, as at the end of the reporting period. The best estimate at the end of the reporting period, will usually take into account increases of costs, using the Consumer Price Index (CPI). The provision will be discounted to reflect the present value of such expenditures where the time value of money is material (AASB 137.45).

4.2 RECOGNITION AND MEASUREMENT

When recording the cost of an item of property, plant and equipment, AASB 116.16(c) the standard requires the cost of such assets to include an initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. An agency incurs this obligation either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

4.2.1 OVERVIEW OF THE PROCESS

The following diagram illustrates the process of calculating the initial recognition of the make good obligation:

Process	Example
1. Estimate the current cost of making good, as at the acquisition date.	Current make good = $120 per m2 x Office space of 400m2 = $48,000
2. Determine the future outlay of the estimation by using the latest released CPI rate.	Future outlay in 7 years indexed annually with 2% CPI 48,000 (1+2%)7 = $55,137
3. Discount the future outlay to present value using an appropriate Government bond rate, which most accurately approximates the time period required.	Discount using average of 5 & 10 year Government bond rate. $55,137 / (1 + 4.91%)7 = $39,421
4. Prepare journals recognising the capitalisation of the present value of the make good obligation.	

4.2.2 Materiality and Disclosure

Materiality in some instances, the difference between the future outlay and the present value (as determined by applying the appropriate discount factor as mentioned above), may be immaterial. This will most often be the case, for instance, where the lease is only for a short duration.

Where the difference between the future outlay and present value is immaterial, agencies have the option of either:

- recognising the future outlay of the make good provision straight up; or
- applying the discount factor and recognising the present value of the make good obligation.

4.2.2 Materiality and Disclosure - continued

Disclosure requirements (as required by most agencies) for provisions for make good are detailed in the ACT Model Financial Statements (Model). Please refer to the current year's Model for appropriate disclosure requirements. https://apps.treasury.act.gov.au/accounting
In the event that an agency's situation differs from that of 'Example Agency' in the Model, agencies are required to adequately determine the appropriate disclosure by referencing the Australian Accounting Standards.

4.2.3 Measurement of an Existing Provision

At the end of each reporting period the provision must be reviewed and adjusted if necessary, to reflect the current best estimate where material. Various events may affect the value of the provision. Details of these events and their treatment are listed below. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision must be reversed (AASB 137.59).

<table>
<tr><th>Events that change the provision</th><th>Treatment when fit out/ leasehold improvements are valued at cost</th><th>Treatment when fit out/ leasehold improvements are valued at fair value</th></tr>
<tr><td>1. A change in the estimated outflow of resources embodying economic benefits required to settle the obligation (e.g. cash flows or change in CPI).</td><td rowspan="2">Increases or decreases in the provision shall be added or deducted from the cost of the asset in the current period.
A decrease in the provision shall not exceed the carrying amount of the asset; otherwise the remainder shall go straight to profit or loss.
If an increase in the provision occurs an agency should consider whether the increased asset is recoverable, otherwise a test for impairment should take place.</td><td rowspan="2">A decrease in the provision shall be recognised in other comprehensive income and increase the revaluation surplus within equity. Except to the extent that it reverses a previous increase, in which case it shall be recognised in profit or loss.
An increase in the provision shall be recognised in profit or loss. Except to the extent that it reverses a previous decrease, in which case it shall be recognised in other comprehensive income and also reduces the revaluation surplus within equity.</td></tr>
<tr><td>2. A change in the market-based discount rate as defined in AASB 137.47 (e.g. a change in the Government bond rate).</td></tr>
<tr><td>3. An increase that reflects the passage of time (also referred to as the unwinding of the discount).</td><td colspan="2">The unwinding of the discount is measured and disclosed as a borrowing cost in the agency's Operating Statement</td></tr>
</table>

4.2.3 Measurement of an existing provision - continued

Consequently, for any changes/adjustment's considerations should include that:

- Under the cost model the asset is initially measured at cost (AASB 116.15) and subsequently carried at cost less accumulated depreciation and subsequent accumulated impairment losses (AASB 116.30). Therefore, any subsequent increase (decrease) in the associated provision for make good is added to (deducted from) the cost of the related asset in the current period (Interpretation 1.5(a)).
- An increase in the cost of the asset may also be an indicator that the asset may not be fully recoverable. Should such an indication exist, the entity would be required to test for impairment in accordance with AASB 136 Impairment of Assets. Agencies should also refer to ACT Accounting Policy, Impairment of Assets.

4.2.3 Measurement of an Existing Provision - continued

- Under the revaluation model, an asset is initially measured at cost (AASB 116.15) and subsequently carried at fair value less any subsequent accumulated depreciation and subsequent accumulated impairment losses (AASB 116.31). Not-for-profit agencies apply revaluations to a class of asset. Revaluation increases and decreases relating to individual assets within a class are allowed to be offset against one another within that class (i.e. net revaluation increase/decrease) but should not be offset by revaluations in different classes (AASB 116.Aus40.2).

5. CHECKLISTS

Taking up the Provision for Make Good at Lease Start

Action	Completed
Determine whether there is an obligation to make good leased premises upon cessation of the lease. • Refer to lease agreement and/or memorandum of understanding.	
Source a current valuation of the cost of dismantling and restoring the leased premises (in current prices). • This could be a block quote, or a quote per square metre.	
Apply a current CPI rate to this current cost to determine total future cost • The CPI can be sourced from the Australian Bureau of Statistics (ABS) or use the estimate in the current published ACT Budget	
Source the current Government bond rate, matching the lease duration and apply that to the future outlay, to arrive at the present value of the lease as at commencement of lease. • The Government bond rate can be sourced from the Reserve Bank of Australia (RBA)	
Assess whether these two figures, i.e. the future outlay and the present (discounted) value are material.	
If material, capitalise the present value (as leasehold improvements within the agencies assets) and recognise the provision. • Prepare asset addition forms (including the present value amount of the provision for make good)	
If immaterial, capitalise the future outlay (as leasehold improvements within the agencies assets) and recognise the provision. • Prepare asset addition forms (including the future outlay amount of the provision for make good)	

5. Checklists – continued

Reporting and Measuring the Provision at the end of the Reporting Period

Action	Completed
No changes in provision	
Where the provision was previously discounted, the winding back of the discount must occur. • This figure is recognised in the Operating Statement and can't be capitalised.	
Changes to the provision resulting from, revaluations, change in discount rate, change in CPI	
Change value of the provision, dependent on whether leasehold improvements are valued at cost or at fair value.	