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Australia

AUTO & ASSET FINANCE COUNTRY SURVEY 2015

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White Clarke Group is the market leader in software solutions and business consultancy to the automotive and asset finance sector for retail, fleet and wholesale. White Clarke Group solutions enable end-to-end credit processing and administration to streamline business practice, cut operational cost and deliver outstanding customer service. White Clarke Group has a 23-year track record of leadership and innovation in finance technology, consultancy and new market entry. Clients value White Clarke Group's industry knowledge, market intelligence and innovation. The company employs some 600 finance and technology professionals, with offices in the UK, USA, Canada, China, Australia, Austria and Germany.

White Clarke Group publish the Global Leasing Report, which is part of The World Leasing Yearbook. To download a copy please go to:

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Australia at a glance

The aim of this new and fully updated Asset Finance International country survey is to provide a wide-ranging and balanced assessment of the auto and asset finance markets in Australia. Key areas covered and principal findings include:

- According to the Australian Equipment Lessors Association (AELA), there was a welcome return to growth for the Australian equipment finance industry in 2014, with total new business volumes (NBV) increasing by 2.4% to A$41.9 billion (US$37.7 billion).
- In the general equipment finance sector, leasing accounted for 17% of total NBV in 2014, of which slightly more than one-third was from operating leases, while finance leases provided the remainder. Other financing products were chattel mortgage (which dominates the market with three-quarters of equipment NBV) and hire purchase.
- Latest figures from AELA indicate that in the fiscal year ending June 2015, NBV increased by 3% over the previous 12-month period, ending a two-year decline.
- NBV for the largest sector, cars & light commercial vehicles, continued to grow; however, the mining, earthmoving & construction sector continued to decline, and the indications are that this sector will continue to struggle in the near term.
- In the auto fleet sector, data from the Australian Fleet Lessors Association (AFLA) shows that although the total portfolio increased only marginally over the 12 months to August 2015, this was an improvement over the previous 12-month period.

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- Market share by type of facility remained stable, with operating leases in all forms taking over 60% of the funded total, and fleet leasing NBV picked up slightly, returning to an average quarterly total in excess of A$1 billion.
- Government figures show growth in the Australian economy slowing to 0.2% in the June 2015 quarter over the previous quarter, the main cause being reduced mining and construction activity.
- Fears have been expressed that the economy could tip into recession. Continued uncertainty over the domestic outlook has weighed on consumer confidence and constrained business investment.
- Australia has been actively involved in a number of trade agreements with Asia-Pacific nations, including recent deals with China, Japan and Korea. The latest of these is the Trans-Pacific Partnership (TPP), which the government claims will improve access for Australian goods exports, services and investment, but which faces close scrutiny in the Australian parliament.
- A number of asset and auto finance industry leaders have provided insights on the Australian market and its outlook.

  Opinions cover a wide range of areas of topical interest, including:

  - Market performance trends, and the effect of the global slowdown;
  - Market dynamics, mergers and acquisitions, and opportunities for new entrants;
  - Whether traditional lending will be affected by the advent of alternative sources of funding such as peer-to-peer lending;
  - The sectors that offer the best prospects for growth in the coming 12 months; and
  - The steps that asset finance companies should be taking to run their businesses more effectively and deliver smarter solutions for their clients.
- This country survey concludes with three specially commissioned articles from experts in their respective fields. The first provides an update on the legal aspects of goods leasing in Australia.
- The second article assesses the potential impact of the proposed new leasing standard, which is finally due to be announced by the end of 2015.
- The concluding article provides an update regarding the tax considerations typically raised by equipment and auto leases in Australia.

The Australian asset finance and leasing market

Equipment finance and leasing is involved in some 40% of equipment capital expenditure in Australia, making the asset finance industry an essential part of the Australian economy.

The leasing market took off in the 1950s and early 1960s and is now a mature market with products provided by all types of financial institution. It is dominated by the 'big four' domestic banks, but integral to it are international banks, captive finance companies, specialist finance companies, fleet lessors and rental companies.

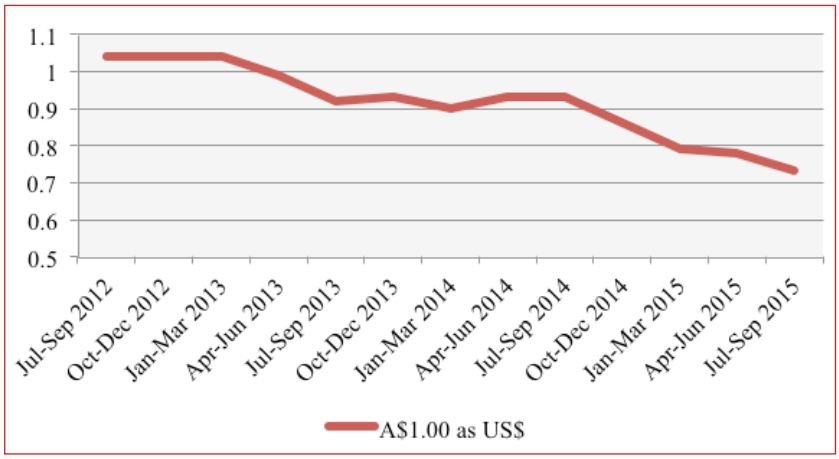
The Australian Equipment Lessors Association (AELA) was founded in 1986 and is the national association for the equipment leasing and financing industry. AELA member companies represent more than 90% of equipment finance activity in Australia, and comprise banks, finance companies, merchant banks, general financiers, equipment vendor lessors and lease packagers. Associate members include other industry associations and legal and accounting firms, and support system suppliers with an interest in lease and equipment finance products. Since its inception, AELA's role has expanded to include hire purchase and chattel mortgages, products that are prominent in the Australian equipment finance market.

The Australian Fleet Lessors Association (AFLA) is the industry body representing the interests of fleet lessors and managers. Its members include Australia's major fleet leasing and management companies. AFLA members have a total portfolio of around 550,000 vehicles under lease or management.

The industry statistics that follow in this section are taken from data provided by AELA, augmented where relevant by statistics for the fleet leasing industry, supplied by AFLA. As data is not available from all AELA members, figures have been adjusted by the association to provide what can be considered a reliable overview of the financing of capital equipment in Australia.

The figures in this section have been given equivalent values in US dollars using average exchange rates for the period concerned. Note that the Australian dollar has weakened in recent years from US$1.04 in 2012 and recently dipped as low as US$0.70.

Average quarterly exchange rate, A$ to US$



Source: OANDA, Asset Finance International

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Asset finance products

There are three basic product groups: leasing (finance and operating), hire purchase, and chattel mortgage.

Chattel mortgage is a major component of the Australian equipment finance market, accounting currently for three-quarters of the total for general equipment finance compared with a little over 50% in 2011, as can be seen in the figures below.

It is important to note that this form of finance does not relate to real estate. A typical chattel mortgage occurs in a situation where the lender does not want responsibility for ownership of the asset. In this case, a purchaser borrows funds for the purchase of a movable asset (in Australia this usually includes cars, commercial vehicles and plant & machinery) from the lender, and the lender then secures the loan with a mortgage over the chattel (the asset). Legal ownership of the asset passes to the purchaser at the time of purchase (unlike hire purchase, where it passes at the end of the agreement), and the mortgage is removed once the loan has been repaid.

Another financial product popular in Australia is novated leases, which are offered by vehicle lessors as part of a salary package rather than fleet management. A novated lease takes the form of a three-way agreement (novation) between an employer, an employee and a lessor, whereby the employee leases a vehicle from the lessor and the employer takes on the lessee's obligations, making the payments and deducting the costs from the employee's pre-tax income, and in return the employee sacrifices a portion of salary to cover the lease rental. A novated lease can be structured as either a finance or operating lease.

Equipment finance market performance

There was a welcome return to growth for the Australian equipment finance industry in 2014, with total new business volumes (NBV) increasing by 2.4% to A$41.9 billion (US$37.7 billion). General equipment finance grew nearly 2% compared with the previous year and fleet leasing NBV surged by 7.7% to A$4.2 billion (US$3.8 billion). Overall, this more than made up for the downturn in 2013.

Total receivables at end-December 2014 amounted to A$92.4 billion (US$83.2 billion), a decline on the prior year of just three-quarters of a percent.

Equipment finance industry aggregates, 2011–14

	NBV (A$bn)			
	2011	**2012**	**2013**	**2014**
General equipment finance	36.7	39.4	37.0	37.7
Fleet leasing	4.6	4.3	3.9	4.2
Total equipment finance	**41.3**	**43.7**	**40.9**	**41.9**
	Receivables (A$bn)			
	2011	**2012**	**2013**	**2014**
General equipment finance	83.5	84.5	83.7	83.1
Fleet leasing	8.9	9.2	9.4	9.3
Total equipment finance	**92.4**	**93.6**	**93.1**	**92.4**

Source: AELA

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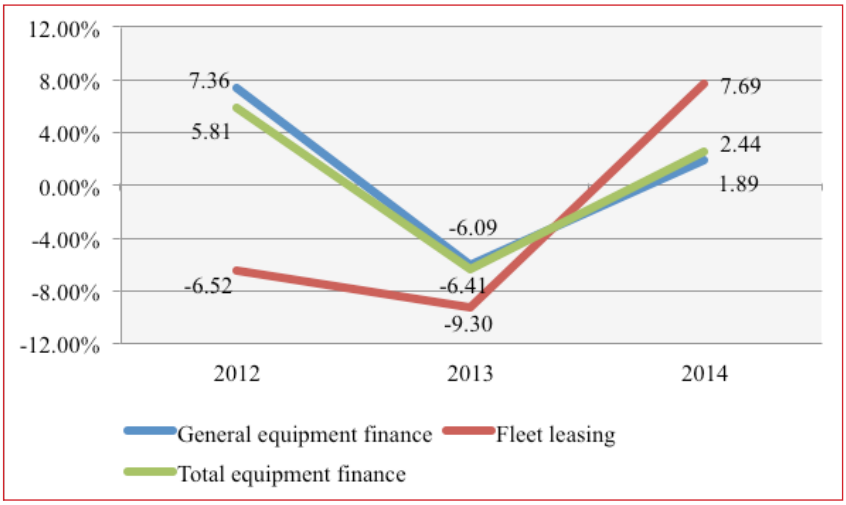
With both general equipment finance and fleet leasing performing better in 2014 than the year before, the year-on-year trend lines reveal a definite uptick from recent years.

Equipment finance year-on-year growth trends



Source: Asset Finance International, AELA

In the general equipment finance sector, leasing accounted for 17% of total NBV in 2014, of which slightly more than one-third was from operating leases while finance leases provided the remainder. None of these shares of the market had changed from the year before.

Other financing products were chattel mortgage (continuing to increase market share with 76% compared with 74% in 2013 and 62% in 2012) and hire purchase (with 7%, continuing to decline gradually).

The only discernible trend here is the increase in chattel mortgage, which is primarily at the expense of HP. The origin of this movement away from HP can be found in a change in its Goods and Services Tax treatment (GST is a broad-based tax of 10% on the sale of most goods and services in Australia) in July 2012, after which it became fully taxable for GST purposes. The GST treatment of HP became rather more complicated, compared with the very simple treatment of chattel mortgage, thereby encouraging a move away from HP to chattel mortgage.

Chattel mortgage plays no part in fleet finance, where leasing makes up 90% of NBV. Here, the bulk is operating leases, which comprise more than half the total market, but finance leases increased share in 2014 to 36% of the total, augmented by novated leases, which are mostly finance leases rather than operating leases.

NBV by product type, 2014

	General equipment finance		Fleet leasing		Total equipment finance	
	NBV (A$ bn)	%	NBV (A$ bn)	%	NBV (A$ bn)	%
Finance lease	4.1	11	1.5	36	5.6	13
Operating lease	2.3	6	2.3	53	4.5	11
Total lease	*6.3*	*17*	*3.8*	*90*	*10.1*	*24*
Hire purchase	2.7	7	0.4	10	3.1	7
Chattel mortgage	28.7	76	0	0	28.7	68
Total	**37.7**	**100**	**4.2**	**100**	**41.9**	**100**

Note: Totals may not add, due to rounding

Source: AELA

Comparative market performance in 2015

The figures in this section do not include all market participants, but give a fair indication of business volumes and growth trends. The following charts use data from AELA members Alleasing, ANZ/Esanda, BoQ, Bendigo and Adelaide, BMW, Canon, Caterpillar, CNH, CBA, DLL, GE Equipment Finance, Komatsu, Macquarie Leasing, NAB, Ricoh, Service, SocGen (to Dec 2013), Suncorp, Toyota and Westpac (including St George and Capital), with some additional AELA estimates. AELA and AFLA figures are normally based on years ending in June, equating to the Australian fiscal year.

In the year ending June 2015, NBV increased by 3% over the previous 12-month period, ending a two-year decline. Impressive gains came in finance lease (+17%) and operating lease (+10%), while chattel mortgage grew 3%. These increases were countered somewhat by a 19% fall in hire purchase NBV, making this now the smallest sector with just 6.5% of the market, down from 27% three years earlier.

NBV by product, June year-end (A$ million)

	Year to June 2010	Year to June 2011	Year to June 2012	Year to June 2013	Year to June 2014	Year to June 2015
Finance lease	3,699	3,982	4,170	4,041	3,325	3,877
Operating lease	1,865	1,903	2,459	1,926	2,033	2,227
Hire purchase	7,181	7,999	9,363	3,556	2,635	2,141
Chattel mortgage/Other	17,083	15,062	18,178	23,744	24,053	24,772
Total	**29,828**	**28,946**	**34,170**	**33,267**	**32,046**	**33,017**

Note: From the January 2015 statistics Members included both previously unreported data and made changes that reduce the coverage from that previously reported.

Source: AELA

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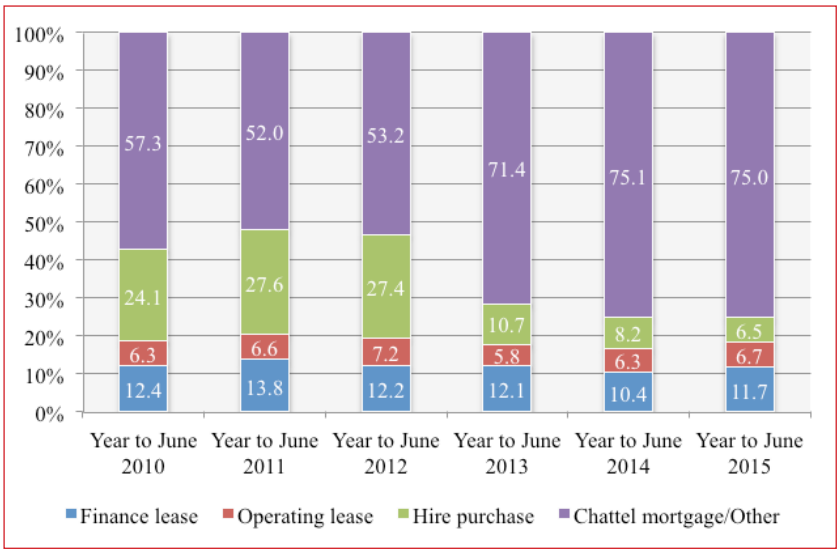
Looking at total NBV for general equipment finance over the five-year period from June 2010 to June 2015, the combined annual growth rate (CAGR) has been 2.05%. This does indicate improvement, if marginal; however, whilst CAGR smooths the ups and downs it cannot mask the fact that new business has declined in three down years compared to two when it went up.

In terms of market share in 2015, the notable trend is the consolidation of chattel mortgage as the prime financing product with three-quarters of the total, at the expense of hire purchase.

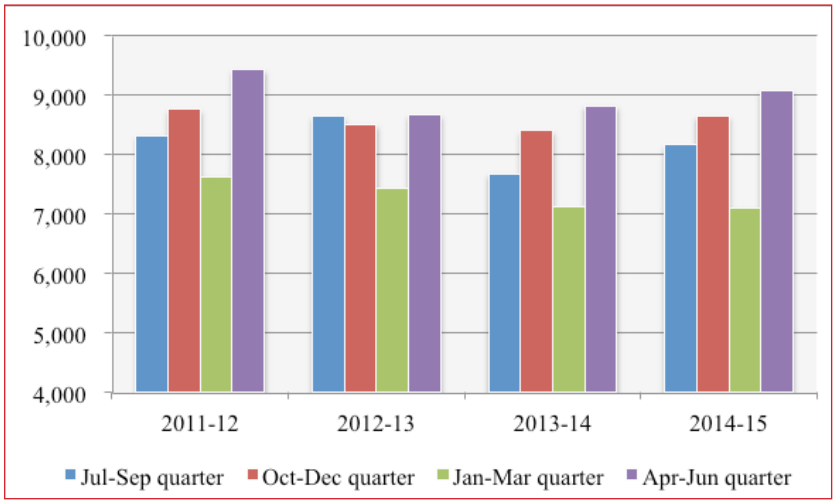
NBV by product market share, June year-end (%)



Source: Asset Finance International, AELA

In recent years the most productive quarter has been the April–June quarter, or the last quarter of the fiscal year. This final fiscal quarter has registered the highest NBV per year over the past four years, while NBV has been lowest in the preceding January–March quarter and in fact volumes in this quarter have steadily declined annually.

General equipment finance NBV by quarter (A$ million)



Source: AELA

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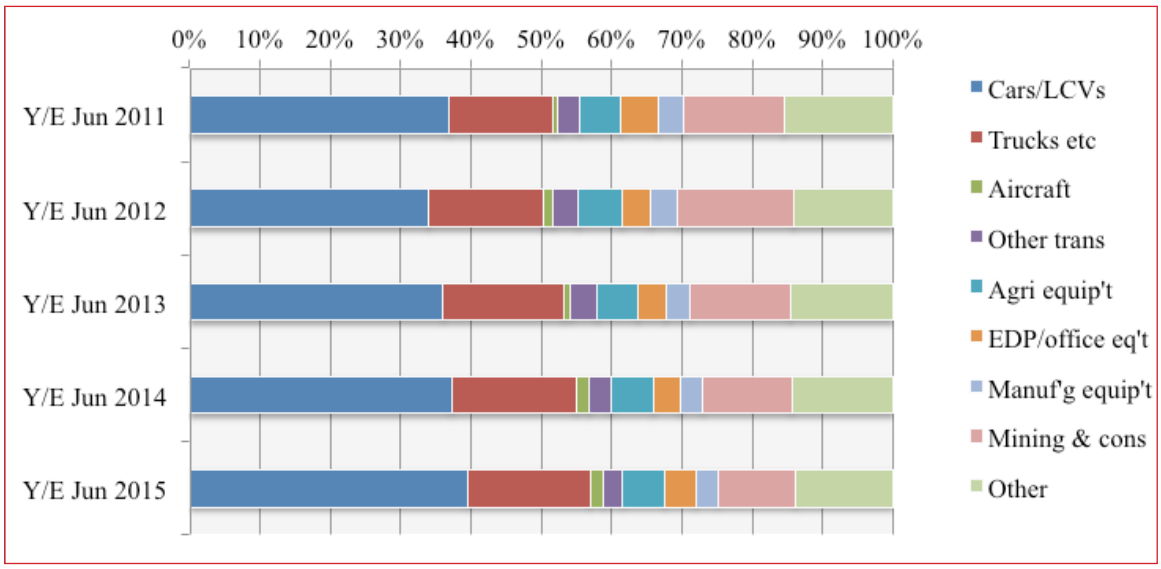
In terms of trends by equipment type, the most notable are that market share held by cars & light commercial vehicles (LCVs) continues to grow and reached nearly 40% as of year-end June 2015, with trucks, trailers and buses remaining second largest on 17%, whereas mining, earthmoving & construction equipment is still in decline – from 16.5% in the year to June 2012 to just 11.1% in the year ending June 2015.

The significance of this ongoing decline in the mining sector cannot be over-emphasised, as the sector is still easily the third largest (not including 'Other'), more than double the size of electronic data processing/office machines and well over three times the volume of manufacturing equipment. By comparison, at year-end 2011, mining, earthmoving & construction NBV amounted to A$4.14 billion (US$4.05 billion) while trucks NBV totalled A$4.25 billion (US$4.20 billion); four years later, this narrow difference had widened to NBV of A$5.74 billion (US$4.82 billion) for trucks compared with A$3.66 billion (US$3.08 billion) for mining and related equipment.

The troubles faced by the mining sector are well known, with demand for equipment remaining slack as the global demand for commodities stagnates. The slowing Chinese economy has had a particular impact, as has the recent strength of the Australian dollar.

Although the indications are that this sector will continue to struggle in the near term, there should eventually be a revival in demand from other expanding economies, especially Australia's near neighbours in Asia, and the weakening Australian currency will help in the longer run.

NBV by equipment type (%)



Source: Asset Finance International, AELA

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Australian fleet sector developments

In the auto fleet sector, the AFLA has members operating nationally with a combined funded and managed portfolio of some 550,000 vehicles with over A$14 billion (US$12 billion) of funding provided.

Monthly data supplied by AFLA (from a consistent group of lessors comprising: Alphabet Fleet, Custom Fleet, FleetCare, FleetPartners, FleetPlus, Interleasing, LeasePlan, nlc, ORIX, QFleet, sgfleet, StateFleet, Summit Auto Lease, and Toyota Fleet Management) shows that the total portfolio increased just marginally over the 12 months to August 2015, although this marks a return in the right direction following a slight decline in the previous 12-month period.

Total vehicle portfolio, by facility/number of units

	August 2014	August 2015	Y-O-Y change (%)	Funded market share, Aug 2015
Operating leases - funding only	38,887	41,736	7.33%	11.9%
Operating leases - other	180,083	179,830	-0.14%	51.2%
Finance leases	37,175	33,940	-8.70%	9.7%
Novated leases	74,022	74,547	0.71%	21.2%
Other funding	19,824	21,038	6.12%	6.0%
Total funded	*349,991*	*351,091*	*0.31%*	*100.0%*
Fleet managed	185,020	192,054	3.80%	_
Total portfolio	*535,011*	*543,145*	*1.52%*	_
Fleet managed, funded by other AFLA members	3,970	14,624	268.36%	_

Source: AFLA, Asset Finance International

However, the separate segment covering fleet vehicles managed by other AFLA member companies, although comparatively small in unit numbers, showed an exceptional surge in unit numbers, jumping nearly fourfold over the year. The spike occurred in February 2015, in which the number of units written totalled 9,653 compared with 101 the month before and 495 the month after, both of which represent more 'normal' months. There was also a smaller spike in June 2015, when the monthly total climbed to 2,042.

The background to these unusual bursts of activity was described to Asset Finance International by AELA director John Bills, who said: "As the name suggests, this category is for fleet units which are managed by one member but funded by another. There was a major development in this category in February, reflected in units written in the month, and which increased the total portfolio."

However, conditions of confidentiality meant Bills could not divulge more, as he explained: "We are aware of the background of these movements, but unfortunately are not in a position to provide more information as members provide these details to AFLA on a confidential basis."

Otherwise, the market share by type of facility remained stable compared to the previous period, with operating leases in all forms taking over 60% of the funded total, followed by novated leases with just over a fifth.

Looking at values, fleet leasing NBVs remained steady over the 12 months to August 2015 and picked up overall compared with the previous year, returning to an average quarterly total in excess of A$1 billion.

Fleet leasing NBV (A$ million)

	Finance Leases	Operating Leases	Novated-Finance Leases	Novated-Operating Leases	Total Novated Leases	Hire Purchase/ Chattel Mortgage	Total
JUNE 14 QTR	***72***	***480***	***336***	***19***	***355***	***88***	***995***
July	29	182	105	6	111	27	349
August	58	194	99	7	106	33	391
Sept	37	192	114	9	123	35	387
SEPT 14 QTR	***124***	***568***	***318***	***22***	***340***	***95***	***1,127***
Oct	33	224	102	8	110	31	398
Nov	28	194	90	7	97	61	380
Dec	25	241	85	3	88	68	422
DEC 14 QTR	***86***	***659***	***277***	***18***	***295***	***160***	***1,200***
2015 Jan	14	148	68	1	69	33	264
Feb	24	164	83	2	85	45	318
Mar	20	217	91	2	93	28	358
MAR 15 QTR	***58***	***529***	***242***	***5***	***247***	***106***	***940***
April	21	208	83	3	86	29	344
May	27	218	87	3	90	29	364
June	28	217	100	3	103	35	383
JUNE 15 QTR	***76***	***643***	***270***	***9***	***279***	***93***	***1,091***
July	34	230	100	4	104	42	410
August	29	199	86	3	89	31	348

Source: AFLA

The period also saw total net receivables in the auto sector remain stable at around the A$9.2 billion (US$7.7 billion) level. The main area of growth in receivables was operating leases, up by some 4%.

Small and medium-sized enterprises (SMEs) form the largest segment in the fleet leasing market, with larger, cash-rich corporations – especially mining and natural resources companies – tending to bulk purchase rather than lease fleet vehicles.

Australia has a highly competitive new car market with a broad range of vehicle choice and pricing that flows on to the second-hand market, although for new cars the choice will be based entirely on imports when domestic car production ceases in 2017.

The Australian economy

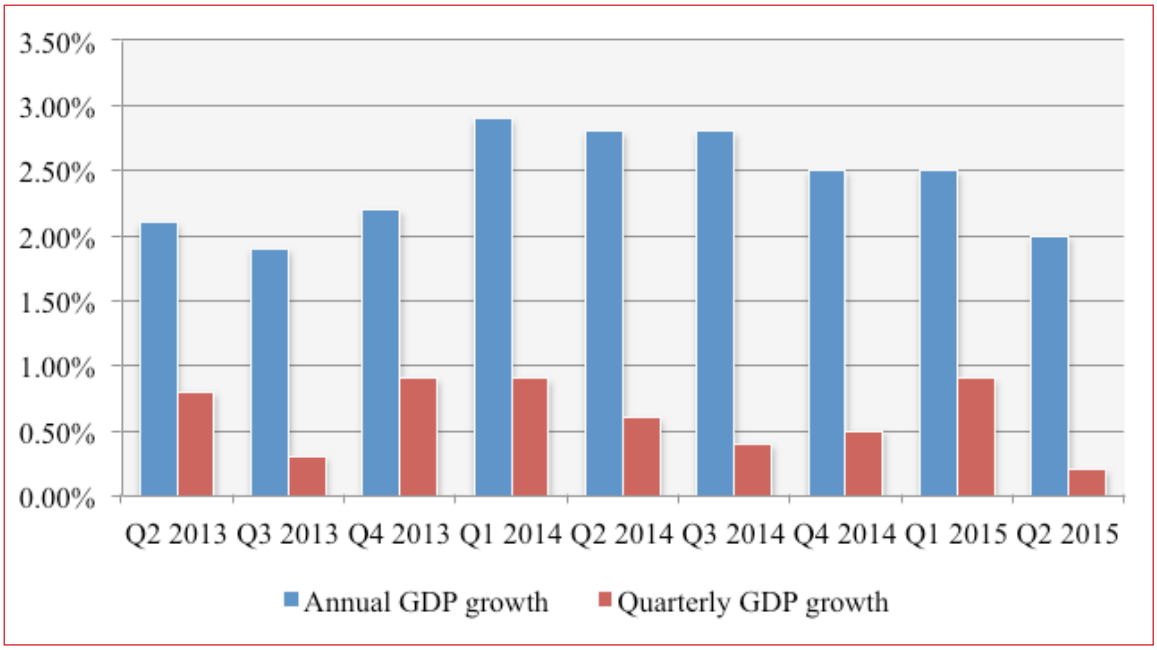
Australia is one of the biggest mining and commodity-based economies in the world and it has been severely hit by the recent commodity price slump coming on the back of a harder than hoped-for slowdown in China.

Australia is the world's biggest exporter of iron ore and China's steel consumption, which had driven the boom in demand for ore, has fallen, leaving iron ore prices nearly two-thirds lower than in 2013. Low commodity prices have helped to dampen inflation, but will also be a prime contributor to slower economic growth.

The national accounts for the June 2015 quarter show growth in the Australian economy slowing to 0.2% over the previous quarter. According to the Australian Bureau of Statistics, the main cause for this was reduced mining and construction activity, with an additional decline in exports, although there was growth in domestic and government expenditure.

Compared with the same quarter a year earlier, growth of 2% in the June 2015 quarter displayed further signs of a slowdown, continuing a gradual downward trend in year-on-year growth.

Australia GDP growth



Source: Asset Finance International, ABS

The question is whether Australia is likely to tip into recession, as has been the case in other commodity-centric economies such as Brazil and Canada, and at the time of writing there are plenty of views both for and against such a scenario.

Some observers point to the fact that over the past 20-plus years the Australian economy has shown exceptional resilience to global headwinds, a period that of course included the Great Recession. In fact, there have been just three quarters since 1993 when Australian growth was negative, and it takes two consecutive quarters of negative growth to make a recession.

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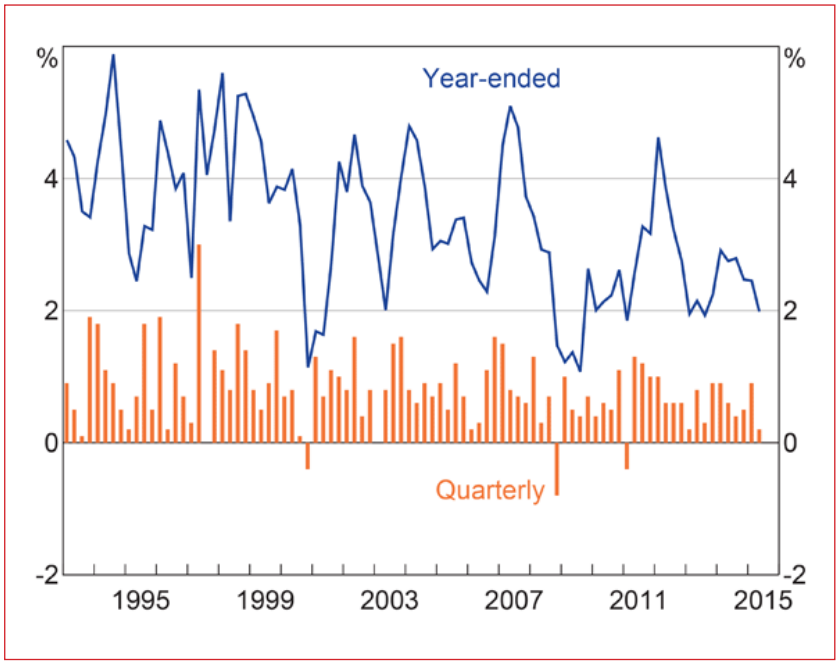
Long-term GDP growth



Source: ABS

Other observers claim that a long period of relative prosperity based on overseas demand for commodities has led to complacency and poor productivity in the rest of the economy. They say the economy has become lop-sided, and the decline in mining and related industries means there is little else to prevent the slowing of GDP growth.

The optimists claim the mining slump will come to an end and, despite the cooling Chinese economy, demand for high-quality commodities will not disappear and is set to grow in coming years, particularly from other expanding Asian countries.

There is also Australia's massive Services sector, by far the largest sector in the domestic economy, representing about 70% of GDP and employing around four in every five Australians. The September 2015 Australian Performance of Services Index produced by information provider Australian Industry Group stood at 52.3, down on the previous month but still the fourth consecutive month of expansion – the longest continuous period of expansion since March 2008. The AI Group's other indices, for manufacturing and construction, were also above 50 in September, indicating expansion, although both have spent much of the past 12 months below that critical figure.

Confidence matters

Nonetheless, a popular view that the economy has been poorly managed has led, on the political front, to Tony Abbott becoming the latest prime ministerial casualty of perceived policy failures when he was ousted by Malcolm Turnbull as head of the ruling Liberal-National coalition and as prime minister in a leadership ballot in September 2015.

Continued uncertainty over the domestic outlook had weighed on consumer confidence and constrained business investment. While wage rises for many have been curbed, household savings have grown at the expense of increased consumption, and companies have tended to run down stock rather than invest.

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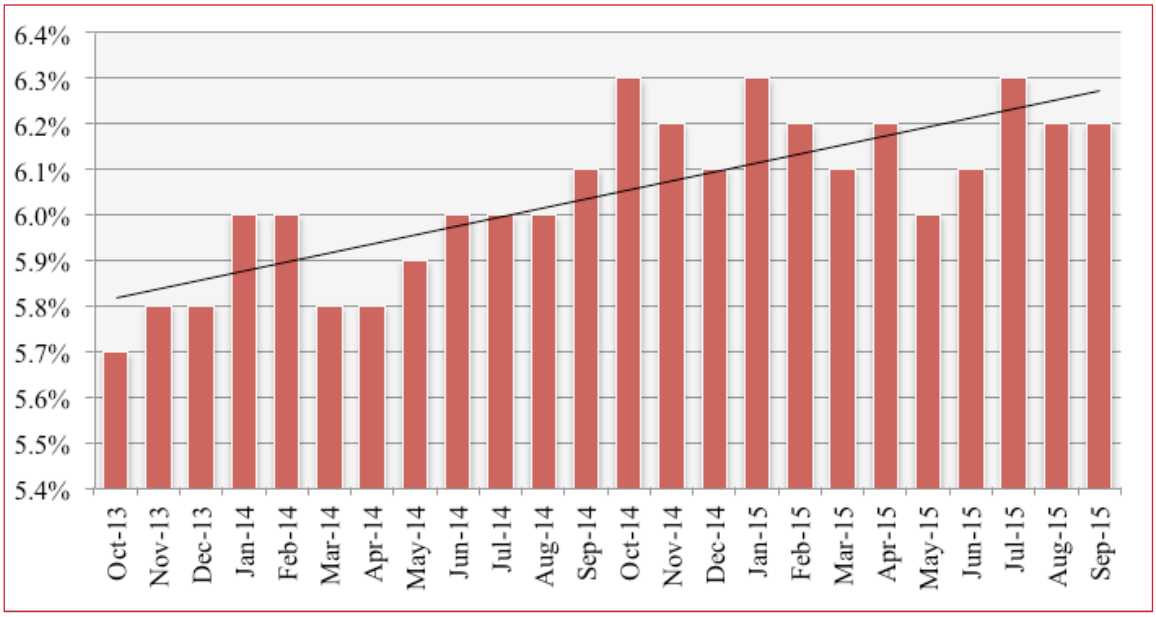
However, the Governor of the Reserve Bank of Australia (RBA), Glenn Stevens, made encouraging noises in the RBA October monetary statement, noting that "the available information suggests that moderate expansion in the economy continues. While growth has been somewhat below longer-term averages for some time, it has been accompanied with somewhat stronger growth of employment and a steady rate of unemployment over the past year." Unemployment has indeed been steady, varying between 6% and 6.3% over 2015, but it should be noted that the trend is slowly upward.

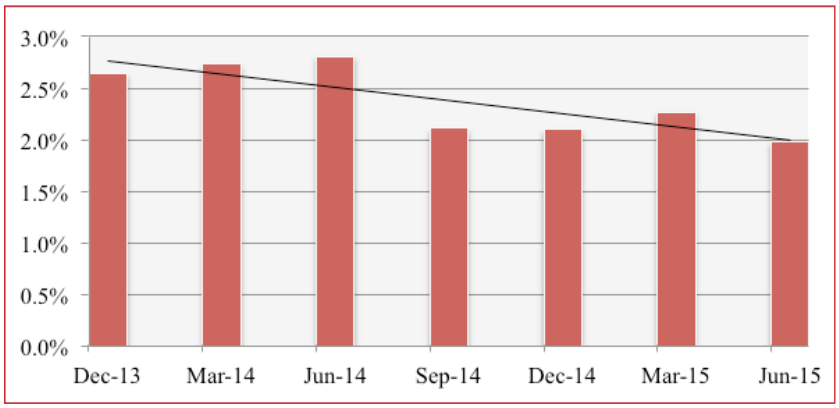
Unemployment rate, with trend line



Source: Asset Finance International, ABS

The RBA statement continued: "Overall, the economy is likely to be operating with a degree of spare capacity for some time yet, with domestic inflationary pressures contained. Inflation is thus forecast to remain consistent with the target over the next one to two years, even with a lower exchange rate." The inflation rate target is 2–3% and a reasonable rate has been maintained, although there is a downward trend.

Core inflation, y-o-y change and trend line



Source: Asset Finance International, ABS

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Meanwhile, earlier in 2015, GE Capital's Capex Barometer of business investment intentions expanded its view to include Australia – ironically, for a company that is divesting its own Australian concerns – and found some positive sentiment, especially among SMEs where it found "60% say they are upgrading existing equipment to enhance efficiency and productivity."

According to this research, 58% of Australian SMEs and 68% of mid-market companies reported revenue growth, and both business segments have a "broadly positive outlook", especially the middle tier firms which are experiencing less difficulty with cash flow than SMEs.

Projections for the Australian economy from independent forecasters are for growth but at a limited rate in the near term. The IMF forecast (in its *World Economic Outlook*, October 2015) is for real GDP growth in 2015 of 2.4% and 2.9% in 2016. The OECD projects a dip in growth to 2.25% in 2015 but also forecasts a pick-up to nearer 3% in 2016. However, in its *Economic forecast summary* of June 2015, the OECD advised: "Enhancing the climate for business investment in non-commodity sectors requires maintaining sound macroeconomic policies, further tax reform, cuts to red tape and competition-boosting measures."

Trade agreements

Australia has actively sought beneficial free trade agreements with a number of countries, including those recently signed with China, Japan and Korea. However, despite opening up markets for Australian exporters, these agreements work both ways. The deal with China has brought concern in some parts about the degree of influence of inward investment – China is now the largest source country of investment in Australia – with, for instance, the possibility of Chinese labour being used in preference to domestic workers in large Chinese projects in the country.

The latest and potentially far-reaching trade agreement is the Trans-Pacific Partnership (TPP) which, if ratified by all 12 countries, will involve Australia, the US, Canada, Japan, Malaysia, New Zealand, Singapore, Vietnam, Brunei, Chile, Mexico and Peru. After five years, negotiations were concluded in October 2015 and new prime minister Malcolm Turnbull hailed the TPP as a "gigantic foundation stone for our future prosperity."

The TPP will be the largest ever regional trade deal, representing nearly 40% of global GDP, even before taking into consideration a longer-term vision that would see the addition of other Asia-Pacific nations, including the Philippines, Korea, Taiwan, Thailand and presumably somewhere down the line, China.

The government claims the TPP will eliminate 98% of import tariffs across a range of sectors, improving access for Australian goods exports, services and investment. However, the deal faces close scrutiny in the Australian parliament as opposition parties seek clarification on various issues.

What the experts say

Leaders in the Australian asset and auto finance and leasing industry provided Asset Finance International with their insights into the current state of the market, the opportunities and challenges it faces in the near and medium term, the direction of market trends and the outlook for the coming year.

Recent performance trends

The initial topic for discussion concerned the performance of the market over the last 12 months, which has picked up compared to the year before, and whether the upward momentum can be expected to continue and what will drive it.

The general view was mixed but not particularly rosy. Craig Gee of Marubeni Equipment Finance (Oceania) and AELA Chairman for 2015-16 stated: "We're not so optimistic that the momentum will continue," adding: "Investment in plant & machinery (according to the Reserve Bank) has been declining over the past few years, as has general business investment as a percentage of GDP."

Craig Gee

Capital expenditure, or lack of it, has been a problem expressed in previous Asset Finance International surveys of the Australian market, and this continues to be a prime concern. John Dennis of Australian Structured Finance Group (ASF) commented:

"Major capex investment remains relatively subdued"

"Major capex investment remains relatively subdued," but he could see some brighter areas, such as "a significant increase in new motor vehicle sales fuelled by a low interest rate environment, and smaller ticket construction and transport equipment funding is up on the back of our domestic property boom."

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He also noted, "Tax changes for small and medium-sized enterprises (SMEs) allowing a 100% deduction on equipment purchases under A$20,000 acquired between 12 May 2015 and 30 June 2017 contributed to stronger figures to 30 June 2015," but concluded: "Until the Australian dollar drops further and commodity prices/Chinese demand rise, I suspect major capex and equipment funding demand will remain static at best."

One positive development picked out by John Dennis and by George Lagos of Canon Finance Australia is the recent change in prime minister which has led, at least initially, to increased business optimism. Lagos observed that consumer confidence has increased at the same time and continuing low interest rates will also help growth, although he added that this will vary from state to state, saying: "Western Australia is suffering greatly from the downturn in the mining industry, Queensland also but not to same extent," while on the other hand, "Infrastructure spending in New South Wales is causing strong growth."

However, there is the constraint that the Australian markets are more at the mercy of global headwinds than in the past, as pointed out by John Dennis, who said: "Recent volatility in the domestic share market immediately following overseas volatility demonstrates we have little control over our local markets."

Effects of the global slowdown

So what effect is the slowdown in global commodities having on underlying business confidence levels and asset finance in particular in Australia?

Hugh Lander

In the view of Hugh Lander of BOQ Finance, "The weakness in commodity prices is directly impacting business confidence and capex activity in the mining and associated service industries. More generally, the weakness in commodity prices has caused national income growth to be only modest. In turn, this has meant only modest growth in company profits, and crimped capex activity in the non-mining sectors."

Craig Gee agreed, stating: "Falling commodity prices have resulted in reduced capex, higher financial distress in the mining & mining services markets, and lowering of mining asset values. Whilst viable mines will continue to need to replace old equipment from time to time, miners are endeavouring to stretch the life of existing assets while trying to improve the productivity of exiting assets. Thus the number of mining asset finance opportunities has been reducing and will remain bearish for some time to come."

The recent woes of Glencore, the world's biggest commodities trader and one of Australia's largest mining companies, illustrate the problems that have hit the industry. As demand for commodities grew, Glencore expanded rapidly through debt-based acquisition – debt that has weighed heavily as the market has stagnated. Fears about the mountain of debt caused the company's share price to nosedive in 2015, which triggered a wide-ranging debt reduction plan including asset sales and

provided what has been described as the "Lehman Brothers moment" for the resources industry. In Australia, the firm has recently announced production cuts and worker redundancies at its zinc mines and put a copper mine up for sale – for which, ironically, potential purchasers are the Chinese – and there has even been speculation regarding the future of some of its coal mines.

"The good news is that there have been some signs that firms are revising up their expected spend on investment"

Nonetheless, commodities and mining aren't everything and, according to Hugh Lander: "The good news is that there have been some signs that firms are revising up their expected spend on investment. But significant growth in capex activity is unlikely for at least the next year."

To this, John Dennis added: "I think most Australians see our export economy as primarily food and commodity based, so there will always be a significant correlation between business confidence and a boom/bust cycle for global commodities."

Regional trade deals

Increasing global interconnectedness has encouraged the development of international trade agreements, as mentioned earlier in this report. What are the opinions of the panel of experts on agreements such as the proposed Trans-Pacific Partnership (TPP) improving opportunities for Australian manufacturers and exporters?

The majority view was summed up by Hugh Lander: "Any free trade agreement, such as the proposed Trans-Pacific Partnership, over time should assist Australian exporters."

It should be noted that the Australian economy is much broader based than some of its Asia-Pacific neighbours and has a wide mix of commodities – not only natural resources, but agricultural commodities such as meat and milk, a point was made by Craig Gee, who said: "The TPP will be helpful to exporters of agricultural products."

However, John Dennis was not convinced, commenting: "I doubt free trade agreements/TPP will have much impact on new capital equipment investment; however, a falling Australian dollar – making exports more competitive – will have a more significant impact," although he also commented: "Of course this is a double-edged sword, as the vast majority of capital equipment is imported into Australia."

Market make-up and opportunities

The asset finance market in Australia has long been dominated by the 'Big 4' banks – ANZ, Commonwealth Bank, NAB and Westpac – although for these institutions leasing is a relatively small part of the overall business mix. Despite this, the number of independent lessors has been diminishing, with players such as Investec selling its Australian interests to BOQ and Westpac acquiring Capital Finance from Lloyds Bank.

There was one notable new entrant to the market in 2014 – SMBC. Asset Finance International asked the panel members whether they thought other foreign lenders would follow this lead.

George Lagos

Unfortunately, the outlook is more of continued dominance by the Big 4. In fact, as George Lagos stated, developments are more likely to be outward rather than inward: "It's not a huge market compared to Europe and US, and players are looking to expand overseas (mainly into Asia)."

And in addition to remaining the dominant players in the asset finance market, Craig Gee reported that "in the SME sector, the Big 4 have been chasing market share and driving down net interest margins."

He continued, predicting consolidation: "M&A within the market will see a further overall reduction of the number of lessors," although he did add: "However, SMBC Leasing has entered the Australian market with a focus on large ticket lease transactions only." Perhaps the competition amongst the Big 4 in the SME sector has restricted SMBC's ambitions.

"The biggest issue facing our local market remains the total lack of independent financiers"

The overall prospects are not encouraging, according to John Dennis, who stated: "Sadly, in line with comments made in previous surveys, the biggest issue facing our local market remains the total lack of independent financiers, a situation only to be exacerbated once GE Capital sells its local portfolio and exits." Underscoring this, he added, was the fact that "an issue recently raised at AELA related to the likely need to remove the category 'General Financier' from the membership definition as there will be no true non-bank owned, independent general financiers remaining."

John Dennis

Dennis provided a slightly different view regarding SME and large-ticket facilities: "There are a few smaller lessors emerging, relying upon receivable warehousing and sell down/securitisation; however, this generally remains in the SME space, with no new entrants at all in the larger ticket/larger facility end of the market."

On the other hand, Dennis agreed that there is a 'race to the bottom' in terms of lease and finance rates offered between the dominant equipment lessors within the market, where risk margins and returns continue to be squeezed. "This certainly confirms," he stressed, "there is no collusion between market competitors, as each seeks to undercut the other in search of volume and credit quality."

The unfortunate consequence of this is an environment where potential new entrants are unlikely to view the returns available in the Australian market as sufficient to justify their entry.

Dennis concluded with a better scenario for vendor finance: "There is some growth in vendor finance representation. Of course, the contraction in risk appetite for certain industry sectors (such as mining) has enabled those OEM vendor financiers to improve their market share at higher margins."

Chris Pearson

There has certainly been a degree of activity in the auto sector, as described by Chris Pearson of software solutions provider White Clarke Group. Referring to GE Capital's planned exit from the market he said: "There have been

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some interesting recent developments, an important one being the acquisition of GE Capital's fleet management operations by Element Financial – a case of one North American firm buying an asset of another. More recently still, we have one of the Australian Big 4, ANZ, selling its Esanda dealer finance unit to Macquarie, a fellow domestic financial institution. These moves don't mean market consolidation, but new owners might add to competition levels."

The AFLA's Helen Gordon does not anticipate this M&A activity will fundamentally change the market: "As we see it and based on earlier recent acquisitions of this type (for example, the Westpac acquisition of Capital Finance) these transactions typically run smoothly, with little direct or indirect impact on the fleet market."

Alternative sources of funding

A potential change to the make-up of the funding market, at least for small businesses, is the arrival of new funding sources such as peer-to-peer (P2P) lending and crowdfunding. Asset Finance International asked the industry experts if there has been much use made of alternative sources by SMEs so far, and what their views are of the prospects for these types of funding in the longer term.

"There is no doubt peer-to-peer lending will make an impact in time"

The responses were generally non-committal. BOQ Finance's Hugh Lander commented: "There is no doubt peer-to-peer lending will make an impact in time. To date, however, this impact has only been minimal – focused on micro businesses – higher risk (new businesses) and charging higher rates."

And in the opinion of George Lagos of Canon Finance Australia, if any inroads in the market have been made, they are "at this stage inconsequential."

There was little comment otherwise, as mainly large-ticket equipment leasing precludes active contact with what are still very much small business-oriented operations. However, John Dennis of large-ticket lease packaging group ASF did observe: "This is not applicable to my market so I'm unable to comment, although I am aware of both UK and US groups approaching brokers and some of the home loan aggregators moving into the equipment finance markets to explore opportunities here."

Speaking of the changes that financial technology is bringing to customer experience, White Clarke Group's Colin Fleischmann stated: "Entrepreneurs are exploiting the internet and the fact that consumers are using new technology to research products and services, which has made alternative funding possible. Acceptance of these sources will grow amongst SMEs as they realise they can technically access funding far quicker than through any traditional method."

Colin Fleischmann

White Clarke Group

Asset finance growth hot-spots

The next topic for debate was which market sectors are likely to offer the best prospects for growth in the coming 12 months. First, the panel looked at overall growth prospects.

There was agreement that the market will grow, although not by a great deal. John Dennis was of the opinion that "the entire economy appears to remain cost focused, with margins keeping reasonably tight. Very few Australian Securities Exchange listed companies have reported significant growth, other than those in service industries where major equipment capex will be limited."

In terms of whether large corporations or SMEs will perform best, Hugh Lander said: "Exporters are likely to do a little better than firms solely reliant upon domestic demand, reflecting the benefits of the sharp decline in the exchange rate. This typically favours larger firms."

However, close knowledge of the construction equipment market meant Craig Gee of Marubeni Equipment Finance favoured smaller businesses. He said: "Our feeling is SMEs will perform well with the uptick in housing construction in Sydney and Melbourne markets."

"I expect personal and business finance for passenger vehicles to outperform the growth in plant & machinery finance"

Regarding more specific sector prospects, Gee commented: "Demand for passenger vehicles seems to be improving over the last few months. I expect personal and business finance for passenger vehicles to outperform the growth in plant & machinery finance."

Others agreed that the passenger car sector looks relatively strong, helped by record low rates, consumer confidence and healthy competition driving prices down. At the heavy end of the vehicle segment the same cannot be said for trucks, which is declining due to the impact of conditions in mining.

Reasonable levels of consumer spending are likely to see growth in office equipment, technology and telecoms, and two other sectors that received multiple mentions were healthcare and the renewable energy sector – these may grow in the higher single-digit range.

The healthcare sector "should have a better run as government spending restraint eases," according to Hugh Lander, while renewables should also benefit from changes in government policy, as described by Craig Gee: "Leasing of solar panels and storage equipment declined under the Abbott government, but under the Turnbull government the outlook for this sector has improved."

Vehicle emissions

Having heard the generally positive views regarding the prospects for passenger cars and also for cleaner energy, a looming dark cloud is the question of the potential knock-on effect on Australian vehicle leasing – and captive lessors – from the VW emissions scandal.

There was a reluctance to comment much on an issue that may spread to other manufacturers. Craig Gee simply noted that "lessors of VW vehicles may want to assess whether or not they are exposed to any potential legal liabilities."

"Australians are not particularly focused on green energy and climate change or fuel consumption/ vehicle emission levels"

However, John Dennis took a sanguine view of how deep an impact this might have in Australia, observing that "Australians are not particularly focused on green energy and climate change or fuel consumption/ vehicle emission levels. If emissions were of primary concern to the voting public, it would be a greater issue in federal politics."

The federal position is, as in many developed nations, full of headline good intentions undercut by policy uncertainty. The current Liberal Government abolished the previous Labor administration's Carbon Pricing scheme upon gaining power and has introduced a new Direct Action plan, at the centre of which is a taxpayer-funded programme called the Emissions Reduction Fund which allows companies to volunteer to cut their pollution level. This has not been well received and in fact the new Prime Minister Malcom Turnbull has long been a vocal critic of Direct Action.

There may be repercussions of the VW emissions scandal that will affect residual values and bring problems for fleet lessors down the line, but for John Dennis at the moment, "I suspect there will be little to no impact and I haven't seen VW, Audi, Skoda, Porsche, etc discounting cars just yet...."

Improving customer service

Moving on to how the rapid technological advances can benefit asset finance companies, the panel considered what they should be doing to run their businesses more effectively and deliver smarter solutions to their clients.

The first area of focus was small ticket finance, summed up by George Lagos, who stressed: "Auto processing, especially in small ticket financing, is critical."

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John Dennis agreed: "There is little doubt the smaller ticket end of the market has increased its focus on credit scoring and automated approval processes in a bid to reduce product delivery costs and potentially generate greater customer engagement with automatically pre-approved limits."

However, he qualified this with the view that it has come at the cost of maintaining educated and experienced credit officers capable of supporting transactions that fall outside a credit scoring matrix that predominantly relies on historical trading results. "The risk here is that potential borrowers seeking to expand when the economy finally recovers will find access to debt funding limited if all of the banks and their subsidiaries and associates adopt near identical customer profiling and credit techniques."

"Despite the greater use and reliance banks place on technology, there continues to be a 'dumbing down' of the industry more generally"

He concluded: "In short, despite the greater use and reliance banks place on technology to make their marketing and credit decisions more uniform and to gain greater efficiencies and reduce overheads, there continues to be a 'dumbing down' of the industry more generally."

Nonetheless there are many areas where technology can successfully boost the customer experience. Craig Gee suggested the following: "Electronically delivered documentation and e-signatures by lessees, web-based access for clients, and in-field e-finance quote systems for channels/introducers."

To these, George Lagos added: "Subscription-based billing demand is growing dramatically and financiers will need to accommodate financing of hard and soft costs, changing throughout the term under one master agreement."

White Clarke Group's Chris Pearson commented: "Speed and flexibility are so important in the customer experience. It is imperative that asset finance and leasing companies keep their technology updated. On the fleet vehicle side for example, software-as-a-service solutions are constantly improving fleet clients' connectedness with their mobile workers. There is growing demand for connected intelligence, which is transforming companies' effectiveness and efficiency."

His colleague Colin Fleischmann took this up, stating: "Technologies enabling better use and analysis of big data bring operational efficiencies. Through monitoring assets, leasing companies can optimise product usage across a product lifecycle."

New leasing standard

The final subject for discussion was the hoary one of the seemingly endless deliberations by the lease accounting boards – the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) – over the proposed new standard.

This is covered in full in the special article 'A new world of leasing' later in this report, and it looks as though the Boards are finally nearing a conclusion, but there remains a strong element of doubt among the asset finance experts.

A practical point was made by Craig Gee, who noted: "It would be helpful if both the IASB and FASB agreed on the leasing standard. To have totally different accounting treatments under IASB and FASB is a poor outcome."

The view that, whatever the outcome, any new standard is unlikely to make much difference was voiced by John Dennis, who said: "The dysfunctionality between the two accounting bodies continues to appear petty and laughable – even to their own members. Equipment finance is more generally viewed as a form of stand-alone funding not particularly driven by the accounting treatment of the product. This is supported by the proportion of equipment funding undertaken using a secured loan compared to operating lease within the Australian market."

The concluding thought came from George Lagos, who summed up a mood of weariness surrounding the whole process: "I don't think anyone is taking it seriously that they will ever put something out!"

An update on the legal aspects of goods leasing in Australia

By Nino Di Bartolomeo, partner at Norton Rose Fulbright Australia

We have seen fundamental changes in the law relating to security over personal property in Australia since the commencement of the *Personal Property Securities Act 2009* (Cth) (PPSA) on 30 January 2012, including significant implications for lessors of goods.

Under the PPSA, if a lease of goods is characterised as a security interest, that is, it secures payment or performance of an obligation or it falls within the definition of a 'PPS lease' (discussed below), then among other things:

- Ownership of the leased goods is not sufficient to protect the lessor's interest in those goods;
- The security interest needs to be perfected (generally by registration);
- A lessee can grant a security interest in leased goods to parties other than the lessor;
- In the absence of a valid registration undertaken within applicable time limits, the leased goods may be made available to satisfy obligations owed by the lessee to other creditors;
- The lessor's interest in the leased goods may be lost in its entirety on insolvency of the lessee if the lessor has failed to perfect its interest;
- A purchaser of leased goods may take those goods free of the lessor's interest, including where the lessor has not perfected its interest.

PPS leases and recent amendments

A PPS lease is a lease of goods by a lessor who is regularly engaged in the business of leasing goods (regardless of whether it secures payment or performance of an obligation) where the lease is:

- For a term of more than one year;
- For an indefinite term;
- For a term of up to one year but is automatically renewable; or
- For a term of less than one year but the lessee retains uninterrupted possession of the leased goods for more than one year with the consent of the lessor (in which case it becomes a PPS lease after the term exceeds one year).

Until 1 October 2015, the position in relation to leased goods which had a serial number for the purposes of the PPSA (such as motor vehicles, aircraft and watercraft) and the lease was entered into prior to 1 October 2015, was that the one year period referred to above was 90 days rather than one year.

However, an amendment to the PPSA which took effect on 1 October 2015 removed the 90-day threshold for leases of serial numbered goods. As a result, the one-year thresholds (set out above) apply to all leases of goods entered into on and from 1 October 2015. The

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amendment does not affect leases and bailments of goods entered into prior 1 October 2015, so the 90-day threshold still applies when determining whether a lease or bailment of serial numbered goods entered into prior to that date is a PPS lease. Leasing businesses that use fixed term leases of serial numbered goods for less than one year will no longer need to register those leases on the Personal Property Securities Register (unless the lease secures payment or performance of an obligation).

PPSA review

The PPSA is currently subject to a statutory review by the Australian Government. The final report on the review, which was tabled before Parliament on 18 March 2015, covered all aspects of the operation of the PPSA and made 394 recommendations. The recommendations range from changes to the substance of the PPSA and the Personal Property Securities Register to proposals to educate and improve awareness of the regime. If implemented, many of the recommendations would result in significant changes to the application of the PPSA, thus affecting current market practice.

Cape Town Convention

On 26 May 2015, Australia acceded to the *Convention on International Interests in Mobile Equipment* 2001 (Cape Town Convention) and its related *Protocol on Matters Specific to Aircraft Equipment* (together, the Convention), an international treaty designed to provide, among other things, an international standard for protection of security and other prescribed interests (including leases) in certain types of aircraft assets. The Convention took effect from 1 September 2015.

Under the Convention, an international register is available for registration of certain interests (including the interest of a lessor) in particular aircraft objects. Prior to 1 September 2015, security interests in and PPS leases of aircraft objects were regulated by the PPSA. Post-1 September 2015, both the PPSA and the Convention apply. However, the Convention prevails over the PPSA to the extent of any inconsistency. The Convention only applies to aircraft objects which satisfy the capacity, power and use requirements of the Aircraft Protocol. As a result, the PPSA continues to apply to aircraft objects that fall outside of this scope. Other inconsistencies between the PPSA and the Convention (such as the treatment of proceeds under the PPSA) mean that secured parties should consider continued registration on the Personal Property Securities Register as well as the international register under the Convention.

Unfair contracts terms

On 24 June 2015, the Federal Government introduced legislation to extend existing statutory prohibitions on unfair contract terms in consumer contracts (as set out in the *Competition and Consumer Act* 2010 and the *Australian Securities and Investments Commission Act* 2001) to “small business contracts”. This change, once passed, would essentially affect every form of agreement (with the exception of insurance contracts, some shipping contracts, managed investment schemes and company constitutions).

Under these amendments, if a provision in a small business contract is "unfair" and that contract is a "standard form contract", the unfair provision in the contract is excised, but the remainder of the contract remains in effect.

A "small business contract" is a contract to which at least one party is a small business (being a business with fewer than 20 employees) where the up-front price payable under the contract is less than $100,000 or, for a contract term of more than 12 months, $250,000 (excluding interest). A proposal has been made, as part of the parliamentary process leading to passing of the legislation, to increase the monetary thresholds to $300,000 and $1,000,000 respectively. This would impact on the potential scope of the new legislation. At the time of writing, the outcome of that proposal is not known. In the context of a lease, the up-front price would include the scheduled lease payments (other than interest).

Under the relevant statutes, the matters that a court must take into account when determining whether a contract is a "standard form contract" include:

- Whether one of the parties has all or most of the bargaining power in the transaction;
- Whether another party was given an effective opportunity to negotiate the terms of the contract (other than negotiations relating to the price and the subject matter).

A term in a small business contract will be considered "unfair" if:

- It would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
- It is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the provision; and
- It would cause detriment (financial or otherwise) to a party if it were to be applied or relied on.

If passed, the proposed legislation is likely to be introduced some time in 2016. It will apply to new contracts as well as existing contracts that are renewed or varied after the commencement date.

Disclaimer: The content of this article is for general information purposes only. It is not intended to be comprehensive or to include advice which may be relied on.

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A new world of leasing

Michelle Gibbs and Carmen Luk of KPMG Australia assess the potential impact of the proposed new leasing standard

After much deliberation, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, 'the Boards') will be releasing the new leasing standard IFRS 16 Leases (IFRS 16) in December 2015. The standard will be effective for reporting periods beginning on or after 1 January 2019, with early adoption available whereby the entity has also adopted IFRS 15 *Revenue from Contracts with Customers*.

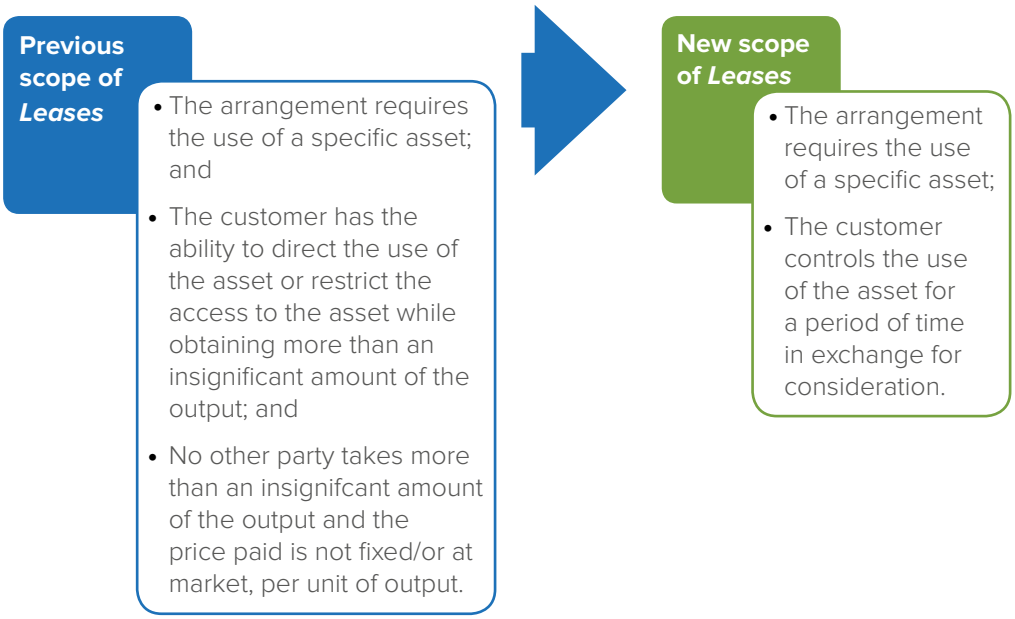
The Board's objective for IFRS 16 is to establish a set of principles that when applied, would report relevant information to investors and analysts over the timing, magnitude and uncertainties arising from leases. The key impacts of the new standard are expected to be:

- All leases will be reflected on the balance sheet;
- Different measurement models for lessees under IASB and FASB, creating a GAAP divergence for dual reporters and making comparison more difficult between entities; and
- Tighter definition of a lease, which places greater scrutiny around the determination of whether the arrangement is an accounting lease (on balance sheet) or a service contract (off-balance sheet).

As the final standard has not yet been issued, our comments and observations have been formulated based on updates issued by the IASB and FASB to date.

Scope of the leases standard

The definition of a lease has now shifted to consider the concept of control as introduced by recent accounting standards such as IFRS 10 *Consolidation*.



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If the arrangement involves the use of a specific asset and the customer controls the use of the asset (e.g. has the ability to decide how the asset is used) for a period of time, the arrangement is a lease. In contrast if the supplier retains control of the use of the item needed to deliver the service, the arrangement will be accounted for as a service contract. Key to this analysis will be the consideration of:

- Substitutability of the asset with another asset, additional criteria expected to be included in the new standard that requires that the substitution must benefit the supplier in order for the arrangement not to be considered a lease of a specific asset;
- Whether the customer has the ability to gain substantially all of the economic benefits from the asset during lease term; and
- Whether the customer directs how and for what purpose the asset is used during the term (largely consistent with current standard, additional guidance will be provided to illustrate when this criteria is met).

Given service contracts are accounted for off balance sheet we expect there will be additional pressure of lessors to structure contracts that will not meet the definition of a lease.

How will the standard impact customers?

It is anticipated that lessees will be required to retrospectively adopt IFRS 16 and report all existing and new leases on the balance sheet as a financial liability, with a corresponding 'Right-to-Use' asset (ROU asset); however, we expect there will be some relief provisions allowed.

The accounting methodology to be applied will differ slightly under FASB and IASB standards and is detailed below.

Lessee accounting

Types of leases

US GAAP

- Entities complying with US GAAP will now be required to classify lease arrangements as a Sales-type lease (previously referred to as Type A in the 2013 exposure draft) or Operating lease (previously referred to as Type B in the 2013 exposure draft) where:
  - Sales-type lease is generally considered to be the finance leases of today characterised by the transfer of the risk and rewards of the asset to the lessee; and
  - Operating lease is generally considered to be the operating lease and other leases that are not classified as Sales-type. This classification impacts the profit and loss treatment only as detailed below.

IFRS

- IFRS compliant entities will have to adopt a single lease accounting model. The recognition and measurement will be the same for all leases.

FASB Lessee accounting (US GAAP)

Balance sheet

- Record a ROU asset equal to the liability plus initial direct costs.
- Record a financial liability measured at the present value of fixed lease payments (including inflation or index-linked payments and expected residual value guarantees) and optional payments the lessee is reasonably certain to make. This will include an assessment on the appropriate lease term giving consideration to whether there are economic factors that influence the lessee to exercise any options.

Statement of profit and loss

- For Sales-type leases, the lessee will amortise the ROU asset to the P&L on a straight line or other systematic basis reflecting pattern of asset use, over the shorter of lease term and useful life. Record interest expense on the liability that will be front-loaded to the start of the lease (like a finance lease under the current standard).
- For Operating leases, this means the introduction of a new model which will allow a total lease expense in the P&L to be recorded on a straight-line basis. Interest expense will be calculated as for Sales-type leases and amortisation expense will be a 'plug' figure to ensure total cost of the lease is equal across the periods of the lease.

IASB Lessee accounting (IFRS)

Balance sheet

- Record a ROU asset equal to the liability plus any direct costs.
- Record a financial liability measured at the present value of fixed lease payments (including inflation or index-linked payments and expected residual value guarantees) and optional payments the lessee is reasonably certain to make. This will include an assessment on the appropriate lease term giving consideration to whether there are economic factors that influence the lessee to exercise any options.

Statement of profit and loss

- For all leases, the lessee will amortise the ROU asset to the P&L on a straight line or other systematic basis reflecting pattern of asset use, over the shorter of lease term and useful life.
- Amortisation of the lease asset will be greater than the reductions in the financial liability over the first half of the lease, and therefore will have a negative impact on equity.
- Record interest expense on the liability that will be front-loaded to the start of the lease (like a finance lease under the current standard).

Available reliefs

- Short-term leases (less than 12 months) and leases of small assets (e.g. laptops and office furniture with immaterial value to entity, IFRS only), can be exempt from inclusion in the balance sheet and will apply service contract accounting (i.e. recognise lease expense when incurred).
- Additionally, portfolio-level accounting can be applied where there is no material difference from accounting of each individual lease.
- For US GAAP entities only, leveraged leases will be exempt from applying the new standard.

Key implications to lessees

While the new standard is not expected to be effective for several years, the impact of the new standard may result in:

- An increase in EBITDA for lessees that currently have operating leases recorded off balance sheet, as under the new standard (IFRS only), amortisation and part of the lease payment will be reported (finance costs) which is below the EBITDA line. Further, the timing of the expense recognition of the lease over the term will be different as the expense will be front loaded to the start of the lease (as opposed to recoded on a straight line basis under current practice) for IFRS;
- Customers needing to consider the implications of bringing all leases onto the balance sheet to debt covenants and ratios, KPIs and remuneration packages where linked to these measures, and allocation of spending between opex and capex budgets;
- Customers wishing to amend current lease terms to reduce impact to the balance sheet;
- Reduced appetite for leases if accounting treatment was a key motivation;
- A high cost in complying with the new standard due to increase data/process requirements and reporting; and
- Increased focus on transaction structuring for leases towards service contracts.

How should lessors prepare for the changes?

- Consider the impact of these changes to long term leases entered into now and before the application date of the new standard;
- Sales staff have sufficient training to address client concerns and queries;
- Consider whether existing contracts meet the new definition of leases and consider restructuring current product offerings or develop new offerings that meet the requirements of your customers (e.g. consider short term lease relief, lease term, structuring lease payments as contingent rents and structuring arrangements as service contracts) where commercially viable;
- Sales and marketing efforts to customers should clearly articulate the benefits of leases vs purchasing an asset from the following perspectives: accounting (e.g. leases may result in lower values of the asset and liability where a residual value payment is not required vs a purchase and lending arrangement), commercial (e.g. provisions of services such as repairs and maintenance that can be included in a leasing arrangement), financial (management of residual value) and other tax considerations;
- Consider transitional provisions for the new standard and any available relief provisions.

What do the changes to the new lease standard mean for lessors?

- The accounting consequences for lessors under the new standard remain substantially consistent with current practice where leases will continue to be classified as either operating or finance leases. Lessors will continue to recognise an asset for finance leases equal to their net investment (lease receivable and residual asset) and the associated finance income, and for operating leases, will continue to recognise the asset (record associated depreciation) and earn rental income on a straight line basis.

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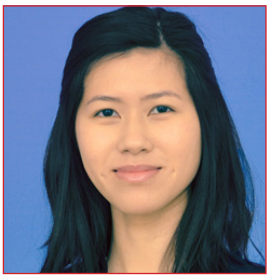

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The tax treatment of equipment and auto leasing in Australia

Joel Phillips of KPMG Australia provides a brief overview of the Australian tax considerations typically raised by equipment and auto leases

The treatment of purely domestic leases has been largely settled since 2007, when rules were introduced to negate the tax-timing benefits of leases to tax-exempt bodies or non-residents. However, 2015 has seen significant changes affecting the treatment of cross-border leases: the proposed introduction of a multinational anti-avoidance law, and a (welcome) expansion of Australia's offshore banking unit regime.

Income tax

For income tax purposes, a distinction is drawn between 'genuine' leases and hire purchase arrangements.

These categories raise similar conceptual issues to the accounting classification of a lease: they address whether, in substance, the lease arrangement provides secured finance to the lessee.

Chattel leases generally qualify as 'genuine' leases if the lessee has no right or obligation to purchase the leased asset, and the residual value complies with guidelines laid down by the Australian Commissioner of Taxation in 1960. This is intended to ensure that the lease is not, in substance, an instalment sale.

By contrast, lease agreements under which the lessee has a right or obligation to buy the leased asset (and instalment sale agreements) are likely to constitute hire purchase arrangements.

The tax classification of a lease is relevant to the Australian income tax treatment of the lessee and lessor, as regards both the timing of assessment and deduction, and also the applicability of withholding tax (should the lessor be a non-resident).

Under a genuine lease, the lessee is normally entitled to deduct the lease payments it makes to the lessor, and the lessor is assessed on these. The lessor may also claim 'capital allowances' (tax depreciation) in respect of the leased asset.

The availability of capital allowances means a genuine lease usually produces a tax loss for the lessor in the early years of the lease.

Hire purchase arrangements are instead treated as if the lessor had made a loan to the lessee, and the lessee had then purchased the leased asset from the lessor. Similar rules apply to leases made to tax-exempt entities (such as state bodies) or non-residents where the lessor lacks a predominant economic interest in the leased asset.

Goods and Services Tax (GST)

The distinction between leases and hire purchase arrangements is also relevant for GST purposes. In general, GST is payable separately on each lease payment, but for hire purchase arrangements GST is levied upfront on all the payments due over the life of the lease. The lessor

is required to pay the GST over to the Australian Taxation Office (ATO), and may also be eligible to claim a refund of any GST it incurred on the purchase of the leased asset.

Novated leases

A peculiarity of the Australian leasing market is the use of novated leases.

Under a novated lease arrangement, an employee enters into a lease with a finance company. The employer then assumes the employee's obligation to make the lease payments, and in exchange the employee sacrifices part of their salary.

Novated lease arrangements enable employers to provide car fringe benefits to employees without the risk of acquiring an unwanted car on termination of employment, and without having to recognise cars on their balance sheets. The arrangements also benefit from concessional tax rates. In essence, the sacrificed amounts are taxed more favourably than they would have been if received as salary (the employer may also recover the GST charged on the lease payments). Changes to the concessions were announced in the run-up to the 2013 Australian federal election but were subsequently reversed following a change of government.

Cross-border leasing

Foreign lessors leasing *into* Australia must consider whether the lease payments they receive will be taxed at source (i.e. subjected to withholding tax) or on an assessment basis, or whether one of Australia's 'good' treaties (such as those with Japan, the UK and the US) can be accessed to provide a full exemption from Australian withholding tax and income tax.

In determining whether treaty benefits are available, leasing groups must consider the impact of both Australia's existing general anti-avoidance regime (Part IVA) and a proposed new multinational anti-avoidance law. The latter (currently before Parliament) will be particularly relevant where client relationship-building activities are carried on in Australia. Briefly, the proposed law can apply to schemes that have a *principal* purpose of obtaining Australian *or* foreign tax benefits – a lower threshold than under the existing Part IVA.

Common GST considerations include whether the lease payments will be subject to GST (this depends in part on where the leased asset is located when it is delivered to the lessee), and how the cash flow impact of any GST liability can best be mitigated (e.g. by making use of a reverse-charge agreement, or by staggering payment dates). In that regard, proposed GST amendments (published 7 October 2015) will, if enacted, remove from the scope of GST certain sales of leased assets between non-resident lessors.

For domestic lessors entering into *outbound* leases, recent changes to Australia's offshore banking unit regime may be relevant. For income years starting on or after 1 July 2015, the regime's concessionary 10% income tax rate can apply to both hire purchase arrangements and genuine leases.

Stamp duties

Australia has a relatively complex stamp duties regime. Duty is imposed by the various Australian states and territories (rather than the federal government), meaning the stamp duties of several different jurisdictions may be relevant.

Chattel leases normally raise two key questions. First, will transfer duty be payable on the acquisition of the leased assets? And second, will mortgage duty be payable (if external borrowings are secured on the leased assets)?

Other issues

As will be evident from the discussion above, leasing raises many tax issues, whether it takes place wholly within Australia or cross-border. Lessors and lessees should seek tax advice before they agree to the terms of a lease or (particularly in the case of cross-border leases) the allocation of tax risk.

Whilst the Australian tax treatment of leases is largely settled, some matters remain unresolved. These include the application of the Commissioner's prescribed minimum residual values, the GST consequences of an assignment of lease receivables, and the application of the proposed multinational anti-avoidance law.

Other changes to the Australian tax system may also affect the relative attractiveness of leasing. For example, recent changes to Australia's thin capitalisation rules (reducing the levels of debt on which taxpayers can claim interest deductions) may encourage affected taxpayers to increase the proportion of genuine leases in their funding mix.

The information contained herein is of a general nature and is not intended to address the specific circumstances of any particular individual or entity.

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