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NOTICE TO MEMBERS

NEW LEASE ACCOUNTING STANDARD-COMMENTARY

Executive Summary

The new Lease Accounting Standard AASB 16, requiring most operating leases to be reported on the lessee's balance sheet, has an application date of 1 January 2019.The accompanying commentary from KPMG provides an overview of the new Standard, and its impact on lessees and lessors. It focuses on leases captured by AASB 16 and exemptions, treatment of service arrangements, accounting implications for lessees including P&L and balance sheet treatments, the impact for debt covenants, summarises the key financial and operating consequences for lessees, and addresses transitional arrangements. Also covered are disclosure requirements for lessees and key differences with the US Standard.

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Director

Lease accounting to change with the introduction of AASB 16 Leases

How will this impact lessees and lessors?

The IASB released AASB 16 Leases on 13 January 2016, which was later ratified and released by the AASB for application in Australia. The new standard will require lessees who apply AASB to bring most leases onto the balance sheet. Members participating in the AELA/AFLA statistical profile reported operating lease receivables of $5.8/$5.9 billion respectively at the end of April 2016.

This article addresses the key requirements of AASB 16, how this will impact on clients, and suggests how lessors can assist lessees deal with the impending change.

Key facts about AASB 16

- Application date - 1 January 2019 (early adoption permitted)
- All leases (equipment and property) on balance sheet
- Exemptions - service contracts, short-term & low-value leases.
- Balance sheet grossed up
- P&L profile to change
- Impact to key financial metrics, debt covenants, KPIs and tax effect accounting balances
- Key differences between US and IFRS lease standards
- Communication of impact to stakeholders is key.
- Impact on existing processes and systems given the reassessment requirements of AASB 16.
- Modelling of transition options effect to P&L and B/S will be key to determine which option to apply on the application of the standard.

Overview

The initial fears held by many about the negative impact to the operating lease industry as a result of the IASB's proposals to bring leases onto the balance sheet of lessees has calmed. This is due to the simplification of the final standard, introduction of exemptions and the long application period (AASB 16 will apply for annual reporting periods beginning on or after 1 January 2019).

Key impacts to lessees with operating lease portfolios as a result of applying AASB 16, will be:

- "Gross up" of the balance sheet;
- Changing profile (amount and presentation) of lease payment;
- Flow on effect to key financial metrics (including KPIs, debt covenants and undertakings); and
- Changes required to existing lease processes and systems to capture the requirements of the standard.

It is important to note that the economics for leasing have not changed and the impact to the balance sheet for operating leases is less than would be required for a borrow and buy strategy, given the lessor takes the residual risk.

Leases captured by AASB 16 and exemptions

All contracts that meet the criteria of a lease, as defined in AASB 16 (see below) will be captured, **unless** the contract meets one of the two following exemptions:

Low value assets – optional exemption

Leases of assets that have a low value (such as computer equipment, tables, chairs etc.) will not come onto the balance sheet. This applies on an asset by asset basis (even if material in aggregate) and must be applied at an asset level that is not highly interrelated or dependent on other assets. The IASB has indicated that they consider low value to be, when new, USD 5,000 or less.

Short term leases – optional exemption

Leases which have a term (including options to extend) of less than 12 months (this includes incumbent leases with less than 12 months remaining in the term. Typically these contracts would be accounted for on a straight-line basis to the P&L (similar to operating leases today).

Definition of a lease

All contracts that contain the right to control the use of an identified asset for a period of time in exchange for consideration are classified as leases. This definition is similar to the definition today, however additional application guidance in AASB 16 may result in differences in practice.

Given the elimination of the off-balance sheet treatment for operating leases, structuring the contract as a service arrangement, as opposed to a lease, will be a key focus area. Service arrangements are accounted for off-balance sheet with the rental expense recorded in P&L as incurred.

In order for an arrangement to be classified as a lease, the following three conditions must be met (therefore to be considered a service contract you must fail one of the following conditions):

- There is an identified asset. An identified asset does not exist if the supplier has the practical ability to substitute alternative assets and the supplier can benefit from the substitution (i.e. benefit of substitution outweighs the cost);
- Customer has the ability to gain substantially all of the economic benefits from the asset during lease term (previously a lessee could accrue 100% of the economic benefits if the price paid was fixed per unit of use/output); and
- Customer directs how and for what purpose the asset is used during the lease term (e.g. decides when or where the asset is used and how it is used). Protective rights of suppliers such as limiting machine hours to avoid excessive wear and tear are not considered.

Consideration should be given as to whether existing or new lease contracts can be structured as service arrangements if off-balance sheet treatment is desired.

Accounting for leases by lessees

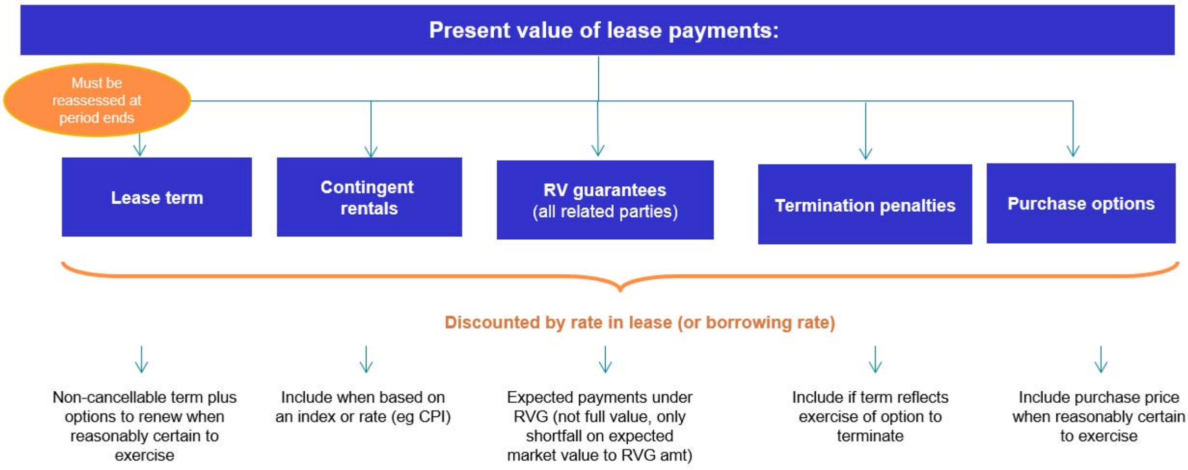
Accounting for ‘simple’ leasing arrangements (e.g. fixed term with fixed rentals and no term extension/early redemption options, no purchase options, no variable rents nor residual value guarantees), is relatively straight forward and is illustrated in Diagram 2. Further, the accounting treatment for operating leases is comparatively similar to the current treatment of finance leases (with key differences being for residual value guarantees and variable rents as explained below).

Upon adoption date, lessees will be required to record all leases at that date (unless exempt), on the balance sheet, represented by:

Leased “right of use” asset
Initially equal to the amount of the liability plus direct costs, any pre-paid rents and make good provisions, less any incentives received. Subsequently the leased asset is amortised to the profit & loss on a straight line basis (or pattern of use), less any impairment, and adjustments as a result of remeasuring the liability as detailed below.

Lease liability
Calculated as the present value of lease payments, discounted at the rate implicit in the lease (or if this rate can’t be determined, the relevant borrowing rate) for the lease term. The lessee will be required to make an assessment of the terms, including any lease payments linked to a rate or index, estimates of residual value guarantees, purchase options and term penalties. Subsequently the liability is accreted for interest, reduced for principal payments, and reassessed each reporting period for changes to the factors detailed in Diagram 1 below.

Diagram 1: Measurement of lease liability



The diagram below shows the impact to a lessee's financial statements and certain key financial metrics before and after adoption of AASB 16, for an operating lease arrangement one year after implmenentation. The terms of the lease are: 5 years, yearly rents of $1,000 in arrears, 7% rate implicit in the lease, no variable purchase or termination options, no variable lease payments and no options to extend. Note this example does not include the impact of tax effect accounting entries. See Appendix 4 for detailed calculations.

Diagram 2: example impact to lessee financial statements

Balance Sheet (after 1 year)	AASB 117 (today)	AASB 16 (future)
Property, Plant and Equipment	44,250	44,250
Right of use asset	-	**3,280**
Other	35,256	35,256
Total assets	**79,506**	**82,786**
Borrowings	(22,567)	(22,567)
Lease liability	-	**(3,387)**
Net assets	**56,939**	**56,832**
Profit and loss in year one:		
Revenue	10,000	10,000
Operating lease payments	**(1,000)**	-
Impairments on leased assets	-	-
Service components	(10)	(10)
EBITDA	**8,990**	**9,990**
Amortisation	-	**(820)**
EBIT	**8,990**	**9,170**
Interest expense	-	**(287)**
Net profit/(loss)	**8,990**	**8,883**

Ratio/Metric	Effect
Leverage (liabilities/equity)	↑
Asset turnover (sales/assets)	↓
EBIT/operating profit	↑
EBITDA	↑
EPS (in early years)	↓

The profile and amount of the lease expense will also change for operating leases from a straight line rental expense over the lease term reported above EBITDA ("above the line"), to the following which will be reported below EBITDA ("below the line"). This is similar to the current treatment of finance leases.

Depreciation	▪ Calculated on a straight line basis (or pattern of use) over the earlier of, the useful life or lease term. If title is expected to pass to lessee or right of use asset reflects lessee will purchase the asset, the right of use asset will depreciate over useful life of the asset.
Interest expense	▪ Calculated on an effective interest basis, which will result in the lease expense being greater at the start of the lease than at the end (similar to current accounting treatment for finance leases).

The following will still be reported above EBITDA ("above the line"):

Variable lease payments	▪ Payments (that are not already included in the lease liability i.e. not linked to an index or rate), that vary in response to a variable such as usage or sales in the current period.
Service component	▪ May be reported separately from the leased asset and liability (i.e. off balance sheet) and recorded as an expense when incurred.
Impairments (if any)	▪ Recorded as a result of existing impairment testing requirements for business segments.

Key impacts to finance leases

The accounting requirements under AASB 16 for finance leases are broadly the same as the accounting requirements today, except for the following:

Residual value guarantees	▪ The expected payment under a residual value guarantee (which maybe zero if priced at market) is included as opposed to the full or maximum residual value guarantee currently required under AASB 117. ▪ Reassessment is required at each reporting date for changes in market value expectations of residual value at the end of the lease, with the lease liability and asset updated accordingly for the present value of that movement (which will also impact future interest expense charges).
Variable lease payments	▪ Payments linked to a rate or index will be included in the leased asset and liability and will continually be reassessed as detailed above.

Sale-and-leaseback transactions

The table below details three key benefits of sale and leaseback transactions and how this will be impacted by AASB 16:

Benefit of sale and leaseback transactions	Still available under new standard	Comments
Off balance sheet financing	✖	No off balance sheet treatment unless treated as a service contract or meets one of the exemptions
Recycling of capital	✔	Benefit still exists
Profit generation	✔ (however a different calculation)	Provided sale occurs (see below) profit recognised relates to the rights transferred to the buyer (lessor)

A sale will occur when the seller/lessee has transferred control of the asset. It is typically expected that control of the asset is likely to be transferred unless the seller/lessee has a forward purchase or call option or the purchaser/lessor has a put option where the terms are such that it is determined that there is a significant economic incentive to exercise the put option. If a sale occurs, the asset is derecognised and the new leased asset and liability is recorded along with any associated profit or loss. If a sale does not occur, then the seller/lessee continues to recognise the asset and records a financial liability for the amount received.

Sub-lease arrangements

In the event a lessee (intermediate lessor) sub-leases the same asset to another party, AASB 16 is applied to the original head lease and to the sub-lease. The intermediate lessor accounts for the head lease and the sub-lease as two different contracts and records:

Head lease
- Leased asset
- Leased liability

If leaseback is an operating lease
- Rental income

If lease back is a finance lease
- A lease receivable is in place of the leased asset
- Gain/loss for any difference
- The lease receivable and liability cannot be offset unless there is a right to set off and payments are settled on a net basis or simultaneously.

Note that when determining if the sublease is an operating or finance lease reference is made to the right of use asset and not to the underlying asset, e.g. if a sub-lease is for the full term of the head lease, the sub-lease will be a finance lease.

Tax effect accounting

The changes to the lease accounting rules will not change the tax categorisation and resulting treatment. AASB 16 only addresses lease accounting on a pre-tax basis, however, leases are in scope of AASB 112 Income Taxes. As a result lease related tax assets and liabilities will be affected on application and going forward. Typically this will involve reversing the effects of interest expense and depreciation and recording the rental charge as the deductable amount.

Date of application and transition

AASB 16 is effective for reporting periods beginning on or after 1 January 2019 (for entities within the EU this is subject to EU endorsement).

Earlier application of AASB 16 is permitted, but only in conjunction with AASB 15 *Revenue*. This means that an entity is not allowed to apply AASB 16 before applying AASB 15. The date of initial application is the beginning of the annual reporting period in which an entity first applies AASB 16.

Lease definition on transition

The new rules must be applied retrospectively to pre-existing leases that have more than 12 months to run as at the date of initial application. However, on transition to AASB 16, companies can choose whether to apply the definition of a lease to all of their contracts or apply a practical expedient to 'grandfather' their previous assessment of which existing contracts contain leases (this must be applied to all contracts, no cherry picking allowed!).

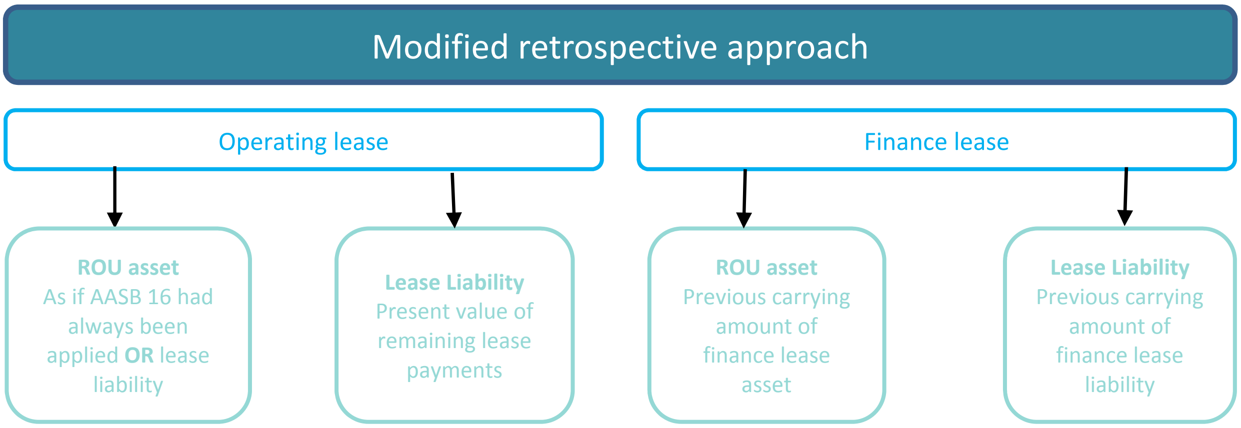
A company that chooses to take advantage of the practical expedient:

- Applies AASB 16 to leases (both operating and finance) previously identified in accordance with the current accounting requirements;
- Does not apply AASB 16 to contracts previously assessed as not containing a lease in accordance with the current accounting requirements; and
- Applies AASB 16 definition of a lease to assess whether contracts entered into after the date of initial application of the new standard are, or contain, leases.

Lessee approach to transition

A lessee is permitted to adopt the standard retrospectively or follow a modified retrospective approach and applies this election consistently to all of its leases. If a lessee elects to apply AASB 16 using the modified retrospective approach, then it does not restate comparative information (otherwise the prior year financial statements would be restated for AASB 16). Instead, the lessee recognises the cumulative effect of initially applying the standard, as an adjustment to equity at the date of initial application.

Diagram 3: Summary of the modified retrospective approach



When applying the modified retrospective approach to previous operating leases, there are a number of other practical expedients that the lessee may use on a lease-by-lease basis, such as:

- Applying a single discount rate to a portfolio of leases with reasonably similar characteristics;
- If remaining lease term is less than 12 months the short term exemption may be applied;
- Exclusion of initial direct costs from the measurement of ROU asset; and
- Use of hindsight to determine the lease term.

Accounting requirements for lessors

Whilst there is limited impact to financial reporting requirements for lessors, as the operating and finance lease distinctions will remain, there are some differences for:

- The definition of a lease as detailed above;
- Inclusion of variable rents based on index or rate as for lessees;
- A lease and sub-lease as detailed above;
- Sale and leasebacks (and new requirements for assessment of sale); and
- Additional disclosure requirements.

Regarding the treatment of a financial institution's own leases, it is still unclear at this stage how regulatory bodies such as Basel and APRA will treat leases for regulatory capital purposes.

How can lessors help their clients?

We recommend that you understand how your products will be accounted for under the new accounting standard by your clients, and consider if there can be any structural amendments to reduce the impact.

For example, consider whether the following is commercially viable for your organisation:

- Structuring the lease as a service contract;
- Minimising the size of the balance sheet impact by reducing term and accepting higher residual risk;
- Minimising the use of rentals linked to an index or rate;
- Disclosing the amount of the service charge;

- Consider changing rental payments to include contingent rents not captured by the standard (e.g. sales or usage payments);

- Completing sale and operating leasebacks now to be able to recognise the profit on sale; and
- Assisting clients understand the quantum of their lease portfolio and calculation of AASB 16 accounting requirements.

Fundamentally, the economics for leasing have not changed. There are still many reasons why lessees choose leasing as opposed to buying the asset outright. For example, the impact to the balance sheet for operating leases is less than would be required for a borrow and buy strategy given the lessor takes the residual risk.

Inherent Limitations

The information contained in this article is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although KPMG, AELA and AFLA endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation. The ultimate responsibility for the accounting treatment and tax effect accounting of any matter rests with the preparers of the financial statements.

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Appendix 1: Disclosure requirements for lessees

AASB 16 increases the disclosure requirements for lessees so that there is more useful information which allows users of the financial statements to understand the effects that leases have on the financial position and performance of the company and its cash flows. At a minimum the following should be disclosed:

Item	Description
Right-of-use asset	▪ Depreciation charge (by class of underlying asset) ▪ Carrying amount (by class of underlying asset) on the face or notes to financial statements ▪ Additions
Lease liabilities	▪ Carrying amount on the face or notes to financial statements ▪ Interest expense ▪ Maturity analysis
Recognition and measurement exemptions	▪ Expense relating to short-term leases ▪ Expense relating to leases of low-value assets
Other disclosures relating to income statement	▪ Expense relating to variable lease payments not included in lease liabilities ▪ Income from subleasing right-of-use assets ▪ Gains or losses arising from sale and leaseback transactions ▪ Short-term lease commitments
Future cash outflows from	▪ Variable lease payments ▪ Extension options and termination options ▪ Residual value guarantees ▪ Leases not yet commenced to which the entity is committed
Qualitative disclosures	▪ Nature of the lessee's leasing activities ▪ Restrictions or covenants imposed by leases ▪ Sale and leaseback transactions

Appendix 2: Differences to US GAAP

Although the IASB and US FASB set out to create one standard, divergence eventuated, with the key differences as follows for lessees:

Topic	AASB 16	US GAAP standard
Lessee accounting model	▪ Single lease accounting model ▪ No lease classification test ▪ Lease expense front loaded to the start of the lease	▪ Dual lease accounting model ▪ Lease classification test based on AASB 117 classification criteria ▪ Lease expense for operating leases will be on a straight-line basis
Practical expedients and targeted reliefs	▪ Optional lessee exemption for leases of low-value items i.e. assets with a value of USD 5,000 or less when they are new, even if they are material in aggregate	▪ No exemption for leases of low-value items
Variable lease payments	▪ Required for variable lease payments that depend on index/rate (when there is a change in cash flows)	▪ In general no reassessment (however, re-measurement is required if the lease is reassessed for another reason)
Sale and leaseback	▪ Gain or loss on sale is limited to the amount that relates to the rights transferred ▪ Repurchase options and substantive put options preclude sale	▪ If leaseback is a finance lease then no sale is recognised (and no profit), if leaseback is an operating lease then full profit recognition based on underlying asset carrying value. ▪ Repurchase option does not preclude sale if exercise price is fair value and asset readily available, non-specialised
Sub-leases	▪ A sub-lessor considers the right of use asset to be the leased asset in determining the classification of the sub-lease	▪ A sub-lessor considers the underlying asset to be the leased asset in determining the classification of the sub-lease
Effective date	▪ Accounting periods beginning on or after 1 January 2019 ▪ Early adoption is permitted if AASB 15 is also adopted	▪ Fiscal years beginning after 15 December 2018 ▪ Early adoption is permitted, even before the adoption of the US version of the revenue standard
Presentation, disclosure and transition	▪ There are a number of differences in the presentation, disclosure and transition requirements. These are primarily a consequence of the differences between the lessee accounting models, and differences between other requirements of AASB and US GAAP that affect leases.	

Appendix 3: Summary of key impacts to business areas

Business area	Description
Finance and Operations	▪ Existing systems and processes currently do not cater for AASB 16 requirements and will need to be updated; ▪ Existing and new lease data will need to be captured and recorded; ▪ Lease calculation is not set and forget, leased assets and liabilities will need to be reassessed by management and updated at least each reporting period for changes to term and discount rates, variable lease payments (linked to index or rate), residual value guarantees, term penalties and options to extend or purchase; ▪ Increases the asset base that must be tested for impairment and therefore may increase the likelihood of impairment for some lessees; and ▪ Recalculation of tax effect accounting balances.
Investor considerations/ Lending arrangements	▪ Quantification and consequential impact from grossing up of balance sheet and changing P&L profile (due to front loaded lease expense) to key financial metrics, management KPIs and ratios; ▪ Communication of impact to market and ratings agencies; ▪ Impact to debt covenants and undertakings and timing/process for required amendments; ▪ Introduces balance sheet volatility given reassessment requirements for lease payments, term and discount rates as detailed above; ▪ Lease payments that are in a foreign currency, or linked to CPI or rates will create balance sheet and P&L volatility that clients may wish to hedge; and ▪ May drive lessees to consider leases structured as service arrangements to get off-balance sheet treatment.

Appendix 4: Detailed calculations for Diagram 2

Right of use asset:

Period	Beginning Balance ($)	Amortisation ($)	Closing Balance ($)
Year 1	4,100	(820)	3,280
Year 2	3,280	(820)	2,460
Year 3	2,460	(820)	1,640
Year 4	1,640	(820)	820
Year 5	820	(820)	-

Lease liability:

Period	Beginning Balance ($)	Payment ($)	Interest @ 7% ($)	Closing Balance ($)
Year 1	4,100	(1,000)	287	3,387
Year 2	3,387	(1,000)	237	2,624
Year 3	2,624	(1,000)	184	1,808
Year 4	1,808	(1,000)	127	935
Year 5	935	(1,000)	65	-

The starting value of the leased asset and liability is present value of the lease payments discounted at the rate implicit in the lease of 7% which is calculated to be $4,100.