A NEW APPROACH TO LEASE ACCOUNTING

On 13 January 2016, the IASB published the long-awaited IFRS 16 Leases, which has been adopted as AASB 16 in Australia. The project to issue a new leases standard began in 2006, primarily in response to user concerns about off-balance-sheet assets and liabilities arising from operating leases, and resulted in multiple exposure drafts and discussion papers. The new standard will be effective for periods beginning on or after 1 January 2019. Earlier application will be permitted for entities that also apply AASB 15 Revenue from Contracts with Customers before 1 January 2019.

RSM OBSERVATION

For most Australian entities, the new standard will come into force for the financial statements for the year ended 30 June 2020. However, entities should consider whether to early-adopt by one year in 2019. This would mean that the new lease standard would be adopted at the same time as AASB 15 Revenue from Contracts with Customers and AASB 9 Financial Instruments. Adoption of all three new standards at the same time may make the transition process smoother, and increase the year-on-year comparability of financial statements.

IMPACT

AASB 16 will affect all entities that enter into lease arrangements, in particular those who currently have operating leases. Recognising new lease assets and liabilities will significantly affect key metrics, such as debt-to-equity ratios and EBITDA, and may hold implications for debt covenants. In preparation for AASB 16, we suggest entities consider the terms of their ongoing leases and new leases, and the implications for future financial reporting.

The effects of implementing AASB 16 may be wider than just the finance function, as it may require input from operational and property functions. In many cases, the information necessary to implement the new standard may require a specific data-gathering exercise, which may involve the review of a mixture of paper and electronic documents, and some changes to IT systems may also be necessary. We recommend that all affected entities undertake an impact assessment as soon as practicable.

SUMMARY

AASB 16 requires entities to follow the process below in accounting for contracts which may contain a lease

Determine whether a contract contains a lease

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Determine what is part of the lease agreement

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Determine the term of the lease

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Determine the lease liability

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Recognise the interest on the lease liability and amortisation of the asset over the term of the lease

TRANSITIONAL REQUIREMENTS

All existing leases will be required to be reassessed when AASB 16 is adopted. However, for existing contracts, previous conclusions reached on whether an arrangement contains a lease under Interpretation 4 can be 'grandfathered' as long as this approach is applied uniformly. A lessee is permitted to apply either a fully retrospective approach in accordance with AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors, or a modified retrospective approach whereby the lessee recognises the cumulative effect of applying AASB 16 in the opening balance of retained earnings without restating the comparatives.

DETERMINATION OF WHETHER CONTRACTS CONTAIN A LEASE

It may sometimes be straightforward to identify a lease, but some arrangements may be more problematic. A lease is defined as a contract where

- There is a specifically identified asset
- The contract conveys the right to control the use of that asset for a period of time
- There is a right to substantially all of the economic benefits from the asset during the term of the contract

Determining whether a contract contains a lease may involve significant judgment. An asset may be identified either explicitly within the contract, or implicitly, where only one asset is realistically available to fulfil the terms of the contract.

A right to control the use of the asset may arise in two circumstances. The right may be explicit through the contract, where it gives the customer the right to determine how or where the asset is used. Alternatively, where the use of an asset is predetermined (such as a power plant, for example), the right to control would exist if either:

- The customer has the right to operate the asset throughout the period of use; or
- The asset was designed by the customer, or to the customer's specifications, in a way that predetermines its use.

The key determination of a right to control an asset is the ability to determine how and when it is used. While lease contracts often give the lessor "protective" rights in respect of maintenance or operation of the assets, for example, restrictions on using the asset in certain locations or in an unsafe manner, this is less important than the ability to direct how and for what purpose the asset is used.

EXAMPLE 1 – **A TRANSPORT FLEET**

The XYZ supermarket chain enters into an agreement with a haulage company to deliver groceries from its distribution centres to its retail stores. The agreement specifies that the deliveries must be made in trucks which have XYZ branding painted onto the side, which will be purchased for the purposes of this contract, and that the deliveries will be made according to a schedule set by XYZ. The haulage company will supply the trucks and drivers, and will operate and maintain the trucks.

This arrangement is considered to contain a lease. This is because there is an identified asset – even if the trucks are not explicitly specified in the lease, this is implicit through the branding requirements in the contract. The trucks deliver according to the instructions of XYZ, which determines the timing of deliveries and the cargo carried. The branding requirement is also likely to restrict the haulage company from using the trucks for other customers, and therefore XYZ will have the right to substantially all of the economic benefits for the term of the lease.

If the agreement was for delivery services in plain-marked vehicles, and did not specify which vehicles were to be used, then it would be considered a service contract rather than a lease, as the assets would not be specifically identified, since the haulage company would have the right to substitute vehicles. Furthermore, XYZ would not necessarily be entitled to all of the benefit of the trucks during the lease, as they could be used for other deliveries when not used for XYZ.

EXAMPLE 2 – **CAPACITY AT A MANUFACTURING FACILITY**

Leopard Motor Corporation is a manufacturer of motor vehicles. They contract with BB Inc, a component supplier, to supply a specified quantity and type of brake cables. BB has only one factory capable of manufacturing the required components, and the contract will require about 75% of the capacity at this factory.

This arrangement is not considered to be a lease, because, while there is an identified asset:

- *Leopard does not have the right to direct the use of the factory. It is up to BB Inc to determine when, how, and at what production level to run the factory in order to fulfil the contract.*
- *Leopard does not have the right to substantially all the economic benefit from the factory, as the remaining capacity can be used to fulfil orders for other customers of BB Inc.*

EXAMPLE 3 – **A WIND FARM**

ElectricCo, a utilities provider, enters an arrangement with GeneratorCo, a power company, to purchase all of the power produced by a new wind farm. The arrangement lasts for 10 years, and specifies that the electricity must be produced by the wind farm. GeneratorCo is responsible for operating and maintaining the wind farm.

The nature of the asset means that how and for what purpose the asset will be used is predetermined – it can only be used for electricity generation, and the amount of electricity generated is determined by wind conditions. Whether the arrangement contains a lease is therefore determined by who designed the facility. If it was designed by ElectricCo, the arrangement would be considered a lease. Similarly, if ElectricCo had the right to operate the plant during the contract period, it would be considered a lease.

If the plant had been designed by GeneratorCo without input from ElectricCo, and GeneratorCo also managed the operation of the plant, then the arrangement would not be a lease, and would be treated as an arrangement for the supply of goods (electricity).

DETERMINING WHAT IS PART OF THE LEASE CONTRACT

Contracts may contain both lease components and non-lease components. AASB 16 gives two options in these circumstances:

- Account for the lease component(s) separately from non-lease components; or
- A practical expedient allows the entire contract to be accounted for as a lease.

Where a non-lease component is identified, it is outside the scope of AASB 16, and is accounted for under the relevant accounting standard.

EXAMPLE 4 – **COMMERCIAL MACHINERY**

A warehousing company rents a fork-lift truck for use in its operations for five years, at a cost of $10,000 per year. The contract includes both the vehicle rental, and the maintenance of that vehicle. The vendor of the truck provides similar maintenance contracts to customers that purchase trucks outright for $1,500 per year.

In this situation, the company would use the observable standalone price of the maintenance component to determine the allocation of the contract. $8,500 per year would be allocated to the lease, and therefore recognised as a lease liability at inception (see below). The remainder would be determined to be a service contract, and therefore recognised as an operating expense in each period.

DETERMINING THE LEASE TERM

The lease term is the duration of any non-cancellable period in the lease contract, but must be extended to include:

- Any period for which the lessee has an option to extend the lease, if the lessee is reasonably certain to exercise that option
- Any period for which the lessee has an option to terminate the lease, if the lessee is reasonably certain not to exercise that option

Determining whether a lessee is likely to exercise an option will require the application of judgment, and may include consideration of:

- Whether the rent payable during an option period would be significantly different to market rates
- The existence of any termination penalties or option fees, or conditions attached to the option.
- Whether significant leasehold improvements have been made
- The costs of termination to the lessee, and the availability of suitable alternatives

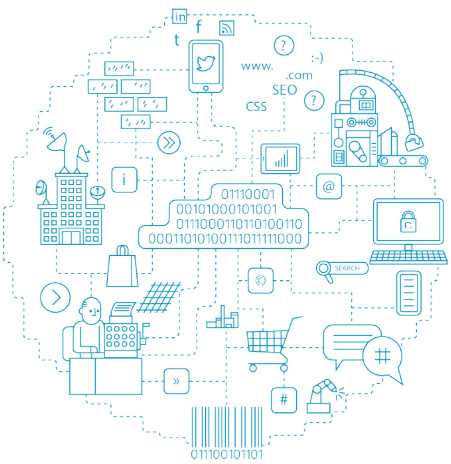
The likelihood of an option being exercised does not have to be reassessed at each financial reporting date, but must be reconsidered where there is a significant event, such as significant leasehold improvements being made, or a sublease being entered into.

EXAMPLE 5 – **AN OPTION TO RENEW**

A retailer enters into a 10 year lease for retail premises with an option to renew for a further 5 years. At the inception of the lease, the retailer determines that they are not reasonably certain to exercise the option, and therefore the lease term is 10 years.

After four years, the retailer enters into a sub-lease for part of the premises for a period of 11 years. This is considered a significant event, as it is now reasonably certain that the option will be exercised, since the retailer cannot otherwise honour their sublease contract.

The lease liability and associated right of use would be remeasured on this date, based on the option being exercised, meaning that the remaining lease term is now 11 years.



DETERMINING THE LEASE LIABILITY

The accounting for the lease is largely similar to how finance leases are currently treated under AASB 117, with the lease liability being measured at the present value of the lease payments, discounted at the interest rate implicit in the lease. The following payments are included in the lease:

- Fixed payments
- Variable lease payments that depend on an index or rate, for example rental payments that are indexed to the consumer price index, or RBA Reserve rate.
- Any amounts payable under a residual value guarantee
- Any exercise price of an option that is reasonably certain to be exercised (see above).
- Any lease incentives receivable are deducted from the payments

Variable lease payments (for example, rent for a retail store based on a percentage of turnover) are not considered part of the lease liability, and are expensed as they fall due.

ACCOUNTING FOR THE LEASE

Once the lease liability has been determined, it is recognised at the inception of the lease, together with a "right-of-use asset" for the same value.

Over the lease term, the lessee will recognise two expenses

- Interest on the lease liability, based on the interest rate implicit in the lease
- Depreciation on the right-of-use asset, based on the shorter of the lease term and the asset's useful life

The effect of this is that there is no rent expense recognised in the financial statements any more, only interest and depreciation. This is likely to impact key metrics such as EBITDA and interest cover.

EXEMPTIONS

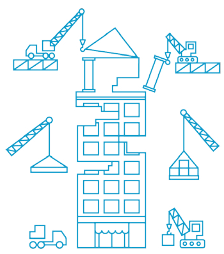
There are two exemptions from the requirements of AASB 16 set out above.

- Leases of less than 12 months in duration
- "Low-value" leases. While this is not formally defined, the Board's basis for conclusions indicated that leases of less than USD 5,000 would generally be considered low value

In both cases, these leases would be treated in a similar manner to how operating leases are currently recognised, with the cost of the lease being recognised on a straight-line basis over the lease term.

LESSOR ACCOUNTING

The lessor accounting model under IFRS 16 is largely unchanged from the existing requirements in IAS 17. The lessor is still required to apply the same principles as under IAS 17 to distinguish between finance leases and operating leases, and apply the relevant accounting requirements accordingly. However, IFRS 16 requires enhanced disclosure from lessors in relation to risk exposure.



For further information please contact Ralph Martin or your local RSM practitioner.

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EXAMPLE 6 – **EXAMPLE OF LEASE ACCOUNTING**

A distribution company rents a warehouse for $25,000 per year for a lease term of six years from 1 January 2020 (paid on 1 January each year). The interest rate implicit in the lease is 9%. Currently, a rental expense of $25,000 would be recognised for each year. Under AASB 16, the following would be recognised

Year	1 Jan 2020	31 Dec 2020	31 Dec 2021	31 Dec 2022	31 Dec 2023	31 Dec 2024	31 Dec 2025	Total
Payment	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000		$150,000
NPV of payment	$25,000	$22,936	$21,042	$19,305	$17,711	$16,248	$0	$122,241
Lease Liability	$97,241	$80,993	$63,282	$43,978	$22,936	$0	$0	
Interest Expense		$8,752	$7,289	$5,695	$3,958	$2,064	$0	$27,759
Right to use Asset	$122,241	$101,868	$81,494	$61,121	$40,747	$20,374	$0	
Depreciation		$20,374	$20,374	$20,374	$20,374	$20,374	$20,374	$122,241
Total expense	$0	$29,125	$27,663	$26,069	$24,332	$22,438	$20,374	$150,000