

SPECIAL GAAP REPORT

‘AASB 16’

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Look before you lease

AASB 16 Leases explained

Even though recently issued IFRS 16/AASB 16 *Leases* has an effective date of 1 January 2019, you'll need plenty of time to prepare for it.

The IASB is replacing 30-year-old IAS 17's/AASB 117 *Leases* with more than 340 pages of authoritative material. Ninety pages cover the standard itself, there are 57 pages of examples, 90 of bases of conclusions and 103 of effects analyses. To say the least, this presents a significant challenge for CFOs and auditors.

Simply put, AASB 16 eliminates the classification of leases as either 'operating' or 'finance'. There is now a single lessee model, which requires a lessee to recognise on statements of financial positions assets and liabilities for leases with terms of more than 12 months unless the underlying asset is of low value.

AASB 16 will have no effect on the total amount of cash flows reported, but it is expected to have an effect on their presentation. Cash flows relating to operating leases are presented as if they were from operating activities; applying the new standard will result in the presentation within financial activities of cash flows relating to the repayment of principal on lease liabilities.

The accounting requirements for lessors are substantially the same as those in IAS 17/AASB 117. A lessor, therefore, continues to classify its leases as 'operating' or 'finance', and accounts for them differently.

Peppercorn leases (below-market leases) entered into by not-for-profits, particularly in the public sector, will be considered as a consequential amendment in AASB 10XX *Income of Not-for-Profit Entities* rather than additional guidance in AASB 16 *Leases* and AASB 1004 *Contributions*.

The adoption of AASB 16 combined with the new AASB 9 *Financial Instruments* and AASB 15 *Revenue from Contracts with Customers* (effective 1 January 2018) means that big changes are coming in quick succession.

AASB 16 requires early consideration

While there might be few changes for lessors under AASB 16, the changes for lessees from today's lease-accounting model are significant.

It's estimated that listed entities around the world have about \$US3.3trillion of lease commitments. Eighty-five per cent of them do not appear on entities' balance sheets due to their classification as operating leases. Off-balance-sheet leases are an important part of understanding an entity's going concern and can have major impacts on evaluating assets and financial leverage. Investors and analysts make important estimates and judgements based on operating leases.

To give better visibility, lessees will be required to recognise all the leases on their balance sheets, addressing the difficulties associated with AASB 117, enabling investors and analysts to compare entities that lease or borrow to buy similar assets.

Finance teams will need to be prepared for transitional requirements to understand and implement the changes. They need to consider how the changes will affect statements of financial position, performance and cash flows.

Below is a time-frame for implementation.

	December reporting period	June reporting period
AASB 16 effective date	31/12/2019	30/6/2020
Opening balance sheet date / transition date – <i>modified</i>	1/1/2019	1/7/2019
Opening balance sheet date / transition date – <i>full retrospective</i>	1/1/2018	1/7/2018

Businesses with financial year-ends of 30 June have two years to implement the full retrospective changes. Whether an entity chooses modified or full retrospective options, there will be significant impacts on key financial measures. Think early about how changes will be communicated and reported to internal (board, legal and finance teams) and external (lenders, analysts, shareholders) stakeholders.

Does the contract contain a lease?

The definition of a lease applies to both parties to a contract, the lessee (customer) and the lessor (supplier), and is defined in AASB 16 as:

'a contract that gives the **customer** the right to **control** the **use** of an **identified asset** for a period of time in exchange for consideration'.

Under the new standard, the definition is little different from AASB 117's, however guidance and its interpretation have changed. Whether a contract contains a lease (or service) will require entities to pay close attention to the key areas summarised below.

Control	<ul style="list-style-type: none"> Does the customer or supplier have the right to control the use of the asset? Who decides how and for what purpose the item is used?
Identified asset	<ul style="list-style-type: none"> Does the lease involve the use of an identified asset? Does the supplier have the right to replace or exchange the asset?
Separate components	<ul style="list-style-type: none"> Does the contract contain both lease components and non-lease components? AASB 16 deals only with components of a contract that relate to a lease.

Lessees, be prepared

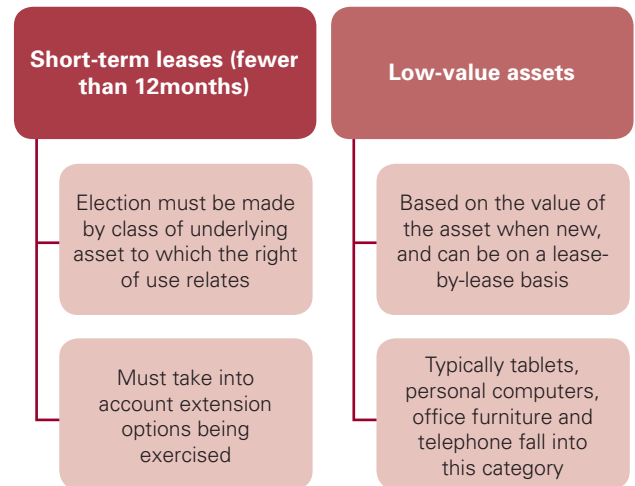
So, where to from here? Once a lease or lease component in a contract is identified, lessees are required to recognise a right-of-use asset and a lease liability at commencement date. A right-of-use asset is to be measured at cost and includes the amount of the initial lease liability, any lease payments made before the commencement date and any indirect costs incurred by the lessee. The lease liability is measured as the present value of any unpaid and unavoidable amounts. Let's take a look at how the accounting changes will affect a lessee's financial statements.

Balance sheet	Income statement	Cash-flow statement
Right of use asset	Depreciation	Lease payments
Lease liabilities	Finance costs	Interest payment

a. **Balance sheet** – AASB 16 requires leases to be reported on balance sheets (other than short-term leases and low-value assets), resulting in an increase in lease assets (right-of-use asset) and financial liabilities.

- b. **Income statement** – Rental expenses (single-expense charge to operating expenses under the current accounting model) will be replaced with a depreciation charge on lease assets and finance costs relating to the interest component of the lease liability.
- c. **Cash-flow statement** – Disclosure of principal payments in relation to lease payments become part of financing activities.

Two options are available for lessees that **do not** require recognition of a lease asset and liability.



The basis for conclusions on the standard (which summarises the IASB's consideration and reasons in either accepting or rejecting views) provides a value of \$US5000 or less for low-value assets. An entity that elects to apply the short-term lease or low-value asset exemption is required to recognise the payments for those leases as an expense on either a straight-line basis over the lease term or some other systematic basis.

What do the changes mean for the finance team? When considered together with two other major changes in accounting standards, AASB 15 and AASB 9, your organisation's finance team needs to be fully equipped with the knowledge, data and accounting-system modifications. Capturing historical leasing information may require significant staff time.

Business-loan covenants, EBITDA, and asset turnovers are just some of the key financial measures that will be affected. While it is expected that lenders will consider the impact on solvency and profitability from the changes, entities need to consider the impact on debt covenants and effectively manage the impact with their lenders.

Transitional considerations for lessees

AASB 16 permits an entity to elect not to recognise assets and liabilities for leases ending within 12 months of the date of the standard's first application.

Otherwise, a lessee has two options when applying AASB 16. One is a fully retrospective approach in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. A concern when implementing this option is the ability for an entity to capture, assess and record historical information – including start date and lease payment schedules – and determine if recognition exemption applies.

A second option is a modified retrospective approach that has the cumulative effect of initially applying the AASB 16 recognised at the date of initial application in opening balances. In applying this approach, the lessee is permitted to apply some practical expedients on a lease-by-lease basis. One of those expedients allows the lessee to choose how to measure the right-of-use asset for previously recognised operating leases.

Think carefully which transitional option you choose. Significant fluctuations between the current year and comparatives in your financial statements will require justification.

Lessors need to communicate a change in disclosure

The requirements of lessor accounting under AASB 16 remain unchanged from their AASB 117 counterpart apart from some enhanced disclosure requirements about risk exposure. The latter will include information about how the lessor manages its exposure with the residual interest related to the leased asset (a significant risk with operating leases where the lessor retains most of the asset risk at the end of the term).

Under AASB 16, a lessor continues to distinguish between an operating lease and a finance lease and account differently for them. Assets subject to operating leases will need to be disclosed separately from an entity's owned assets (that are held and used by the lessor). The enhanced disclosures will provide users of financial statements with a better understanding of the lessor's leasing activities, including amounts, timing and uncertainty of cash flows.

What the finance team needs to know

Consider our eight-point plan.

1. **Educate staff** – Ensure that the finance team and other departments (legal team) know and understand the changes. Identify areas of the business affected by the changes
2. **Contract review and process** – Review new contracts when first implementing AASB 16 to determine if a lease exists. Develop a process to assess whether a contract contains a lease. Significant staff time might be needed to identify, retrieve and assess historical lease information and any new leases entered into at or near the effective date of implementation
3. **Multi-element contracts** – Identify multi-element contracts and separate lease and service components
4. **Financial measures** – Identify your organisation's key financial measures and how they will be affected by the changes
5. **Communicate change** – Draw up strategies to communicate changes to key internal and external stakeholders. Decide who they are and what they need to know
6. **Lease inventory** – Develop a complete register of leases, gather historical information required for the life of the contract, including terms and conditions, lease payments, lease term, discount rate, optional payments and recognition exemption (if applied). Set up systems to manage and track leases more frequently
7. **Fixed asset register** – Prepare and update for right-of-use assets (excluding short-term leases and low-value assets), and
8. **Monitor short term leases and low-value leases** – Set up a process to identify, monitor and disclose any recognition exemptions applied.

While much will be written about AASB 16, to us it ranks as number three in importance behind the recently issued standards AASB 15 *Revenue from Customer Contracts* and AASB 9 *Financial Instruments* (in particular, impairment). CFOs will need to start their journey on understanding these standards and prepare their implementation plans.



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