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FOR STRATEGIC BUSINESS LEADERS

IFRS 16 (AASB 16) LEASES EXPLAINED

LIVE CHAT TRANSCRIPT: QUESTIONS AND ANSWERS

INTRODUCTION

The new accounting standard for leases that becomes effective for accounting periods commencing on or after 1 January 2019 is set to fundamentally change the accounting for leasing transactions.

For lessee accounting, the new standard will no longer distinguish between finance and operating leases, resulting in almost all leases being recognised on the balance sheet. Lease contracts will result in a lease asset and lease liability.

The lease asset will have to be depreciated over its useful economic life, while the lease liability will be unwound through interest charged to the income statement over the lease term.

The new requirements appear to be similar to accounting for finance leases. However, the detailed calculations can be very different, particularly for changes in rent like CPI increases.

The size of off-balance sheet assets and liabilities, and the lack of transparency around them, were the main drivers behind the [IASB's Leases Project](#), which culminated in the issue of IFRS 16. It's estimated that the present value of future off-balance sheet lease payments globally is currently more than US\$2 trillion and the new standard aims to bring most of this value back onto company balance sheets.

The choice of transitional provisions will affect future profits and needs close attention.

The experts who addressed members' questions about the new leasing standard were:

- David Hardidge, Technical Director, Queensland Audit Office. Before joining QAO, Hardidge completed a contract for a hotel group to determine the impact of AASB 16 Leases.
- Ram Subramanian, Policy Adviser – Reporting, CPA Australia.

PRIMARY RESOURCE

http://www.aasb.gov.au/admin/file/content105/c9/AASB16_02-16.pdf

FURTHER RESOURCES

[IFRS 16 podcast](#)

[IFRS 16 factsheet](#)

[IFRS 16 online course](#)

[AASB resource](#)

What is the effect on profit as a result of applying IFRS 16?

The combination of the lease liability interest expense and right-of-use asset depreciation will usually be higher than the lease rental expense at the start of the lease. Then it flips during the lease term, so there is a lower interest expense as the lease liability is repaid. This is known as the financing effect.

I have a lease that changes each year for CPI. How do I deal with CPI adjustments? Do I have to get someone to forecast future CPI changes for me?

The good news is that you do not have to forecast future CPI increases and do true-ups to actuals. Not only was this acknowledged as a burden on preparers, but the true-up for the future discounted liability might have meant adjustments to profit and loss (P&L). What you do is forecast future cash flows based on known and fixed payments.

How will AASB 16 affect the P&L of companies such as airlines?

Interesting given former chair of the IASB, Sir David Tweedie, stated back in 2008 that one of his greatest ambitions before he died was to fly on an aircraft that is on the airline's balance sheet.

While he said it in a joking manner, it reflects that there are a lot of assets companies use that they have commitments to pay for, that are not on their balance sheets.

The new standard will require the capitalisation of future operating lease payments on the balance sheet as a right to use asset and liability. The accounting will also affect profit and loss, with depreciation and interest expense instead of lease payments.

How do I work out the discounted cash flows and lease liability?

You will probably need a computer system that does this. While an Excel model can be developed relatively easily for an individual lease, it gets far more complicated when you try and aggregate a series of them with different starting dates. Accounting for rental adjustments like CPI is complex.

Will the take on values of the asset and liability be based on the remaining lease term?

There are some complicated transitional provisions. The lease liability will be based on future rentals determined under the standard, based on the lease term, and usually a transition date discount rate. Calculating the asset depends on the transition method chosen.

I would like to check if IFRS 16 would affect the current users' treatment of a typical standard photocopying contract, where the provider charges a fixed rental for a fixed period plus photocopying charges based on rate per copy, and where ownership of the equipment remains with the provider.

For photocopiers, the small value exemption will apply, so they will be exempted (i.e. less than USD \$5000 each when new). So, the accounting will be the same as it is now – expense as paid (this is assuming, of course, that the value of the photocopier when new would be below US\$5000).

Could you run through what you consider to be the major change to the leases standard?

The single most major change is probably going to be the way in which lessees account for operating leases. Under the new standard, lessees will need to recognise a “right-of-use asset” and a corresponding liability for all leases. This will be the approach to be taken for both current categories of operating and finance leases, which of course are accounted for quite differently under IAS 17.

There are some exemptions from the requirement to include all leases on the balance sheet, including low value leases and short-term leases.

At commencement of the standard, will existing leases' take-on values be based on the remaining lease period?

See previous response on transitional provisions.

How do we calculate the interest rate for deductions?

The tax deductibility of lease payments will not change and will depend on the local tax authority's approach to tax deductions for lease rental payments. This is just for accounting, which will now recognise an interest expense on the new lease liability. The interest expense will be based on the discount rate used for calculating the NPV/lease liability of future lease payments. This will be either the interest rate implicit in the lease (difficult to work out for a lessor), or an incremental borrowing rate.

Is this going to affect a car operating lease? Does it mean it's no longer in P&L?

In essence the answer is likely to be yes. There are some exemptions, including certain leased assets on the balance sheet, but these exemptions may not be available for a car operating lease.

With rental leases that have been ongoing for years, how do we account from operating to finance leases? What are the assets' costs?

Essentially, by capitalising future lease payments as a liability and right-of-use asset. The initial asset is based on the initial liability. The asset is then depreciated and interest expense recognised on the lease liability. (Also see above for accounting under the new standard.)

Is there a minimum lease value, where leases under this value are ignored?

Leases with a short term (defined in the standard) are exempted, as are leases with a low value (indicated to be US\$5000 per asset when new).

How will leasehold improvements be treated?

Should be the same as they are now. The new standard requires you to recognise a right-of-use for the building lease (previously ignored). Any improvements will be capitalised and amortised over shorter of lease life or asset life.

Do I have to do anything when the CPI changes and my rentals change?

Yes. When the rentals change, you recalculate the discounted cash flows; i.e. the lease liability. You stay with the original discount rate. The difference between the discounted cash flows before the rental change and the discounted amount after the change is recognised as an adjustment to the lease liability. There is a corresponding change to the lease asset. Then you recognise interest expense on the adjusted liability and your depreciation expense is also adjusted.

When calculating the right-of-use asset value, can recurring costs on the asset (e.g. rent, electricity, maintenance, licence fees) be taken into account for the asset value? Or are these (normally) operating expenses still to be treated as opex?

Only the payments for the right-of-use asset should be included. However, if your rental payments are fixed and include extras, then either you make estimates to exclude that portion, or you are allowed to include them in the capitalised lease rentals – though that increases the lease liability and right-of-use asset and gives a different expense profile than if the electricity costs etc. were accounted separately.

How will peppercorn leases in the not-for-profit sector be accounted for? For example, they may have a 30 year lease over a property provided to them by a council or government department and are only paying \$100 a year in rent.

Not-for-profits have special rules that require them to recognise leases as though they paid market rentals. So in your case, the right-of-use asset is fair valued (based on market rents), and recognised. The corresponding credit is the notional liability – split between a recognised liability for future cash payments and the difference recognised as a contribution.

If there are several computer leases – say, 100 computers at \$4000 each – will the exemption apply to each computer, or will it be on a collective basis: $100 \times \$4000 = \$400,000$, so no exemption?

The standard exempts assets that are of low value. This is indicated to be around US\$5000 if bought new. The standard also exempts leases with a term of less than 12 months. You do not have to do your own materiality assessment. They are excluded from the standard. Generally the value test is applied to individual assets and not collectively, so it is likely the low value exemption is available for the computer leases in this scenario.

If lease assets are recorded on the balance sheet from commencement, does this mean that the full amount of GST on the asset purchased will be claimable upfront in the same manner as chattel mortgage finance agreements?

The new accounting standard does not change the tax deductibility of asset purchases or lease payments. The tax treatment will fall under the requirements set by local tax legislation.

Have the rules around capitalising initial costs incurred in entering into a lease changed?

Initial direct costs for entering into a lease are capitalised. Current accounting seems to be mixed with some people expensing legal costs etc. for operating leases, and some capitalising. The transitional rules mean you do not have to go back and work out what should be capitalised – you can keep your old accounting for old leases.

Will the lease asset just be added to the main depreciation schedule or will a separate depreciation schedule be drawn up for lease depreciation?

Accounting for CPI changes is complex. So, after a few years your lease right-of-use asset will actually be the original right-of-use asset depreciated over, say, 10 years – the CPI adjustment after year one depreciated over 9 years, the CPI adjustment in year two depreciated over eight years. I do not think many current asset registers can deal adequately with the new standard's calculations.

If the lease started back in 2007 and ends in 2022, do we need to account the asset's costs from that period – i.e. the depreciation and interest expenses adjustment from 2007 – or can we adjust in the retained profit?

IFRS 16/AASB 16 is applicable for accounting periods commencing on or after 1 January 2019. While there is an option to retrospectively apply the standard and include comparatives, most people are likely to apply the modified retrospective approach, which does not require comparatives. The answer to your question will depend on whether you adopt the full retrospective approach or the modified approach.

Is the right-of-use asset presented with tangible or intangible assets?

A tangible asset falls under the applicable property, plant and equipment class. However, there is likely to be a further note of disclosure distinguishing between owned and leased assets. Also, the standard does optionally allow for the application of the standard to intangible assets that are not scoped out.

Under AASB 16, what are the journal entries for a lease contract of \$4 million over five years with the CPI index of 2.5 per cent per year, if the current interest rate is 5.3 per cent?

As discussed above, CPI adjustments are recognised when the cash flows change. In some leases there are "CPI" adjustments, but they are worded such that they are fixed.

Fixed increases of 2.5 per cent are included in the discounted future lease payments. Changes based on the CPI only occur when the CPI changes and rentals change. The discount rate will be based on the 5.3 per cent, but adjusted for an incremental borrowing rate and the terms of the lease.

If leased assets are now reported on the balance sheet, does this mean the full amount of GST attached to the asset is claimable upfront, in the same manner as chattel mortgage finance arrangements?

See above for a similar question on taxation. The accounting standard does not change GST or income tax deductibility rules set by local authorities.

So, for a car operating lease, if we're in the middle of the lease, how do we determine the asset value? Do we need to depreciate it? How about the liability?

See the response above regarding transitional provisions at commencement of IFRS 16.

Are there any changed implications for the employer (IFRS preparer) for salary-packaged novated leases? I understand a lease is novated with a three-way agreement (“Deed of Novation”) between an employer, employee and the finance company, under which the employee, who has leased a vehicle from the finance company, the financier and the employer agree that the employer will take on the employee’s obligations under the lease.

If the employee ceases to be employed by that employer, the lease is re-novated back to the employee and all obligations assumed by the employer under the novation agreement revert to the employee. The lease can subsequently be novated to a new employer. Once the term of the lease has expired, all obligations of the employer cease.

Novated leases can be complex. To be caught by the new standard, the lease must be of an asset you control. If an employee can take their lease whenever they like, it could be argued the employer does not control the lease, and it is not caught by the new standard.

We have a liability on our balance sheet for about 200 leased properties. This reflects the delta between the actual lease payments we make versus the three-to-five year average of the property lease we have undertaken. This will need to unwind, but how should we treat this?

I am a bit confused by what you mean by “delta”. Under current standards, operating lease payments are straight-lined if the payments increase by fixed amounts. The carrying value of that straight-line lease accrual will disappear on transition as an adjustment to retained earnings. On transition, known fixed payments are included in the forecast future payments and discounted to the lease liability.

If a sports team leases a facility like an arena and that arena is used by other teams that also lease it, is that lease within the scope of IFRS 16?

Very interesting question. There are special rules for not-for-profits requiring peppercorn leases to be recognised. First, you would need to determine whether the lease gets capitalised – as the lease has to be over an asset you control. If the field is open to everyone, then you would probably not get caught by the standard, even if you get to use it every Saturday. Capacity sharing is not enough.

Back to the peppercorn lease question in the NFP sector: if a right-of-use asset based on market rents must be recognised, presumably the organisation would need to engage either an estate agent or even a registered valuer to determine this figure, remembering that a lot of these organisations might be clubs and associations that do not have the expertise to perform these calculations.

The standard requires the valuing of the liability based on rental payments discounted to present value and this is used as the basis for the value of the right-of-use asset plus any initial lease costs, lease incentives etc. to be taken into account. For NFPs there will be some challenges however; for example in arriving at the applicable discount rate.

I believe this rule becomes effective on or after 1 January 2019, so it will be in the middle of financial year 2019. If so, for that year we will have two different rules, which means no consistency. Do we need to make a note or any adjustment to reflect the right comparison between the first six months and the last six months of that year?

The rules are quite specific: it is for financial years beginning on or after 1 January 2019. So for a 30 June year end, starting 1 July 2019 any transactions from 1 Jan 2019 to 30 June 2019 are recognised in the 30 June 2019 financial statements based on the old rules. Then on 1 July 2019 the new rules apply. There are some transition rules that may require old leases to be recalculated and adjusted as from 1 July 2019. There are also some requirements to disclose the effect of upcoming standards to be included in your 30 June 2019 financials.

Thinking about not-for-profit entities, how are they affected?

NFPs will have to follow the same rules. NFPs will also have to recognise leased assets (and a contribution) if they pay rentals at no or minimal cost (like peppercorn rentals). NFPs will also have to do the same if they receive significantly below market rentals.

I work in the public sector and we revalue land and buildings. Will I have to revalue right-of-use assets for building leases?

The standard allows you to revalue the right-of-use asset, like it is property, plant and equipment. The standard requires that if you do revalue the right-of-use asset, you also revalue the related class. However, it seems that if you revalue buildings, you are not forced to revalue right-of-use building leased assets. The ultimate decision will probably be determined by who sets your financial reporting requirements.

If the current asset register cannot deal with the new standard's CPI new calculation, is there a solution for this?

Computer systems are evolving. When I did my contract six months ago, we did not identify a suitable system. The closest would be based on rehabilitation provision accounting. I am starting to see software vendors promoting their solutions, but I have not tested them. Something to watch out for is that the US system (based on capitalising operating leases as well) uses a different calculation methodology. So what works there is not likely to work here. There are differences between IFRS 16 and the US version in their respective leasing standards.

Leases that are sale/purchase agreements are not accounted for as leases under IFRS 16. What criteria is used to determine if the lease is a sale/purchase?

If the agreement is a purchase, then current accounting applies. The leasing standard is about you agreeing to pay for the right to use someone else's asset – an asset they legally own, but you use.

In applying the low value exemption, does it matter if I have 25 leases for say \$4000 items or one lease agreement covering 25 items of \$4000, assuming the threshold is \$5000?

There are rules within the standard to work out whether you have 25 assets or one asset. If there are 25 individual distinct assets that qualify under the standard as "low value" then they would be

exempt from the requirements to capitalise. The value the standard proposes as appropriate is US\$5000.

Re a peppercorn lease: if my not-for-profit has sole use of a local government building each Monday between 9am and 5pm for the year, would that require me to obtain an appraisal of market rent?

It will depend on the circumstances – who is using the building Tuesday to Sunday? The standard refers to capacity sharing as not being sufficient for you to control the asset – and therefore not meeting the definition of an asset – so it would not be included under the standard. If you have control over the week, but choose to only use it one day of the week, then it may be included under the standard.

If I lease a car and the lessor may supply a substitute if the car needs maintenance or repair or is found to be defective, is that a right of substitution that exempts me from the standard?

To be caught by the standard, the lease must be over a specific asset. The question then arises that if the lessor can substitute an asset, whether the requirements are met. The standard includes guidance that if the substitution is for maintenance or repair, then that is not enough to get out of the standard. If the substitution is the lessor's option – for example, often over car park leases that can be shifted around at a lessor's discretion – then the requirements for being a specific asset are not met and not caught by the new standard.

If I lease an intangible asset like telecommunication rights, is that covered by IFRS 16?

Leases over intangible assets are potentially covered by the new standard, not just physical assets. The question is: what is the underlying asset? Telecommunication rights might be shared (e.g. capacity), so that is not enough. On the other hand, if the right is sole access to a specific fibre, then the right might be (adequately) specific. The standard includes guidance on telecommunication rights.

If I lease retail space at a mall and my rent is fixed at \$5000 per month plus 10 per cent of my profit, how do I account for that?

Assuming that the retail space is for a fixed space (meeting the definition of an asset), then the known rentals (i.e. the \$5000) are projected over the lease term (defined in the standard). The 10 per cent profit is called a variable payment and is recognised when cash flows change (i.e. when incurred). So, retailers will still have an operating lease expense in their P&L.

Why is the low value threshold denominated in US dollars? Does this mean we also have to forecast foreign exchange fluctuations?

The low value exemption is not specifically defined in the standard. It is given in the guidance as an indicator. It was expressed in US dollars because most people around the world can relate to it. It is a guideline and not intended to be a hard-and-fast bright-line. Don't forget that the standard only applies to material items, so a single item with a value of US\$10,000 might not be required to be accounted for. So no, you do not have to forecast forex rates.

Disclaimer

The authors have provided their responses to the questions raised during the live online chat using examples and other scenarios to demonstrate how some of the key requirements within IFRS 16 Leases are applicable. This transcript is an edited version of that discussion.

It should be noted that the application of the requirements within IFRS 16 is subject to the exercise of professional judgment and interpretation, and the requirements may vary depending on the specific circumstances.

This transcript and [related article](#) are provided as general guidelines only for readers to obtain a better understanding of the key requirements within the standard. Readers must always ensure they read and understand the requirements in IFRS 16 Leases and accompanying guidance when applying it to their own specific circumstances.

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