BOARD OF TREASURERS

INFORMATION PAPER:

CHANGES TO LEASE ACCOUNTING AND THE IMPACT ON PUBLIC SECTOR DEBT

December 2018

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FOREWORD

Australian Accounting Standard AASB 16: *Leases* will come into effect for financial reporting in Australia for all reporting periods from 1 January 2019. The new standard, which impacts the financial statements of both public and private sector reporting entities, is expected to be reflected in the 2019-20 Budget financial statement disclosures of the Australian States and Territories and will result in a material increase in the reported level of gross and net debt for the public sector of each jurisdiction.

The key message for readers of this Paper is that although the reported level of debt will increase, there is **no material change in the economic or legal circumstances of the States and Territories will occur as a result of applying AASB 16**. Whilst on transition to the new standard there will be a significant increase to jurisdictions' forecasts of assets and liabilities in Budget projections, this Paper shows that the effect of the change on gross and net debt is largely one of timing.

The Paper has been prepared jointly by State and Territory Treasuries and released by the Board of Treasurers.

Board of Treasurers
December 2018

OVERVIEW

AASB 16: *Leases* comes into effect for financial reporting periods that commence from 1 January 2019. The new lease standard will replace AASB 117: *Leases* and sets out the rules for recognising most leases (for lessees) on-balance sheet (comprising of a liability for the future lease payments, and a corresponding 'right of use' asset)[1]. Under current standards, commitments for operating lease payments are **not reflected** as liabilities (instead, they are disclosed in the notes to the financial statements). The new standard will cease to distinguish between operating and finance leases, and will result in the recording of total lease liabilities that include obligations for what are currently known as both operating and finance leases.

AASB 16 is just one of a number of Australian Accounting Standards changes that will come into effect in the near future. Other changes in standards that will impact on whole-of-government disclosures include:

- AASB 15: *Revenue* and AASB 1058: *Income for Non-Profit Entities* (effective from 1 January 2019); and
- AASB 1059: *Service Concession Arrangements: Grantors* (effective from 1 January 2020).

The accounting standards framework is dynamic and standards change to adapt to developments in financial management and reporting that emerge over time. Changes to lease accounting are being added to the Australian Accounting Standards framework at the same time as similar changes are being introduced to international accounting standards. These changes in standards apply to both public and private sector reporting entities.

All State and Territory jurisdictions will be required to present financial statement disclosures in 2019-20 Budgets on a basis that incorporates the new standards. The magnitude of the impact of the changes on public sector reports will differ between jurisdictions. However, changes to the accounting for operating leases will increase the level of gross and net debt recognised on public sector balance sheets, which is the focus of this Information Paper.

It is important to note that the actual increase in gross and net debt is still being determined by each jurisdiction at the time of releasing this Paper.

1 Short-term leases lasting less than a year and leases for immaterial values will generally not be captured by the new lease standard. These exceptions will ordinarily be recorded as operating expenses and can be assumed to represent inconsequential long-term obligations.

ACCOUNTING FOR OPERATING LEASES UNDER CURRENT ARRANGEMENTS

Under current lease accounting arrangements, if an asset is subject to a lease arrangement which results in essentially no risk, reward or ownership rights for an entity (the lessee) but allows for the asset's use, then the arrangement is typically referred to as an operating lease and reflected in the accounts as a rental expense for the lessee, with no associated asset or liability on the balance sheet.

An example of such an arrangement is the leasing of accommodation by public sector agencies. Rental costs are currently brought to book as a day-to-day operating cost, which impacts the accrual operating balance and the operating activities detailed on the cash flow statement.

Classified as an operating lease, there are no accommodation assets or related lease liabilities recorded on the balance sheet. Instead, the balance sheet records the indirect impact on net debt as cash is used to make payments over time (with cash for operating lease payments sourced in general terms from either operating revenue generated on other activities, a run down in cash holdings, an increase in borrowings, or a combination of these sources). In broad terms, current operating lease reporting counts the impact of cash payments over the term of the lease, with no leased asset or lease liability ever shown on the balance sheet.

The following table summarises this arrangement with a hypothetical annual stream of rental payments.

Table 1

GENERALISED REPORTING OF OPERATING LEASES
Current Arrangements

	Year 1 $m	Year 2 $m	Year 3 $m	Year 4 $m
Rental expense/payment	5.6	5.7	5.9	6.0
Leased assets at 30 June	-	-	-	-
Lease liability at 30 June	-	-	-	-

In circumstances where operating lease costs are funded by an increase in borrowings and/or a run down in existing cash reserves, net debt will increase over the lease term as shown in the following table.

Table 2

GENERALISED REPORTING OF OPERATING LEASES
Current Arrangements – Impact on Net Debt at 30 June

	Year 1 $m	Year 2 $m	Year 3 $m	Year 4 $m
Rental expense/payment	5.6	5.7	5.9	6.0
Net debt at 30 June	5.6	11.4	17.2	23.2

Note: Annual increase in net debt may not match annual cash payment due to rounding.

In this example, the cash payments are matched by an increase in net debt over a four-year lease term commencing on 1 July in Year 1 and ending at 30 June in Year 4. This simplified example excludes additional costs such as interest expenses that would be incurred (if the cash payments are funded by borrowings), lost interest revenue (if payments are funded by a run down in cash holdings) or a combination of these funding sources.

The operating lease payments shown in the two tables above include some component costs. Typically these payments will compensate the owner of the rented asset (the lessor) for the decline in the value of the asset over the lease period (i.e. depreciation/amortisation costs), the cost to the lessor of financing the acquisition of the asset, and any risk premium passed on to the lessee. Annualised cash payments will typically also be indexed for inflation (the example above includes indexation of 2% per year).

Reporting operating leases in the manner outlined in the tables above excludes the ongoing burden of rental obligations from balance sheets and only brings the funding requirement to book as payments are made (effectively 'back-ending' the impact on the lessee's balance sheet).

ACCOUNTING FOR LEASES UNDER AASB 16

Under the new leasing standard (AASB 16), reporting entities in both the public and private sectors will be required to disclose commitments on the balance sheet for most leases. For lessees, the distinction between operating and finance leases will disappear and be replaced by a framework based on the more comprehensive reporting currently associated with finance leases (where the lessee effectively exercises ownership rights over an asset). In particular, lease reporting will include the recognition of an asset together with a corresponding lease obligation.

On the asset side, the lessee will carry a 'right of use' asset which results in a non-financial asset being recorded on the balance sheet. The lease liability will be recorded as a form of borrowing in public sector balance sheets, and thus be part of a jurisdiction's gross and net debt, representing the present value of the stream of future lease payments. The associated costs for such leases and 'right of use' assets will include an interest expense and the depreciation of the asset over the life of the lease.

This form of reporting provides a much more complete picture of the lessee's financial position, recognising that an economic benefit (in the form of an asset) has been acquired, and that a financial obligation has been committed to (effectively 'front-ending' the impact on the lessee's balance sheet and giving a clearer understanding of the commitments taken on by the lessee).

The example in the following table shows how the previous operating lease reporting is expected to be reflected in financial statements when AASB 16 becomes effective (and is based on the same assumptions of a four-year lease term commencing on 1 July in Year 1 and ending at 30 June in Year 4[2]).

Under the new standard, the 'right of use' asset will generally be equivalent to the value of the lease obligation at the time the lease is first established. The asset will subsequently decline in value over time as its economic life is consumed (reported as accumulating depreciation charges over the period that the asset is leased). The lease obligation (which is reported as gross debt) will decline in line with the underlying lease payments.

As the lease obligation is gradually paid down, the associated cash will either be sourced from borrowings, a run down in cash, or some other source of funding such as operating receipts.

Table 3

GENERALISED REPORTING OF LEASES

AASB 16 Arrangements

	Year 1 $m	Year 2 $m	Year 3 $m	Year 4 $m
Operating expenses				
Financing (interest) charge	1.2	1.0	0.7	0.3
Depreciation expense	5.0	5.0	5.0	5.0
Total expense	*6.2*	*6.0*	*5.7*	*5.3*
Cash payments				
Financing (interest) charge	1.2	1.0	0.7	0.3
Repayment of principal	4.6	4.8	5.1	5.5
Total cash payments	*5.8*	*5.8*	*5.8*	*5.8*
Assets at 30 June				
'Right of use' (leased) assets	20.0	20.0	20.0	20.0
Accumulated depreciation	-5.0	-10.0	-15.0	-20.0
Value of leased assets at 30 June	*15.0*	*10.0*	*5.0*	-
Liabilities at 30 June				
Lease liability	15.4	10.6	5.5	-
Future lease charges	2.0	1.0	0.3	-
Total lease liabilities at 30 June	*17.4*	*11.6*	*5.8*	-
Borrowing (if cash is borrowed to fund lease payments)	5.8	11.6	17.4	23.2
Total impact on liabilities at 30 June	*23.2*	*23.2*	*23.2*	*23.2*

2 As with the previous operating lease example, the cash used to make the lease payments is assumed to be sourced from an increase in borrowings and/or a run down in cash holdings. These payments could be funded from another source such as from operating receipts. Depending upon capital funding requirements, a reduction in net debt may occur if there is an operating cash surplus after lease expenses are paid and borrowings are not required to fund these payments. This additional scenario is not illustrated in Table 3.

This consistent approach to all leases brings increased visibility to the financial implications of leases, and reduces the avenues for off-balance sheet financing through rental arrangements.

IMPACT ON THE REPORTING OF GROSS AND NET DEBT

State and Territory Governments publish whole-of-government financial reports in line with the Uniform Presentation Framework (UPF). The UPF prescribes minimum whole-of-government reporting detail for the Australian jurisdictions.

The UPF includes the requirement to report gross and net debt that is determined from the face of the balance sheet. A key part of financial statements, the balance sheet (also known as a Statement of Financial Position) is prepared and presented in accordance with Australian Accounting Standards and which, under current lease accounting, presently aligns with the National Accounts concept of gross and net debt used by the Australian Bureau of Statistics (ABS).

Net debt disclosures on public sector balance sheets consist of gross debt liabilities (i.e. cash deposits belonging to third parties, advances (or loans) from other sectors of government, and borrowings) less liquid financial assets (i.e. cash on hand, advances to other sectors, and highly liquid investments, loans and placements). For net debt purposes in the National Accounts:

- finance leases are recorded as interest-bearing financial instruments, form part of the 'borrowings' liability on the public sector balance sheet, and are thus a component of net debt; and
- operating leases are currently off-balance sheet, and have no direct impact on the measurement of liabilities or net debt.

The UPF will continue to require that gross and net debt be reported on public sector balance sheets when AASB 16 comes into force. However, public sector whole-of-government financial disclosures will include leases reported under AASB 16 as part of 'borrowings'. It follows that AASB 16 will require most leases (i.e. all leases other than those with a term less than 12 months and/or for immaterial values) to be reported as interest-bearing financial instruments (i.e. as borrowings).

With public sector accounting disclosures reporting a broader concept of borrowings (that includes those leases previously excluded from the balance sheet as operating leases), the reported value of gross and net debt will also increase for State and Territory Governments. As shown in the previous section of this Paper, the increase will effectively bring forward the debt obligations associated with accounting for operating leases, and bring to book the economic benefit of all 'right of use' (leased) assets at inception and throughout the term of the lease.

It should be noted that under the new Australian Government Finance Statistics 2015 standards, the ABS will no longer publish a single measure of net debt (as was the case in previous disclosures), and will instead be publishing a matrix presentation of all liabilities included on public sector balance sheets.

Accordingly, net debt as it is defined on UPF balance sheets for State and Territory Governments will not conflict with ABS reporting which is being broadened in line with developments in international statistical standards. However, the magnitude of borrowings may differ between whole-of-government reports and ABS statistics due to the different treatment of leases by the accounting and economic statistical frameworks.

The broader UPF measurement of net debt that will come into force with the new lease standard is much the same in concept as the current arrangements for finance leases, in that:

- interest and principal costs are unambiguously characteristic of borrowings on the balance sheet and will thus flow through the derivation of net debt on the public sector balance sheet presented on the basis of Australian Accounting Standards; and
- 'right of use' assets will not be liquid in their nature and thus not be able to be offset against the lease liabilities as a liquid financial asset when assessing net debt.

It is expected that State and Territory Governments will report leases under the measurement rules applying under AASB 16 for the first time in 2019-20 Budgets, expected to be released from late April 2019.

At the time of finalising this Paper, Treasuries in each jurisdiction are working with public sector agencies to determine the value of leases to be brought on to the balance sheet in their 2019-20 Budgets. It is uncertain how much gross and net debt levels will increase as the new lease disclosure comes into force.

The magnitude of any reported increases in gross and net debt levels in 2019-20 Budgets due to implementation of the new standard will depend on the detailed measurement and analysis currently being undertaken in each jurisdiction. In particular, the impact on debt levels under AASB 16 will depend on a number of factors including the transitional methodology, measurement options used in quantifying leases, and the number of operating leases that fall below the materiality threshold.

IMPLICATIONS FOR THE PUBLIC SECTOR FINANCIAL OUTLOOK

Regardless of the value of the reported increase in gross and net debt levels in each jurisdiction, it is important to note that no material change in the economic or legal circumstances of the States and Territories will have occurred as a result of applying AASB 16. Whilst on transition to the new standard there will be a significant increase to jurisdictions' forecasts of assets and liabilities in Budget projections, the effect of the change on gross and net debt is largely one of timing.

While the new lease accounting arrangements will in effect bring forward liabilities that were previously ‘back-ended’, the draw down of cash to make lease payments will be largely unchanged from forecasts prepared under current accounting standards. At the same time, the non-cash increase in ‘front-ended’ lease recognition under AASB 16 will be matched by an increase in the public sector asset base used for service delivery. The overall impact on net worth (i.e. total assets less total liabilities on the balance sheet) is expected to be broadly neutral at the time of adopting the new standard (although this may vary from lease to lease depending on the circumstances).

Of note, the flow-on effect of this change in reporting requirements on credit rating assessments for the States and Territories is not clear. Credit metrics will be materially affected by the reporting changes for leases but credit rating agencies may ‘see through’ these accounting measurement changes in finalising annual credit rating assessments in future.

Further detail on the implications of AASB 16 on public sector finances may be provided by individual States and Territories in the lead up to the release of their 2019-20 Budgets.

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