NSW GOVERNMENT | The Treasury

Guidance for AASB 16 *Leases*

7 April 2017

Contents

1. Overview

1.1 Objective

The new accounting standard AASB 16 *Leases* (AASB 16) is effective for NSW public sector agencies from FY19-20, and replaces the current standard AASB 117 *Leases*. The objective of AASB 16 is to improve transparency on financial leverage and capital employed by bringing all lease assets and liabilities onto the balance sheet.

This Treasury guidance aims to provide a high-level summary of the new leasing standard including the practical transitional impacts and available simplifications. However, agencies still need to review AASB 16 in detail to ensure they understand its requirements.

Treasury is continuing to analyse the impacts of AASB 16, and more detailed guidance will be provided. This will include determining the appropriate options for the NSW public sector under the transitional provisions available. In the meantime Treasury welcomes any agency feedback on AASB 16.

1.2 Main impact

AASB 16 effectively requires recognition of all leases on the balance sheet, with some exceptions. This will be a significant change for agencies with operating leases. Lessees will recognise a right-of-use asset as well as a lease liability. Measurement of the lease liability under the new standard largely corresponds to the measurement of a finance lease liability under AASB 117.

The income statement will also be impacted as there will be an interest charge on the lease liability. This will increase the expenses recognised in the earlier years of the lease term when depreciation and interest charges on the right-of-use asset are higher.

The accounting by lessors under AASB 16 is substantially unchanged and lessors will continue to classify all leases using existing principles in distinguishing between operating and finance leases.

1.3 Scope

The scope of AASB 16 includes all leases, including leases of right-of-use assets in a sublease (para 3). The following are excluded from the scope of AASB 16 (para 3):

- certain exploration leases,
- biological assets,
- licences of intellectual property, and
- service concession arrangements (a new standard will apply to these arrangements)

Certain licenses of intangible assets, including motion picture films, manuscripts, patents and copyrights are also excluded from the scope, although AASB 16 may be applied to leases of other intangible assets.

1.4 Exemptions

AASB 16 provides optional relief in the following circumstances:

- leases of 12 months or less
- leases of low-value assets (such as personal computers, telephones, office furniture etc.)

While not defined, the Basis for Conclusions to AASB 16 refers to low value being US$5,000 or less. This exemption should be applied on an individual lease basis, and is based on the value of the asset when new.

2. Key Considerations

2.1 Definition of a lease

Lease
A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. [AASB 16 Appendix A].

AASB 16 retains the key elements of the definition of a lease from AASB 117. However, AASB 16 focuses on whether there is the right to control the use of an identifiable asset, which is important in determining whether an arrangement contains a lease or is a contract for service, or both. AASB 16 also replaces AASB Interpretation 4 *Determining whether an Arrangement contains a Lease,* AASB Interpretation 115 *Operating leases – Incentives*, and AASB Interpretation 127 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease.*

2.2 Identifying a lease

The determination of whether a contract is a lease or contains a lease happens at inception (para 9). Each lease component within a contract shall be accounted for as a lease separately from non-lease components (para 12). This is only reassessed if the contract terms and conditions change (para 11). There is a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration**.**

To assess whether a contract conveys the right to control the use of an identified asset, it is necessary to assess whether the customer has both (para B9):

- the right to obtain substantially all of the economic benefits from use of the identified asset; and
- the right to direct the use of the identified asset.

Identified asset

An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer (para B13). For example where the precise asset has not been specified in the contract, but an identified asset is needed to fulfil the contract from commencement.

Right to obtain economic benefits

Control is dependent on the customer obtaining substantially all of the economic benefits, throughout the period the asset is used. This includes benefits obtained indirectly such as through sub-leases (para B21).

Right to direct the use of the identified asset arises when either:

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
- relevant decisions about how and for what purpose the asset is used are predetermined in the contract; and either
  - the customer has the right to operate the asset (or to direct others to operate the asset in a manner it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
  - the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use (para B24).

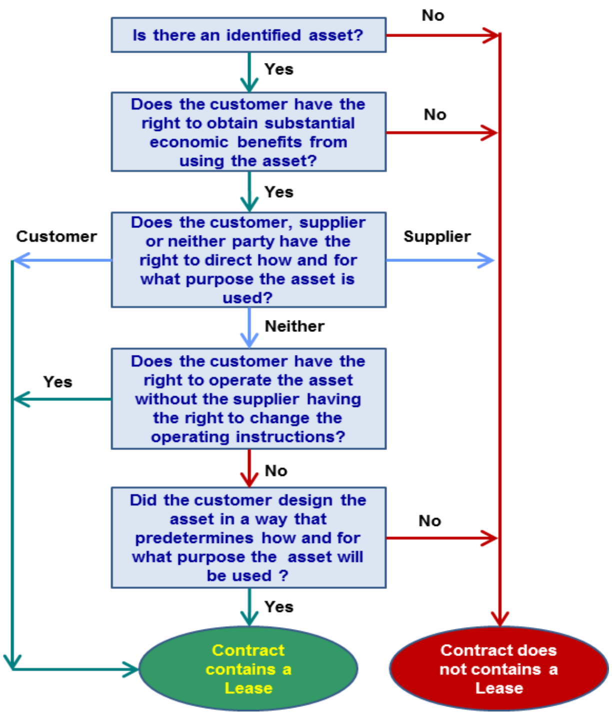
The scope of relevant decisions that can determine a customer's right to direct the use of an identified asset are quite broad. Within the standard's guidance there are several examples of relevant decision-making rights (para B26).

Substantive substitution rights (paras B14 – B19)

If the supplier has substantive rights to substitute the asset then the customer has no right to direct the use of an identified asset, and therefore there is no lease. This is the case where the supplier has the practical ability to substitute the underlying asset and would benefit economically from doing so.

Decision tree – determining whether a lease exists

To determine if a contract contains a lease, AASB 16 provides the following decision tree:



2.3 Lease term

Lease term *The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:* *(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and* *(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. (para 18, Appendix A)*

The lease term is the non-cancellable period of the lease, plus option periods to extend where the lessee is reasonably certain to extend, and periods after an optional termination, where the lessee is reasonably certain not to terminate. This is broadly consistent with the current definition in AASB 117 *Leases*, although it includes explicit reference to periods related to options to terminate the lease. If a material event or significant changes in circumstances that is within the control of the lessee occurs and affects the reasonably certain criteria, a reassessment needs to occur.

3. Accounting Treatment

The main changes introduced by AASB 16 relate to accounting by lessees. Lessor accounting continues to be similar to AASB 117.

3.1 Accounting by lessors

Lessors will continue to classify leases as finance leases or operating leases.

Lessors will account for finance leases by recognising a net investment in the lease on the statement of financial position, and recognising lease income using a constant rate of return on that net investment over the lease term. The net investment is the present value of future lease payments plus any unguaranteed residual value to the lessor.

Lessors will continue to recognise assets under operating leases on the statement of financial position and recognise lease income on a straight-line or other systematic basis.

3.2 Accounting by lessees

The following table illustrates the lessee accounting under AASB 16, where most lease contracts will require recognition of a **right-of-use asset** and an equivalent **lease liability**. Exemptions are discussed in section 1.4.

	Right –of-use asset	Lease Liability
Initial Measurement	**Cost** – which includes: • Initial measurement of lease liability • Lease payments less any lease incentives received before commencement date • Initial direct costs • Estimate of costs to be incurred by dismantling/ removing	**Present value of lease payments** that are not paid at the commencement date Present value of lease payments, discounted using the interest rate implicit in the lease. If not readily determined use the lessee's incremental borrowing rate Lease payments include fixed payments, variable lease payments that depend on an index or rate, option payments (if reasonably certain) and expected residual value guarantees (the definition is updated from AASB 117 which refers to maximum residual value).
Subsequent Measurement	**Cost model** (ie cost less depreciation and any impairment losses), adjusted for any re-measurement of the lease liability in certain circumstances or **Fair value model** • If the fair value model under AASB 140 *Investment Property* has been adopted. • By election, if the revaluation model in AASB 116 *Property, Plant, Equipment has been adopted for* the class of PPE to which the right-of-use asset relates	Initial value (above) adjusted for: • Interest - calculated at a constant rate of return • Lease payments • Any reassessment or lease modifications. ie changes to terms, options, changes to expected amounts due to a changed index etc. Changes in the lease liability resulting from reassessments are adjusted against the carrying value of the asset.

3.3 Other leasing topics

3.3.1 Peppercorn leases – Initial recognition and measurement

Lessees

AASB 1058 *Income of Not-for-profits* (AASB 1058) has been recently released. A key feature of AASB 1058 is that an asset should be recognised at fair value where the consideration paid is less than fair value. This concept means that right-of-use assets under peppercorn leases must now be recognised at their fair value. AASB 1058 makes consequential amendments to AASB 16 to include this requirement.

Where not-for-profit agencies enter into leases at below-market lease terms and conditions:

- recognise a right-of-use asset and measure it at fair value in accordance with AASB 13 Fair Value Measurement (para Aus25.1); and
- recognise a lease liability measured in accordance with AASB 16; and
- recognise any difference between the carrying amount of the right-of-use asset and the lease liability as income in profit or loss statement (AASB 1058 para 10).

3.3.2 Sale-and-leaseback

A sale and leaseback transaction arises when an entity (seller-lessee) sells an asset to another entity and simultaneously leases it back from the purchaser (buyer-lessor). An entity shall assess whether the transfer of the asset is a sale by applying AASB 15 *Revenue from Contracts with Customers* (AASB 15).

(a) Transfer to Buyer-Lessor is a sale

If a transfer of an asset by a seller-lessee is a sale in accordance with AASB 15, then the seller-lessee must recognise a disposal of the rights it transfers, as follows (para 99-103):

Seller-lessee shall recognise:

- *right-of-use asset related to the right of use retained* - measured at the proportion of the previous carrying amount of the asset by the seller-lessee (para 100(a);
- *lease liability* measured at the present value of the lease payments; and
- *gain or loss related to the rights transferred* to the buyer-lessor. This contrasts to AASB 117 where seller-lessees recognise the total gain or loss on sale of the asset (para 100(a)).

Buyer-lessor shall recognise:

- the *underlying asset* and apply the *lessor accounting* model to the leaseback transaction (para 100(b)).

If the sale is not at fair value or lease payments are off-market, the seller-lessee must make adjustments to measure the sale proceeds at fair value, as follows:

  - below-market terms are treated as prepayments of lease payments (i.e. sale price lower than the fair value of the asset); or
  - above-market terms are treated as additional financing provided by the buyer-lessor to the seller-lessee (i.e. sale price higher than the fair value of the asset)

(b) Transfer to Buyer-Lessor is <u>not</u> a sale

If a transfer of an asset by a seller-lessee is not a sale in accordance with AASB 15:

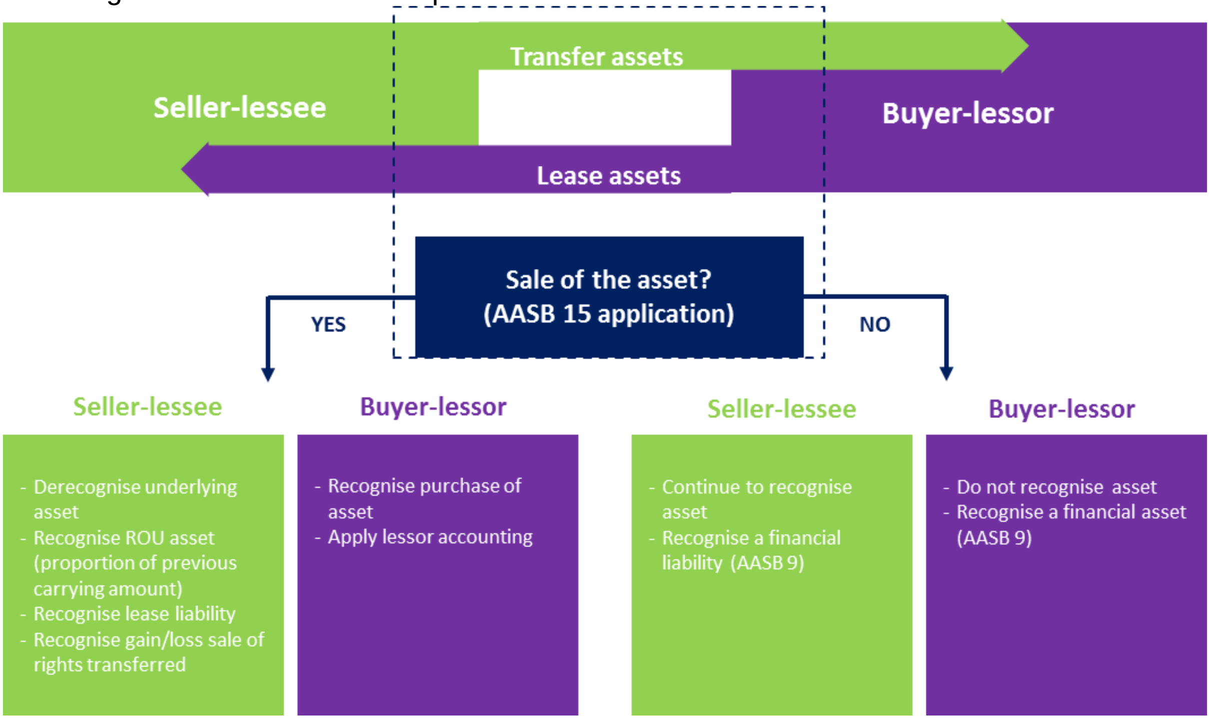
Seller-lessee shall:

- continue to recognise the underlying asset; and
- recognise a financial liability equivalent to the consideration received from the buyer-lessor and account for it applying AASB 9 *Financial Instruments* (AASB 9).

Buyer-lessor shall:

- not recognise the transferred asset; and
- recognise a financial asset equivalent to the consideration paid to the seller-lessee, measured by applying AASB 9.

This diagram summarises the requirements below:



4. Transitional Requirements and Relief

Upon transition there are a number of exemptions and practical expedients available. These are discussed below.

4.1 Transitional requirements for lessees

4.1.1 Lease definition

Relief is available on transition from reviewing all existing contracts to determine whether they contain, or no longer contain, a lease. As a practical expedient, on transition agencies can either:

- apply the new definition of a lease to all contracts in existence at the transition date. This will provide a more accurate reflection of the lease portfolio and may result in some contracts no longer meeting the definition of a lease; or
- choose not to perform this re-assessment. Instead contracts containing a lease under AASB 117 or Interpretation 4 at transition can be treated as leases under AASB 16, and contracts that did not contain a lease under AASB 117 or Interpretation 4 are not reassessed.

Use of this practical expedient is simple, and eliminates the need to review existing contracts. New contracts entered into after transition must then be assessed to determine whether they contain a lease, using the definition in AASB 16.

4.1.2 Retrospective application of the standard

Lessees have two options on transition:

(a) Adopt AASB 16 retrospectively in full – 'full retrospective'

- retrospectively adjust the current year and prior year comparatives as though AASB 16 had always applied, consistent with AASB *108 Accounting Policies, Changes in Accounting Estimates and Errors* (para 22); and
- restate opening retained earnings at the start of the comparatives financial year. ie 1 July 2018 for 30 June year ends.

(b) Apply AASB 16 only at the implementation date – "partial retrospective"

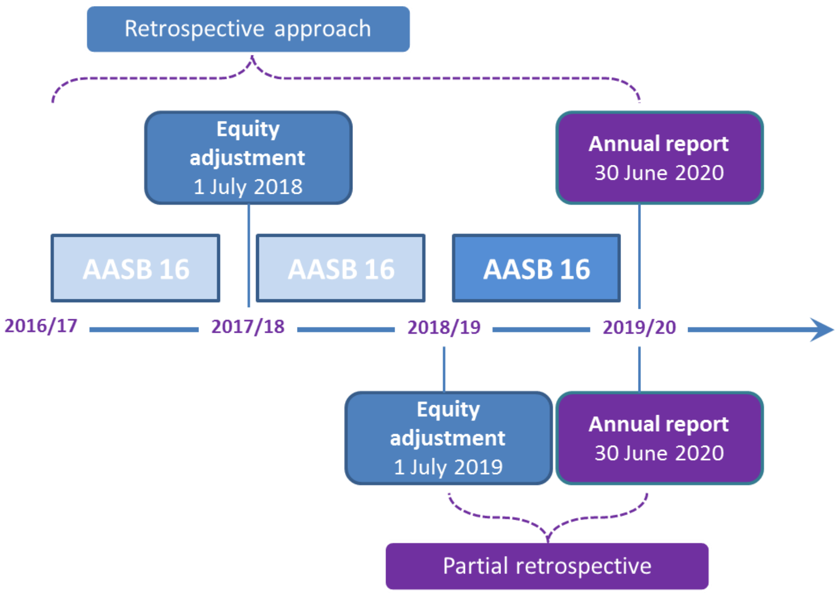
- adjust only the current year as though AASB 16 had always applied;
- do not restate comparative financial information;
- restate opening retained earnings at the implementation date for the cumulative effect of applying AASB 16 up to that date. ie 1 July 2019 for 30 June year ends; and
- more disclosures are required under this option to explain the transition to AASB 16.

The full retrospective option is expected to enhance comparability, although costs of preparing two sets of information for the year prior to implementation may outweigh the benefits.

Adopting partial retrospective also means only current information is needed, such as future lease payments and incremental borrowing rates, or information needed to make historical judgements and estimates. Therefore, implementation costs are expected to be lower than the full retrospective option.

4.1.3 Full retrospective vs partial retrospective timeline

The following diagram illustrates impact of transition rules under the full retrospective approach or partial retrospective approach when adopting AASB 16 in their 30 June 2020 financial statements.



4.1.4 Recognition and measurement

There are key differences in how existing leases are measured on transition, depending on which option the lessee takes.

Full retrospective approach

Under this option, recognition and measurement principles must be applied to each lease for both the year of implementation, the comparative information and in determining the adjustment to opening retained earnings. Therefore the right-of-use asset and lease liability are measured in accordance with section 3.2 *Accounting by lessees*.

This means identifying historical information and judgements that would have been made, at dates before initial application, such as implicit interest rates, expected payments and residual values etc., when accounting for leases that were previously classified as operating leases under AASB 117.

Partial retrospective approach

Under the partial retrospective approach, AASB 16 prescribes some further practical expedients. Contracts previously identified as an operating lease under AASB 117 will recognise the following at the date of initial application (paras C8 – C9):

- *Lease liability* at the at the present value of unpaid lease commitments, discounted using the lessee's incremental borrowing rate at the date of the initial application; and
- *Right-of-use asset* assessed on a lease-by-lease measured at either:
    - the carrying amount as if AASB 16 had been applied since the commencement date, but using the lessee's incremental borrowing rate at the date of initial application; or
    - the amount of the related lease liability (adjusted for any amounts prepaid or accrued).

4.1.5 Summary of full retrospective vs partial retrospective

The following table summarises the main differences between full and partial retrospective options:

Full retrospective	Partial retrospective
Right-to-use Asset Cost less accumulated depreciation and any impairment losses or Fair value in under AASB 116 (or AASB 140)	***Right-to-use Asset*** Carrying amount as if AASB 16 had been applied since the commencement of the lease, using the lessee's incremental borrowing rate at the date of initial application or Amount = lease liability adjusted for any amounts prepaid or accrued

Full retrospective	Partial retrospective
Lease Liability Present value of future lease payments discounted using the interest rate implicit in the lease. If not readily available use the lessee's incremental borrowing rate.	***Lease Liability*** Present value of future lease payments discounted using the lessee's incremental borrowing rate at the date of the initial application.
Timing Restate comparatives. Restate opening retained earnings at the start of the earliest comparatives financial year.	***Timing*** Do not restate comparatives. Restate retained earnings at the implementation date.

4.1.6 Partial retrospective – other relief available

If the partial retrospective option is chosen, then a number of further practical expedients are available to lessees at transition. The following are available on a lease-by-lease basis.

For leases previously classified as operating leases under AASB 117:

- A single discount rate can be applied at a portfolio level if leases contain similar characteristics (para C10(a));
- Rely on assessment of whether leases are onerous under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* as an alternative to performing an impairment review. The assessment and any required adjustments to the lease asset after applying AASB 137 are undertaken immediately before the date of initial application (para C10(b)).
- Leases with terms ending within 12 months of the date of the initial application can be accounted for as short-term leases (para C10(c));
- Initial direct costs may be excluded from the measurement of the right-to-use asset at the date of initial application (para C10(d));
- No adjustment is required on transition for leases of low-value assets, and leases of investment property using the fair value model in AASB 140. The lessee shall account for the right-of-use asset and lease liability by applying AASB 16 and AASB 140 from the date of initial application (para C9(a-c));
- Hindsight can be applied to lease contracts, such as assessing the lease term where there are options to extend or terminate the lease contract (para C10(e)), rather than assessing expectations that would have existed at inception;

For leases previously classified as finance leases under AASB 117:

- The measurement of the right-of-use asset and the lease liability at the date of initial application shall be equal to the carrying amount of the lease asset and lease liability immediately before that date measured applying AASB 117.

4.2 Transitional requirements for lessors

With the exception of sub-leases and sale-and-leaseback, lessors are not required to make any adjustments to leases on transition and apply AASB 16 from the initial date of application.

Where for an asset, an agency is the lessee under the head lease and the lessor under sublease (the intermediate lessor), it must reassess ongoing operating subleases under AASB 16 at the transition date, to determine whether the sublease should be reclassified as a finance lease. If a sublease is then reclassified as a finance lease, it should be accounted for as a new finance lease entered into at the date of application.

4.3 Transitional requirements for peppercorn leases

Consistent with general leases, lessees can choose to adopt a full or partial retrospective approach on transition. The accounting recognition and measurement is included in AASB 1058 in the consequential amendments for AASB 16.

4.4 Sale and leaseback transactions on transition

Agencies are not required to reassess ongoing sale and leaseback transactions to determine if the transfer of the asset is a sale under AASB 15 (para C16).

For sale and leaseback transactions in existence at the transition date, the seller-lessee will need to:

- If classified as a sale and operating lease under AASB 117:
  - account for the leaseback in the same way as any other ongoing operating lease at transition; and
  - adjust the leased back right-of-use asset to recognise deferred gains or losses from any off market terms immediately before the date of initial application (para C18).
- If classified as a sale and finance lease under AASB 117:
  - account for the leaseback as any other ongoing finance lease; and
  - continue to amortise any recognised gain on sale over the lease term (para C17).

5. Presentation and Disclosure

The new standard contains enhanced presentation and disclosure requirements that are both qualitative and quantitative. The following section highlights lease related amounts that should be presented. For detailed disclosure requirements refer to AASB 16.

5.1 Lessees - presentation

Presentation requirements for lessees are detailed at paragraphs 47 to 50.

Statement of Financial Position

Agencies can elect to either:

- present in the statement of financial position the *right-of-use assets* and *lease liability* separately from other line items; or
- disclose in the notes to the financial statements which line items in the statement of financial position include those *right-of-use assets* and *lease liabilities*.
    - If this option is taken then right-of-use assets must be included in the same line item in the statement of financial position, as if they had been owned (para 47).

Right-of-use assets classified as investment property shall be presented as investment property.

Income Statement

The following must be presented separately:

- Interest expense on the lease liability; and
- Depreciation charge on right-to-use assets.

Statement of Cash Flows

AASB 16 (para 50) requires that cash flows relating to leases are presented in the statement of cash flows as follows:

Payments for:	***Cash Flow activity***
Principal	**Financing**
Interest portion	Apply AASB 107 - agencies are to classify within the activity where interest of similar liabilities are reflected
Short-term leases, low-value leases, variable lease payments not included in measurement of lease liability	Operating

5.2 Lessees - disclosure

The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.
[AASB 16 para 51]

Paragraphs 53 to 60 of AASB 16 contain detailed disclosure requirements for lessees, and agencies should refer to the Standard. In particular, paragraph 53 has extensive requirements for disclosing amounts such as interest, depreciation of right-to-use assets, expenses related to short-term leases and low-value assets etc, and there is a presumption that a tabular format is appropriate for these.

The following tables are an excerpt from IFRS supporting materials (IFRS 16 Leases - Effect Analysis), showing the difference in presentation and disclosure requirements under IAS 7 and IFRS 16 using a property, plant and equipment lease as an example.

Illustration 1 - Current disclosure requirements under IAS 17

The next paragraphs illustrate the information that a company is expected to present in the notes to its financial statements applying previous lease accounting requirements and in applying IFRS 16 and the FASB model. The illustration does not include any additional relevant information required by paragraph 59 of IFRS 16, or any qualitative disclosures required by the FASB model.

IAS 17

Leased assets[75]

Property, plant and equipment includes leased assets whose underlying contracts are structured as on balance sheet leases (finance leases). The following table shows leased assets for which Airline is a lessee:

	Aircraft	Real estate and other	Total
Costs[76]			
Opening balance	13,527	825	**14,352**
Additions	2,483	–	**2,483**
Closing balance	16,010	825	**16,835**
Accumulated depreciation[76]			
Opening balance	(3,340)	(560)	**(3,900)**
Depreciation for the year	(835)	(70)	**(905)**
Closing balance	(4,175)	(630)	**(4,805)**
Net carrying amount			
Opening balance	**10,187**	**265**	**10,452**
Closing balance	**11,835**	**195**	**12,030**

On balance sheet lease obligations

Future minimum lease payments arising from on balance sheet leases are as follows:

	Within 1 year	Between 2 and 5 years	After 5 years	Total
Lease payments	**1,426**	**5,405**	**5,529**	**12,360**
Discount	(269)	(948)	(627)	**(1,844)**
Present value	**1,157**	**4,457**	**4,902**	**10,516**

Off balance sheet lease commitments

Future minimum lease payments arising from off balance sheet leases are as follows:

	Aircraft[77]	Real estate and other[77]	Total	Subleases
Within 1 year	2,308	503	**2,811**	16
Between 2 and 5 years	6,324	1,633	**7,957**	31
After 5 years	4,239	4,748	**8,987**	28
	12,871	**6,884**	**19,755**	**75**

Expenses related to off balance sheet leases recognised in the income statement amount to 2,630 and include 77 of contingent rents. Income from sub-leases amounts to 59.

75 This information may be presented in the notes section related to "property, plant and equipment".

76 Applying previous requirements, the disclosure requirements for owned property, plant and equipment also applied to lease assets arising from on balance sheet leases. Those requirements did not require separate disclosure for leased assets and owned assets included in the same asset class (for example, leased aircraft separately from owned aircraft) – information about leased assets is shown here for illustrative purposes.

77 Breakdown by class of leased asset was not required by IAS 17. However, some companies with significant amounts of off balance sheet leases often provided disclosures of lease commitments by class of leased asset.

The information in Illustration 1 has been prepared using reported information for a number companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

Illustration 2 - Disclosure requirements under IFRS 16

IFRS 16

The carrying amount of lease assets, split by major class of asset, and new lease assets during the reporting period, are presented in the table below.

Lease assets	
Carrying amount of lease assets	**25,430**
Of which	
- Aircraft	*21,459*
- Real estate and other	*3,971*
Additions to lease assets	**5,486**

A maturity analysis of lease liabilities based on undiscounted gross cash flows is reported in the table below:

Lease liabilities[78]	
Less than 1 year	4,238
2 years	3,786
3 years	3,466
4 years	3,166
5 years	2,943
6 years	2,452
7 years	2,402
8 years	2,382
9 years	2,362
10 years	1,545
Between 10 and 15 years	1,965
More than 15 years	1,408
Total lease liabilities (undiscounted)	**32,115**

Income statement	
Depreciation of lease assets	**(2,672)**
Of which	
- Aircraft	*(2,268)*
- Real estate and other	*(404)*
Interest on lease liabilities	**(1,728)**
	(4,400)
Variable lease payments	**(77)**
Sublease income	**59**
Gains on sale and leaseback transactions	**100**

Cash flow statement	
Total cash outflow for leases	(4,096)

78 In accordance with IFRS 7 a company would apply judgement in determining which time bands to disclose.

The information in Illustration 1 has been prepared using reported information for a number companies. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of IFRS 16 on specific companies and industries could differ materially from those presented herein.

5.3 Lessors presentation and disclosure

Under AASB 16, underlying assets related to operating leases shall be presented in the statement of financial position by class of underlying asset.

The objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.
[AASB 16 para. 89]

Disclosure requirements for lessors are contained in paragraphs 89 to 97. Additional disclosures are required where necessary to meet the disclosure objective. The following amounts must be disclosed (para 90):

Finance leases:
- profit or loss on sale;
- finance income on the net investment in the lease; and
- income from variable lease payments not included in the measurement of the net investment in the lease.

Operating leases:
- lease income (separately disclosing amounts related to variable lease payments that do not depend on an index or a rate).

5.4 Transition disclosures

AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (AASB 108) contains disclosure requirements relating to implementation of new Accounting Standards. However AASB 16 requires additional disclosures when lessees choose the partial retrospective approach, including (C12):

- the weighted average lessee's incremental borrowing rate used in determining the lease liabilities at the date of initial application; and

- any discrepancies between the present value of reported operating lease commitments immediately before the date of the initial application (under AASB 117) and the lease liabilities recognised at the date of initial application (under AASB 16); and

- the fact that the lessee applied practical expedients in paragraph C10, discussed in 4.1.6.

The requirement to explain variances between operating lease commitments under AASB 117 and the initial lease liabilities under AASB 16 means agencies will need to consider the completeness and accuracy of leasing commitments disclosures as the application date approaches.

6. Impacts of the New Standard

6.1 AASB 16 - Benefits

The two key benefits expected by the International Accounting Standards Board (IASB) from the implementation of the new Standard are improved:

- **Quality of financial reporting** - currently investors and analysts, including credit ratings agencies estimate off-balance sheet leases. Reflecting the assets a company has control of provides a more faithful representation of the financial position and greater transparency about financial leverage and capital employed.
- **Comparability** - requirements to recognise and measure leases are now prescribed and consistent.

6.2 AASB 16 – Costs

Expected implementation and compliance costs include, but may not be limited to:

- **Information system revision/changes** – potential updates to the system to capture new information as required by the Standard
- **Identifying a lease based on the new standard definition** – as part of the transition agencies can choose to reassess all ongoing contracts to determine if a lease is present. Some agencies will have a high volume and/ or complexity of lease contracts
- **Separating leases and services within contracts** – only the lease portion of the contract is required to be on the statement of financial position (except where practical expedients are used on transition (6.3 below))
- **Determining the discount rate** – the need to determine the discount rate on a lease-by-lease basis unless a practical expedient is used (see section 6.3 below)
- **Training** – compared to typical financial reporting changes, training will need to be extended well beyond the financial reporting team. All staff involved in leasing transactions will need a broad understanding that leases need to be identified and recorded.

6.3 Simplifications and practical expedients

In addition to the scope exclusions (see section 1.4) AASB 16 also provides simplifications with the intention to reduce the compliance costs. These include:

- **Variable lease payments and optional payments** – this simplification means variable lease payments linked to future use of the leased item or sales from the lease are not included in the measurement of the lease liability and respective right-of-use asset. This means agencies do not need to exercise judgement or create forecasts for these items, rather expense these costs only when they are incurred (para BC168-169).
- **Combining lease and services within contracts** – as a practical expedient, the Standard allows agencies to not separate lease and non-lease components (service components) and instead account for them together as a single lease (para 15).
- **Portfolio application** – the standard can be applied to a portfolio of leases with similar characteristics, where the outcome would not be materially different from the application of the standard on a lease-by lease basis (para B1).

6.4 General effects on financial statements

The table below highlights effects of AASB 16.

Effects on Financial Statements		
Effects	**Statement**	**Explanation**
↑ Lease Assets ↑ Financial Liabilities	Balance Sheet	Increase as requirement of recognising almost all off-balance sheet leases as a right-to-use asset and a respective lease liability
↓ Equity	Balance Sheet	Decrease as the carrying amount of lease assets is likely to reduce more quickly (with a higher interest expense at the beginning of the life of the lease) than the carrying amount of lease liabilities
↑ EBITDA	Income Statement	Operating lease costs included in operating expenses will be replaced by interest and depreciation expenses
↑↓ Profit before tax	Income Statement	Interest expenses are higher in the earlier years. Combined with depreciation this will accelerate expenses compared to operating lease expenses. The impact on annual profit will depend on the lease portfolio.
↑ Cash from operating activities ↓ Cash from financing activities	Cash flow statement	Increase in cash from operating activities as the interest portion of lease payments will be classified as cash outflows from financing activities, instead of the entire operating lease payment being classified as a cash outflow from operating activities
↔ Total cash flow	Cash flow statement	No change expected as changes are related to reclassification of interest and principal in different sections of the cash flow statement

6.5 Effects on key financial metrics

The table below highlights some of the expected effects.

Effects on Key Financial Metrics		
Metric	**Metric measure**	**Explanation**
↑ **Leverage (gearing)**	Long-term solvency	Increase as financial liabilities increase
↑↓ **Interest coverage ratio**	Long-term solvency	Dependent on the features of the lease portfolio, as both EBITDA and interest expense will increase
↓ **Current ratio**	Liquidity	Decrease as current liabilities increase (interest expense increase) and no change in current assets
↓ **Asset turnover**	Profitability	Decrease as recognition of off-balance sheet operating leases as part of total assets
↑ **EBIT/ Operating profit**	Profitability	Increase as depreciation expense charges associated with leases under AASB 16 is lower than the operating lease expenses under AASB 117
↑↓ **Profit or Loss**	Profitability	Dependent on the features of the lease portfolio – leases with different lease terms will replace the current leases which will also change the size of the lease portfolio and the discount rates applied
↑↓ **EPS**	Profitability	Dependent on profit and loss, consequently also dependent on the features of the lease portfolio and tax rates. The impact on annual profit will depend on the lease portfolio.
↑↓ **ROE**	Profitability	Dependent on the effect on profit or loss. If the effect on profit or loss is neutral, the ratio will increase as a consequence of lower equity. The impact on annual profit will depend on the lease portfolio.
↔ **Net cash flow**	Profitability and liquidity	No change expected as changes are related to reclassification of interest and principal in different sections of the cash flow statement

7. Other Effects

- **Cost of borrowing** – not expected to be significant as research has found credit market participants already incorporate off-balance sheet operating leases when making credit assessments and creditors tend to evaluate costs of lending via credit agencies (directly or indirectly)
- **Debt covenants** - debt covenants established in contracts are generally based on accounting standards in place at the time of the agreement. Further, some debt covenants already include off-balance sheet leases in their underlying ratios. Overall, the IASB does not expect AASB 16 implementation to have major effects on debt covenants as contracts are likely to be adjusted accordingly

8. Further information

For further assistance and advice contact the Financial Management & Accounting Policy branch email: accpol@treasury.nsw.gov.au.