TOP 5 ISSUES IN THE IMPLEMENTATION OF **AASB 16 *LEASES***, AND HOW TO THINK ABOUT THEM

AASB 16 *Leases* has now been effective for over 10 months, and RSM Australia's Technical Accounting team is receiving an increasing number of questions about its implementation. We discussed the transitional options available in our earlier article, so in this article we will consider some common implementation concerns.

IDENTIFYING LEASES

The scope of AASB 16 broadens the definition of a lease to capture any contract, or part of a contract, which conveys the right to use an identified asset for a period of time in exchange for consideration, which provides an entity the right to obtain substantially all the economic benefits from the use of the identified asset.

How does this apply to non-standard contracts, in which assets can be contractually substituted by the supplier for other equivalent ones, or to leases in which rent payable partially depends on turnover levels, thereby preventing the entity from obtaining all the rewards from the lease?

EXAMPLE 1
UNAVAILABLE ALTERNATIVE ASSETS

A mining company, Entity A, requires use of an engine in its mining operations, of a very specific design and type. The supplier has only one such item available in the geographic area, which is remote.

Because of the lack of availability of other appropriate engines, this contracted engine is likely to be considered a "specifically identified" asset.

EXAMPLE 2
SUBSTITUTION RIGHTS

Entity B enters into an agreement with a supplier for the provision of construction activities. The contract contains a list of vehicles, identified by make and model, for use in these activities. However, the agreement gives the supplier the right to substitute the identified vehicles for other similar vehicles throughout the period of use. There are no practical impediments to the supplier substituting vehicles.

In this example, the substitution right is substantive rather than protective. Therefore, these vehicles would not be considered "specifically identified assets," and the contract would not be treated as a lease.

This results in the scenario that some assets which are implicitly specified in agreements due to their specific ability to suit the entity's needs may well be in the scope of AASB 16, and that some assets which are apparently explicitly identified, may not be in scope of AASB 16. Preparers must take care to ensure that only contracts which provide an entity with the right to direct the use of specified assets during the whole period of the lease are accounted for under AASB 16.

DETERMINING THE DISCOUNT RATE

The starting point to measure a lease liability involves discounting to present value the fixed and in-substance fixed payments to be made over the term of the lease. Yet a significant issue encountered by preparers is the quantification of the discount rate.

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The standard refers to the 'interest rate implicit in the lease' as the starting point. This is the rate of interest which causes the present value of lease payments and the unguaranteed residual value to equal the sum of the fair value of the underlying asset plus any initial direct costs of the lessor. It is usually the rate at which a supposed Internal Rate of Return is nil. However, in practice, it requires access to information which will often be unavailable to lessees. For example, the lessor may not be willing to communicate their expected residual value to the lessee, or other commercially-sensitive information such as their initial direct costs.

Therefore, most leases are discounted using the Incremental Borrowing Rate (IBR). This is the rate of interest that a lessee would have to pay to borrow the funds necessary to acquire an asset of a similar value to the value of the right-of-use asset, in a similar economic environment as it operates in, over a similar term, reflecting the credit risk of the lessee, and secured against the underlying asset. Determining the incremental borrowing rate will therefore often involve significant judgment.

PRACTICAL EXPEDIENT AVAILABLE: PORTFOLIO BASIS

Leases may be accounted for on a portfolio basis, and the same IBR applied to the portfolio. However, this may only be done if the impact is expected to be materially the same as if IBRs were calculated on a lease-by-lease basis. This will need to be demonstrated, so the expedient may not actually lead to less work!

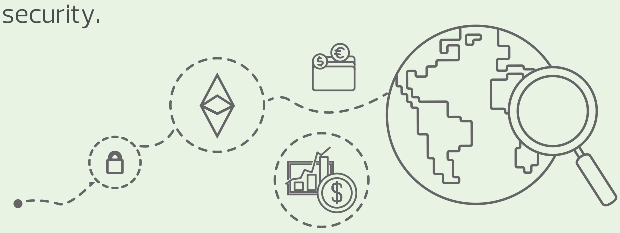
HIGHLIGHT 1

FACTORS AFFECTING THE INCREMENTAL BORROWING RATE

Starting with the Weighted Average Cost of Capital, adjustments must be made to recognise that the WACC includes the cost of equity, but the IBR does not. Other factors to consider include:

- The length of the lease: the longer the lease, the higher the rate
- The underlying value of the asset being leased: the better the security, the lower the rate
- The entity's existing debt: the higher the current cost of borrowing, the higher the incremental cost of borrowing
- The quality of the asset being leased: the better quality of asset, the lower the rate

So, the IBR may differ for different leases held by the same entity. For example, a property lease may have a lower IBR than a vehicle lease, since it will usually have a longer term, and the underlying asset represents better security.

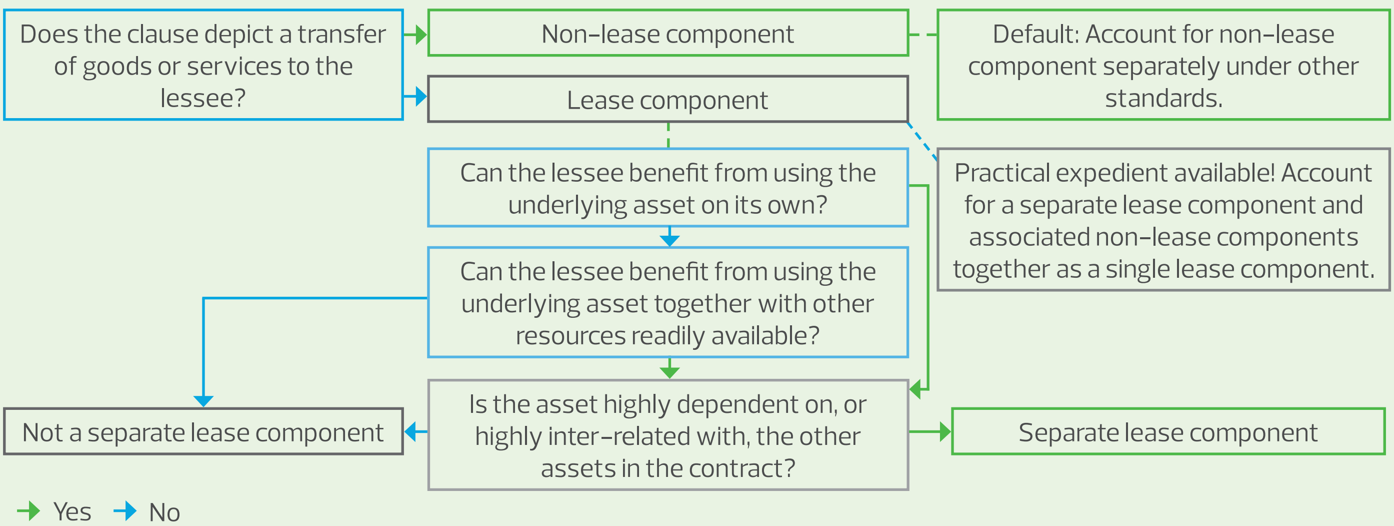


NON-LEASE COMPONENTS

Lease agreements often contain clauses which refer to other goods or services to be purchased from the lessor, such as maintenance costs, utilities, insurance costs, and so on. The accounting treatment of these additional items depends on whether they are for goods or services which provide a benefit to the lessee.

HIGHLIGHT 2

WHAT TO DO WITH LEASE COMPONENTS?



EXAMPLE 3
LEASE AND NON-LEASE COMPONENTS

Lease type	Lease component	Non-lease component	Not components
Car leases	Right to use vehicle	Car servicing, car maintenance	Stamp duty, Registration
Property leases	Right to use a building	Cleaning services, Maintenance services, Common area maintenance, Security, Energy usage, Water usage	Property taxes*, Property insurance, General insurance
Equipment leases	Right to use machinery	Maintenance services, Servicing	–
Accounting treatment	Account separately	Account separately, unless practical expedient elected	Include in the consideration allocated to the components.

**If the lessor has the statutory obligation to pay the property taxes, but the lease agreement requires them to be reimbursed, or paid, by the lessee, common practice would be to account for property taxes as part of the total consideration that is allocated to the separately identified lease and non-lease components of the contract. On the other hand, if the lessee has the statutory obligation to pay the property taxes, they should not be included as part of the consideration which is allocated across the lease and non-lease components of the contract.*

PRACTICAL EXPEDIENT AVAILABLE: COMBINATION

Lease and associated non-lease components may be accounted for as a single lease component rather than separately. This is an election to be made by **class of underlying asset and for all non-lease components** in the contract; and only to for those non-lease components associated with the lease.

If this election is not made, lease components and non-lease components are always separated, and non-lease components are accounted for under other standards.

PROVISIONS FOR RESTORATION OR MAKE GOOD OF ASSETS ON TRANSITION

Many lease contracts contain restoration or make-good provisions. For example, leases for commercial premises often include a "make-good" clause which requires the lessee to remove their fit-out at the end of the lease, and return the premises to their original condition. The expected cost of doing this is recognised as a provision under AASB 137 Provisions, Contingent Liabilities and Contingent Assets.

The recognition of a make-good provision associated with leases is not a new requirement from AASB 16, since it is an existing requirement of AASB 137. However, its treatment changes under AASB 16, because the initial recognition of right of use assets includes 'an estimate of costs to be incurred in [making good] the underlying asset'. We have also seen instances where a provision had not been recognised previously, but the review of lease contracts undertaken to implement AASB 16 has identified that a make-good clause exists, and therefore a provision is necessary.

In the year of transition, the treatment of these costs and associated provisions depends on the transition method applied, and on whether or not such a provision had already been recognised, as follows:

Full retrospective or modified retrospective: Right of Use asset measured as if AASB 16 had always applied

Do the financial statements include a provision for make good from previous years for the leases under assessment?		
NO	YES: EXPENSED	YES: CAPITAL
If this is contractually required: recognise restatement under AASB 16	Reverse out of retained earnings. Recognise under AASB 16	Reverse out of leasehold improvement. Recognise within right of use asset under AASB 16

Simplified modified retrospective: Right of Use asset measured at the value of the Lease Liability at the date of initial adoption

Do the financial statements include a provision for make good from previous years for the leases under assessment?		
NO	YES: EXPENSED	YES: CAPITAL
If this is contractually required: recognise prior period adjustment if material.	Do nothing.	Consider the whether the useful life of the leasehold improvement assets to which the provision is linked.

EXAMPLE 4
MAKE GOOD PROVISIONS: IMPACT ON TRANSITION

Entity C, with a 30 June year end, had entered into a 5-year lease of premises, commencing on 1 April 2016, with a renewal period of 6 years which they are reasonably certain to exercise. Initial rental costs are $198,475 per annum, with fixed yearly escalations of 3.5%. In spite of a contractual clause clarifying that it is the lessee's responsibility to pay for the dismantling of any fit out made, and for any costs of returning the premises to their original state, no make-good provision had been recognised previously.

The costs required were estimated at $50,000.

With an incremental borrowing cost for this asset of 6%, and a risk-free rate of 3% with which to discount the provision, then applying a simplified modified retrospective approach to transition, the entity must recognise the following at 1 July 2019:

ACCOUNT	DR	CR
Right of use asset	$1,539,377	-
Lease liability - Current	-	($135,613)
Lease liability - Non-current	-	($1,403,764)

AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors should be applied to the prior period error, which involves restatement of the comparative figures, which results in a net adjustment to retained earnings brought forward as follows:

ACCOUNT	DR	CR
Retained earnings: opening	$39,861	-
Make good provision	-	($39,861)

DEALING WITH LEASE INCENTIVES FOR FIT-OUT COST REIMBURSEMENT

Lessees will often receive incentives from lessors to enter into lease agreements. AASB 16 defines Lease Incentives as "Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee". The definition is therefore silent on the treatment of lease incentives where lessors reimburse lessees for their fit-out costs.

The main consideration in this question is whether fit-out costs are incurred to build assets which are for the lessor's benefit, or for the lessee's benefit:

- If the assets constructed are to remain the benefit of the lessee, and are of no benefit to the lessor, then the contribution should be treated like any other cash incentive received or receivable;
- If the asset constructed will ultimately be the lessor's, then this is outside the scope of AASB 16: the lessee does not end up with an asset in addition to the right-of-use asset, and instead, is in effect making upfront payments for costs of the lessor, with the lessor reimbursing them!

Careful consideration of terms of the lease agreements is key in ensuring these issues are identified early and addressed accurately in applying AASB 16.

EXAMPLE 5
LEASE INCENTIVES

Entity D, with a 31 December year end, enters into a 10-year lease agreement for a property, agreeing its terms on 1 January 2019 (inception date).

Between 1 January 2019 and 30 June 2019, the tenant undertakes substantial fit-out works to enable them to use the property as they intend. The commencement date of the lease is therefore 1 July 2019.

As an incentive, the landlord reimbursed the tenant for the costs of the fit-out.

For the following scenario:

- Rent: $1,000,000 per annum. Fixed increase of 3% p/a
- Fit-out contribution from landlord: $1,000,000
- Lease term: 10 years
- Incremental borrowing rate: 6%

During the period of construction of fit-outs, entity D records the construction and the reimbursement thus:

ACCOUNT	DR	CR
Asset under construction	$1,000,000	-
Cash		($1,000,000)
To record the building of the improvements		

ACCOUNT	DR	CR
Cash	$1,000,000	-
Accrued lease incentive		($1,00,000)
To record the reimbursement of the fit-out costs		

On commencement date, the value of the lease incentive received is credited against the right of use asset, resulting in the following:

Account	DR	CR
Right of use asset	$ 14,411,165	-
Lease liability	-	($15,411,165)
Accrued lease incentive	$1,000,000	-
Initial recognition of right of use asset and lease liability.		