Global Leasing Survey: an Australian perspective

Results of Australia vs. Rest of the World

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Introduction

Globally, KPMG has conducted a survey to understand the readiness and preparedness of companies in implementing the new leases standard, and the challenges they have faced along the way.

The results to this survey show that many global companies have not completed their implementation programs prior to the transition date, and are expecting to continue to work on the project for some time to come. Notwithstanding the fact that Australian companies have the benefit of an extra six months to their transition date of 1 July 2019 (as opposed to 1 January 2019 for most global entities), Australian companies that participated in the global study by comparison believe they are as prepared, if not more so, than their global counterparts. In this short paper we analyse the Australian responses to the survey in more detail.
48% of Australian respondents stated that they are on track and have not faced any challenges related to the implementation of the new leasing standard.

52% of Australian companies believe they are behind with the implementation of the new lease standard.

67% of Australian respondents expect that their costs of implementing the new standard will not exceed $250,000.

As compared to 46% of overseas respondents.

33% of Australian respondents indicated they had completed their accounting assessment on the impact of the new standard.

Only 29% of Australian respondents have actively completed gathering and validating their lease data.
Planned approaches to estimating the incremental borrowing rate (IBR) in Australia

- 42% Our company will internally estimate the IBR for each lease
- 21% Get direct quotes from a lender
- 8% Different approaches for different types of leases
- 2% Hire a third party to estimate the IBR
- 27% Do not know/Not sure

Key implementation issues in Australia — Discount Rates

27% of respondents are not sure how to estimate an appropriate incremental borrowing rate

System implementation

38% of Australian respondents are planning on complying without implementing any system changes, such as by using spreadsheets
21% of Australian respondents are not sure which system provider to use

System implementation in Australia

- 29% In the process of implementing one
- 6% In the process of customising one
- 21% Implementing but requires manual work-arounds
- 38% Do not know/Not sure
- 6% Manually or via spreadsheets (no system change)
What is AASB 16?

The Australian Accounting Standard, AASB 16 Leases, supersedes the existing AASB 117 and will fundamentally alter the Balance Sheet and Income Statement of companies that lease assets as part of their operations from 1 January 2019 onwards. These leases will now be capitalised on the Balance Sheet of the lessee, resulting in new Right-of-Use assets and a financial liability for the obligation to make future payments. The International Accounting Standards Board (IASB) estimates this change will impact USD 2.2 trillion in leasing commitments of listed entities using IFRS or US GAAP, with many of these payments now being recognised on the Balance Sheet of those entities for the first time.

The Income Statement of these companies will also be affected, as although the total expense recognised for an individual lease over the entire lease term will be the same as under the existing AASB 117, the total expense recognised in any individual reporting period is expected to be different, with a customer now recognising interest and depreciation expense, as opposed to the existing operating lease expense. This change is estimated to have a USD 300 Billion effect on EBITDA globally.

Have Australian companies identified all their leases?

How many leases does your organisation have (including both real estate and equipment)?

<table>
<thead>
<tr>
<th>Number of Leases</th>
<th>Australia</th>
<th>Rest-of-the-World (ROW)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 499</td>
<td>75%</td>
<td>48%</td>
</tr>
<tr>
<td>500 to 999</td>
<td>6%</td>
<td>9%</td>
</tr>
<tr>
<td>1,000 to 2,999</td>
<td>2%</td>
<td>11%</td>
</tr>
<tr>
<td>3,000 to 9,999</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>10,000 or greater</td>
<td>0%</td>
<td>11%</td>
</tr>
<tr>
<td>Do not know/Not sure</td>
<td>8%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Number of respondents: 52. May not equal 100% due to rounding.

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1 pg.16 IFRS 16 Effects Analysis
2 pg.47 IFRS 16 Effects Analysis
One of the primary challenges we have observed from working with Australian companies when implementing the new standard has been to obtain a complete list of their lease portfolio. According to survey responses, three quarters of respondents from Australian companies have stated that they have less than 500 leases, while less than half of the rest of the world responded with the same range — with some overseas respondents having over 10,000 leases.

75% of Australian respondents expect to pull lease data from fewer than nine locations while, in contrast, almost half of the respondents from the rest of the world expect to pull data from more than ten locations. This may indicate that Australian entities have a relatively simpler legal and operating structure compared to their overseas counterparts. But — seemingly simple or not — completeness of the lease register is still the most critical first step in any implementation — and one where complexities such as embedded leases in service agreements remain a common omission.

Given the difficulty of ensuring completeness of the portfolio, auditors and those charged with governance are likely to focus on the process and controls that have been used by entities in identifying leases. Many companies use a decentralised model for managing their leases. As such, we are observing leases projects where the project team are identifying unexpected additional leases when more sophisticated processes (such as Data Analytics) are brought to bear.
Are Australian companies ahead of overseas companies in implementing the new standard?

Please indicate the progress your organisation has made against each of the following implementation activities related to the new leases standards.

- Establish program management team
- Perform lease inventory
- Select lease accounting software
- Perform accounting assessment
- Gather and validate data
- Develop system or process requirements
- Calculate the transition impact
- Design software or process solution
- Conduct training
- Upgrade/implement new IT system
- Complete implementation
- Analyse tax impacts
- Other

Number of respondents: 52. May not equal 100% due to rounding.
Is your company facing any challenges related to the implementation of the new leases standards? (select all that apply)

- No, we are on track
- Yes, in identifying embedded leases
- Yes, in establishing an appropriate incremental borrowing rate
- Yes, in abstracting and entering leases into a leasing system
- Yes, in integrating a lease accounting system to the existing system environment
- Yes, in selecting and implementing an adequate leasing system
- Yes, in reporting on the proper accounting treatment and disclosures
- Yes, in estimating operating costs or service components in leases to exclude from capitalisation
- Yes, in defining a lease

In terms of the overall level of preparedness of Australian companies:

- 50% of Australian respondents have completed the collation of their lease inventory, compared to 37% from the rest of the world
- 33% of Australian respondents indicated they had completed their accounting assessment on the impact of the new standard compared to 23% from the rest of the world
- 29% of Australian respondents have actively completed gathering and validating their lease data while only 15% of the rest of the world have performed this activity.

One of the main differences between the two data sets is that Australian companies also believe they are better prepared in performing the calculation for the transition impact and implementation of new IT systems (where applicable). Overall, almost half of Australian respondents stated that they are on track and have not faced any challenges related to the implementation of the new leasing standard. This compares with only 28% of their global peers taking the same view.

This may indicate the implementation projects for Australian companies are less complex than those being undertaken by their global peers, resulting in fewer challenges being identified during their projects. There is also a risk that this result reflects Australian companies showing greater optimism at an earlier stage of their implementation than their global peers are feeling as they progress their projects. We are observing that as companies work through their implementation projects, unforeseen challenges arise, with common examples of ‘road bumps’ such as: unexpected contracts, intercompany leases/subleases, ‘make good’ provisions, lease transactions unexpectedly not supported by accounting systems (where applicable) and identifying, then accounting for, lease modifications in the future. It is important to ensure that implementation projects stay on track so that these critical areas can be addressed as they arise.
Estimating discount rates is at the front of Australian companies’ minds

How does your company plan to establish an appropriate incremental borrowing rate (IBR) for each applicable lease?

- Our company will internally estimate the IBR for each lease: 42% Australia, 59% Average of ROW result
- Different approaches for different types of leases: 8% Australia, 14% Average of ROW result
- Get direct quotes from a lender: 9% Australia, 21% Average of ROW result
- Hire a third party to estimate the IBR: 2% Australia, 4% Average of ROW result
- Do not know/Not sure: 15% Australia, 27% Average of ROW result

What do you expect the total cost (internal and external) will be for the implementation of the new leases standards (in USD)?

- Less than $249,999: 46% Australia, 67% Average of ROW result
- $250,000 to $499,999: 8% Australia, 11% Average of ROW result
- $500,000 to $749,999: 5% Australia, 12% Average of ROW result
- $750,000 to $999,999: 2% Australia, 3% Average of ROW result
- $1 million to $2,499,999: 4% Australia, 7% Average of ROW result
- $2,500,000 to $4,999,999: 4% Australia, 3% Average of ROW result
- $5 million or more: 0% Australia, 1% Average of ROW result
- Do not know/Not sure: 25% Australia, 25% Average of ROW result

Number of respondents: 52. May not equal 100% due to rounding.
If your organisation’s total expected cost of leasing implementation increased from the prior year, what circumstances led to the increased costs? (select all that apply)

<table>
<thead>
<tr>
<th>Circumstance</th>
<th>Australia</th>
<th>Average of ROW result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased need for outside advisors due to time and internal resource constraints</td>
<td>31%</td>
<td>21%</td>
</tr>
<tr>
<td>The need for a new lease accounting software</td>
<td>27%</td>
<td>20%</td>
</tr>
<tr>
<td>Time to identify, abstract, analyse, and enter leases into a system is taking longer than expected</td>
<td>6%</td>
<td>16%</td>
</tr>
<tr>
<td>Time to complete a comprehensive assessment greater than anticipated</td>
<td>15%</td>
<td>17%</td>
</tr>
<tr>
<td>Challenge of identifying embedded leases required more time and resources</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>Assessment and implementation project began in earnest this year</td>
<td>8%</td>
<td>19%</td>
</tr>
<tr>
<td>Impact to systems and/or processes greater than anticipated</td>
<td>8%</td>
<td>12%</td>
</tr>
<tr>
<td>The need to customise an existing leasing system</td>
<td>6%</td>
<td>9%</td>
</tr>
<tr>
<td>Volume of leases greater than expected</td>
<td>4%</td>
<td>12%</td>
</tr>
<tr>
<td>The need to use cognitive abstraction technology combined with manual labor to abstract lease data into a system</td>
<td>0%</td>
<td>4%</td>
</tr>
<tr>
<td>Lessons learned from underestimating implementation costs on the new revenue standard (IFRS 15/ASC 606)</td>
<td>0%</td>
<td>6%</td>
</tr>
<tr>
<td>Other</td>
<td>2%</td>
<td>7%</td>
</tr>
<tr>
<td>Cost did not increase from prior year</td>
<td>37%</td>
<td>50%</td>
</tr>
</tbody>
</table>
One of the key implementation issues Australian companies face is establishing an appropriate discount rate. 27% of respondents are not sure how to estimate an appropriate incremental borrowing rate (on the basis that the interest rate implicit in the lease is not readily determined), while 42% plan to estimate these rates internally.

When working with Australian clients, we have observed many having difficulty in estimating an incremental borrowing rate that gives due consideration to the asset, term and commencement date of the lease for a loan with similar conditions. The judgement required in relation to these factors requires a process for estimation that is aligned with the objectives of AASB 16.

The discount rate can have a significant impact on a company’s lease assets and liabilities, and a host of key financial ratios. We have observed that while some Australian companies are in the process of developing a methodology to determine their discount rates on transition and post adoption, there are others that have not yet properly considered this important and new requirement under AASB 16.

67% of Australian respondents expect that their costs of implementing the new standard will not exceed $250,000, which is significantly less than global respondents who are expecting higher implementation costs. This can be attributed to the size and location of the lease portfolios of Australian companies, as well as prioritising lower cost implementation projects such as by implementing less expensive system solutions.

This observation is consistent with the fact that 31% of Australian respondents expect some increase in their implementation cost and will likely look to engage external parties to assist them with their implementation efforts. Globally, 62% of respondents indicated their expected costs of implementation have increased over the past 12 months.
Are Australian companies implementing system changes in response to the new standard?

If your organisation is using a system for the new leases standards, select the following that best describes your organisation’s current situation.

- We are in the process of implementing a new lease accounting system: 29% in Australia, 31% average of ROW result.
- We are in the process of customising an existing lease administration system: 6% in Australia, 10% average of ROW result.
- We are in the process of making system changes but are required to implement manual work-arounds because the system will not be ready for compliance: 6% in Australia, 5% average of ROW result.
- Do not know/Not sure: 14% in Australia, 21% average of ROW result.
- We are not planning for system changes for the new leases standards and will be handling required changes manually or via spreadsheets: 38% in Australia, 40% average of ROW result.

Number of respondents: 52. May not equal 100% due to rounding.
When it comes to taking a systems approach to comply with the new standard, Australia is aligned with Canada and Japan, with 38% of Australian respondents not planning for system changes, but planning to calculate new lease liabilities and right-of-use (ROU) assets manually or via in-house developed spreadsheets. We expect this to be predominately based on the size of lease portfolios within Australia. For respondents that are looking to implement a system change, 37% of Australian respondents are not sure which system provider to use.

This is consistent with our observations from working with Australian companies on their implementation projects. Over the last six months there has been increased interest and discussion on the various leasing software tools available in the Australian market and we expect these conversations to continue as we approach the 1 July transition date. For those entities who were planning to use spreadsheets developed in-house, we are already seeing some change their approach when faced with practical difficulties which this approach cannot resolve.

As system changes are expected to take a minimum of six to twelve months to implement, we have observed many Australian companies having significant system implementation work to perform prior to their first reporting period under the new standard. Our expectation is that many Australian companies will not have implemented the system changes prior to their transition date, which will result in effort being focused on a realistic and workable interim solution in order to comply by the reporting date. In these cases, it may be more efficient for companies to use pre-built Excel-based models or to outsource their AASB 16 reporting to service providers. This is as opposed to companies investing time and resources building “tactical” solutions to achieve compliance prior to the completion of the system implementation work so close to the effective date and first reporting period under the new standard.

For those companies that are not planning on a system change, they should consider the need to embed governance over the lease reporting process, particularly processes to support the ongoing identification of new leases, the re-measurement of lease assets and liabilities, the need to monitor for modifications throughout the life of a lease, and also the extraction of information to comply with the new disclosure requirements around short-term and low value leases – despite those leases qualifying for the recognition exemption. Lease accounting is no longer a set and forget exercise.
Have Australian companies decided on their transition approach?

Although a significant proportion of Australian respondents (33%) indicated they have performed their initial impact assessment, there is still more work that needs to be done in order to ensure a smooth transition to the new standard.

A number of Australian respondents appear to have yet to consider whether they will adopt the new standard with the use of practical expedients, and are unsure what transition option to use upon implementation.

Based on our work with clients nationally, most entities are leaning towards the modified retrospective approach where the ROU asset equals the lease liability. This is due to the fact that historical lease data such as changes to lease payments, assessments of lease term, and discount rates, are often not available.

Which transition method will you apply?

<table>
<thead>
<tr>
<th>Transition Method</th>
<th>Australia</th>
<th>Average of ROW result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modified retrospective approach</td>
<td>64%</td>
<td>58%</td>
</tr>
<tr>
<td>Retrospective approach</td>
<td>7%</td>
<td>21%</td>
</tr>
<tr>
<td>Not yet decided</td>
<td>21%</td>
<td>29%</td>
</tr>
</tbody>
</table>

Number of respondents: 52. May not equal 100% due to rounding.
Conclusion

The survey results indicate many Australian companies believe their implementation projects are further progressed than overseas companies. However, the experience of overseas companies with an earlier transition date is that significant challenges continue to be uncovered as their projects progress, particularly those relating to the completeness of their lease portfolio and system implementation, resulting in project delays.

The overseas experience gives Australian companies guidance on potential risks that may arise in their own implementation projects. The next few months will see many Australian companies increase their focus on lease accounting system selection and implementation. With the effective date and first reporting deadlines looming, entities may need to identify risk mitigants such as interim system solutions, or outsourcing the process to service providers.

It may well be the right time now to perform an ‘in-flight’ implementation review in order to allow companies to take a step back, consider the status of their implementation, learn from the risk factors identified by other companies, and then consider whether they have been adequately managed in their own projects. Above all, entities will need to ensure their project timeline considers not only initial compliance but also embedding processes and systems that will support sustainable compliance with AASB 16. There is still some way to go…
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