Today’s presenters

Patricia Stebbens
Partner
Department of Professional Practice
(03) 9288 6261
pstebbens@kpmg.com.au

Michael Voogt
Director
Department of Professional Practice
(02) 9455 9744
mvoogt@kpmg.com.au

Michelle Gibbs
Director
Accounting Advisory Services
(02) 9455 9028
mfgibbs@kpmg.com.au

© 2016 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International. Liability limited by a scheme approved under Professional Standards Legislation.
Why a new leasing standard?

Currently analysts adjust financial statements for off-balance sheet leases

Under IFRS 16, companies will bring these leases on balance sheet, using a common methodology
Agenda

1. Major impacts for lessees
2. New definition
3. New accounting
4. Multiple transition options
5. Next steps & how we can help
6. Key points to remember
Major impacts for lessees
Lessees face major changes

Leases on balance sheet

Balance sheet

Asset
= ‘Right-of-use’ of underlying asset

Liability
= Obligation to make lease payments

P&L

Lease expense
  Depreciation
  + Interest
  = Front-loaded total lease expense
Impact on balance sheet

Companies with operating leases will appear to be more asset-rich, but also more heavily indebted.
Total lease expense will be **front-loaded** even when cash rentals are constant.
Impact on financial ratios

Profit/loss

Balance sheet

Ratios

EBITDA

Total assets

Gearing

EPS

(in early years)

Net assets

Interest cover

Asset turnover
New definition
Lease definition

The new on/off-balance sheet test for lessees – a key judgement area

New standard

Old standard

ON

OFF

Lease classification test

Lease

Service

Finance lease

Operating lease
Lease definition

Contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration

(IFRS 16, Appendix A)
Lease definition - Identified asset

The new definition increases focus on who controls the asset and may change which contracts are leases.

- Identify asset can be specified *explicitly* or *implicitly*.
- No identified asset if supplier has substantive right to substitute asset:
  - Practical ability (right & availability)
  - Benefits economically from exercising right to substitute asset.
- Identified asset is physically distinct.

Is there an identified asset?

No → Contract does not contain a lease.
Lease definition - Control

Is there an identified asset?

- Yes
- No

Customer has right to substantially all the economic benefits?

- No
- Yes

- Primary output and any by-products
- Benefits from use – not ownership of asset

Contract does not contain a lease
Solar farm example

Company C
- 20 yr purchase electricity
- Renewable energy credits

Company D
- Construction tax credits
## Lease definition - Control

1. **Is there an identified asset?**
   - Yes
   - No

2. **Customer has right to substantially all the economic benefits?**
   - Yes
   - No

3. **Who directs how and for what purpose the asset is used?**
   - Consider decision making rights that are most relevant to changing how and for what purpose
   - Examples include: type of output, when, where and whether to produce
   - *Protective rights* of the supplier do not prevent the customer from having right to direct the use

4. **Contract does not contain a lease**
Lease definition - Control

Who directs how and for what purpose the asset is used?

Customer

Predetermined

Supplier

Yes

Customer

- Operates the asset or
- Has designed the asset?

Contract contains a lease

No

Contract does not contain a lease

Customer

Operates the asset or
Has designed the asset?
Power purchase example

- **Company C** acquires all the output from cogeneration power plant owned by **Company D**

- **What if:**
  
  i. **Company C** directs how and for what purpose?
  
  ii. **Company D** directs how and for what purpose?
New accounting
Two major optional exemptions make the standard easier to apply

Leases of low value items
≤ USD 5,000 for example

Short term leases
≤ 12 months
Measuring the lease liability

Lease liability = Present value of lease rentals + Present value of expected payments at end of lease
Lease payments

- **Fixed payments**: includes in-substance fixed payments / incentives
- **Variable lease payments**: only for index or rate / rate at commencement
- **Residual value guarantees**: at amount lessee expects to pay
- **Purchase option exercise price**: if lessee reasonably certain to exercise
- **Payments for terminating**: if lease term reflects termination by lessee
Variable lease payments

Which variable lease payments are included in the lease liability?

- Payments based on an index or rate
- Payments based on turnover or usage
Measuring the right-of-use asset

Right-of-use asset = Lease liability + Initial direct costs + Prepayments + Restore/dismantle - Incentives rec’d
Lessor accounting remains similar to current practice…

but lacks consistency with new lessee accounting model

- Lease classification test
  - ✔
- Finance leases and operating leases
  - ✔
- Consistent accounting model for lessors and lessees
Lessor accounting

Wider changes have an impact
- Definition of lease
- Lease payment guidance
- Sale and lease back guidance
- Sub-lease guidance
- Modification accounting
- Disclosure requirements

Changes in contract terms and business practices
Sale-and-leaseback

IFRS 16 essentially kills sale-and-leaseback as an off-balance sheet financing structure

Is there a sale?

Yes

On-balance sheet lease at cost

No

On-balance sheet financing, potentially at fair value (IFRS 9)
Multiple transition options
Applying the new lease definition

Apply the new definition to all contracts

OR

Grandfather existing contracts and apply the new definition only to new contracts
Applying the new standard

A lessee can choose to apply the standard...

Retrospectively to all accounting periods

OR

As a ‘big bang’ at the date of initial application
Effective date

Early adoption permitted if IFRS 15 is adopted

Effective date
1 January 2019

Annual report
31 December 2019

Interim report
Next steps and how we can help
Things to think about now

Some questions to assess the impact on your company’s financial statements

- Which contracts are leases?
- Which transition options to choose?
- Database of all leases?
- Systems and processes in place?
- What about ratios and covenants?
- Commercial opportunities

IMPACT ASSESSMENT
Broader business impacts

**IFRS 16 Accounting change**

- **Systems**
  - Leasing database
  - System solution
  - ERP integration

- **Treasury**
  - Covenants
  - Credit rating
  - Regulatory capital (banks)

- **Finance**
  - Transition options
  - Data collection
  - Tax
  - KPIs

- **Strategy**
  - Lease vs buy
  - Lease structuring
  - Sale and leaseback

- **Investor relations**
  - Analyst queries
  - KPIs (e.g. EPS)
  - Credit rating

- **Employee benefits**
  - Management remuneration
  - KPIs

© 2016 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International. Liability limited by a scheme approved under Professional Standards Legislation.
# How can we help?

## Assess

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### i. Impact assessment:
- Impact on key business metrics and KPI’s, such as debt covenants and EBITDA
- Estimated lease liability
- Impact on timing of expense
- Data requirements
- Identify commercial opportunities

### ii. Options analysis of key judgements:
- Transition options
- Whether arrangements are in scope
- Discount rates
- Lease term

### iii. Assessment of property database – is it sufficiently detailed, robust and fit for purpose.

## Design

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### i. Support decision making around key accounting judgements

### ii. Technical advice on interpretation and application of standard

### iii. Support development of updated accounting policy

### iv. Support commercial negotiations with landlords to minimise any detrimental impact on key metrics. (e.g. shorter lease terms / more breaks / more variable rents)

### v. Support design of system solution – lease management system / database / ERP integration

### vi. Optionality to regear, sublet, dispose or merge properties and advice on acquisition strategy going forward

## Implement

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### i. Training of finance and commercial staff

### ii. Application of new accounting policy across group

### iii. Implement system solution

### iv. Implementation support - on go forward leases, remedies to existing leases, commercial input
Key points to remember
Key points to remember

- New leases standard will impact most companies.
- Process of assessing impact should start now.
- Additional training and guidance on its way.