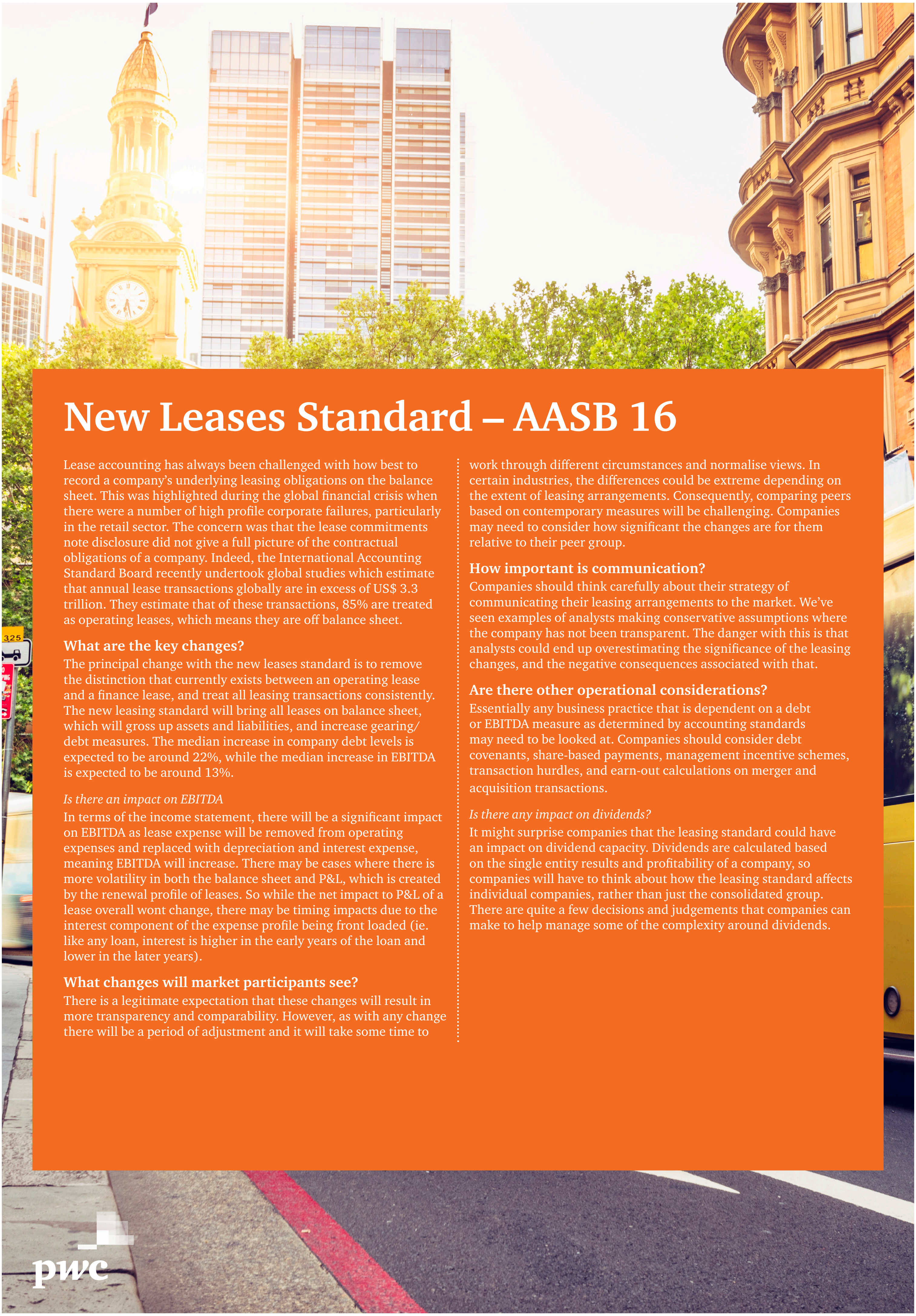


New Leases Standard – AASB 16

Lease accounting has always been challenged with how best to record a company's underlying leasing obligations on the balance sheet. This was highlighted during the global financial crisis when there were a number of high profile corporate failures, particularly in the retail sector. The concern was that the lease commitments note disclosure did not give a full picture of the contractual obligations of a company. Indeed, the International Accounting Standard Board recently undertook global studies which estimate that annual lease transactions globally are in excess of US$ 3.3 trillion. They estimate that of these transactions, 85% are treated as operating leases, which means they are off balance sheet.

What are the key changes?

The principal change with the new leases standard is to remove the distinction that currently exists between an operating lease and a finance lease, and treat all leasing transactions consistently. The new leasing standard will bring all leases on balance sheet, which will gross up assets and liabilities, and increase gearing/debt measures. The median increase in company debt levels is expected to be around 22%, while the median increase in EBITDA is expected to be around 13%.

Is there an impact on EBITDA

In terms of the income statement, there will be a significant impact on EBITDA as lease expense will be removed from operating expenses and replaced with depreciation and interest expense, meaning EBITDA will increase. There may be cases where there is more volatility in both the balance sheet and P&L, which is created by the renewal profile of leases. So while the net impact to P&L of a lease overall wont change, there may be timing impacts due to the interest component of the expense profile being front loaded (ie. like any loan, interest is higher in the early years of the loan and lower in the later years).

What changes will market participants see?

There is a legitimate expectation that these changes will result in more transparency and comparability. However, as with any change there will be a period of adjustment and it will take some time to work through different circumstances and normalise views. In certain industries, the differences could be extreme depending on the extent of leasing arrangements. Consequently, comparing peers based on contemporary measures will be challenging. Companies may need to consider how significant the changes are for them relative to their peer group.

How important is communication?

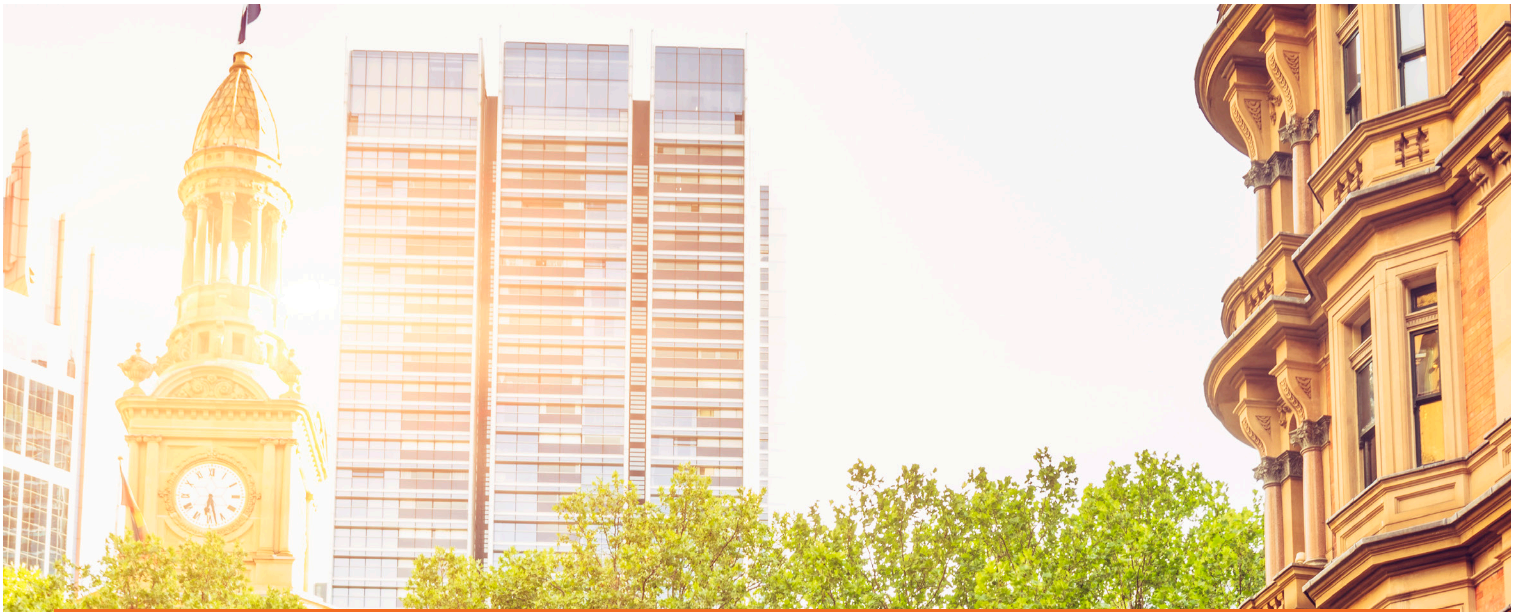
Companies should think carefully about their strategy of communicating their leasing arrangements to the market. We've seen examples of analysts making conservative assumptions where the company has not been transparent. The danger with this is that analysts could end up overestimating the significance of the leasing changes, and the negative consequences associated with that.

Are there other operational considerations?

Essentially any business practice that is dependent on a debt or EBITDA measure as determined by accounting standards may need to be looked at. Companies should consider debt covenants, share-based payments, management incentive schemes, transaction hurdles, and earn-out calculations on merger and acquisition transactions.

Is there any impact on dividends?

It might surprise companies that the leasing standard could have an impact on dividend capacity. Dividends are calculated based on the single entity results and profitability of a company, so companies will have to think about how the leasing standard affects individual companies, rather than just the consolidated group. There are quite a few decisions and judgements that companies can make to help manage some of the complexity around dividends.



New Leases Standard – AASB 16

What should directors keep in mind to ensure their company is ready for the leases standard?

- Directors need to make sure their company is doing a robust impact assessment so they can make informed decisions about the way the standard will affect their business. Directors and management need a comprehensive understanding of the way the standard will impact on key measures.
- In the financial statements prior to adoption, ASIC will be expecting listed companies to disclose both quantitative and qualitative impacts of the standard on their business. Directors should make sure their company is prepared to make those disclosures, and use the financial statements to educate the market about the way the standard will affect their business.
- Companies should think about the broader implications of the standard. As well as the internal business processes that need to be considered, the standard could affect the way that companies deal with customers and suppliers in relation to their leasing arrangements. Directors should make sure management have thought through the strategic implications of the way those parties might change the negotiations of the leasing transactions.

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