IFRS Spotlight

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Leases: On the path to business as usual

The new leases standard applies to Australian entities from 1 January 2019. As with any new accounting standard, it's easy to focus on the immediate problem of getting the numbers right on adoption of AASB 16 and lose sight of how the standard will be applied on a day-to-day basis in your organisation. However, unless you're never signing a new lease again, the transition date (day 1) adjustments are really only the start of the changes that will be required by the lease accounting overhaul.

The standard requires lessees to bring all leases onto the balance sheet and make changes to those leases (and respective assets and liabilities) every time there is a CPI increase, a rent review or an extension in lease tenor. This means finance teams will need to consider what systems, processes and controls should be put in place to help capture this information in their leasing calculation beyond the transition date - and most importantly, who is going to be responsible for these activities. A worst-case scenario would be that all transition efforts (and associated costs) need to be repeated with each reporting cycle. So, how can your organisation make sure it's on the front foot?

The answer is clear: focus on making compliance with the leases standard a business-as-usual process. This will require (i) establishing processes for contract management and data capture; (ii) standardising accounting judgments after transition; and (iii) addressing the broader business impacts early.

Processes for contract management and data capture

Capturing data about your leases is not just a transition date exercise but an ongoing process that will need to be embedded within your organisation. There is an opportunity to get it right today in order to avoid having to resolve problems later. For instance, picture this: after the transition adjustments have been calculated and you are ready to get back to business-as-usual, someone in your Melbourne office enters into a significant and complex property lease as part of their normal role in managing that business unit; then a week later someone from your Darwin office enters into a supposed service contract (which actually has an embedded lease in it) as part of their usual role, and so on. Before long, new contracts have been entered into around the country by numerous people, each of which may or may not contain a lease. Come reporting date, how will you know what contracts should be included in your calculations? And what about the rent reviews that have happened since transition date for existing contracts? Has someone reassessed those?

As illustrated, the problem can balloon quite quickly. Organisations need to think about where responsibility for contract management will lie. It’s likely that the finance team will have ownership of initial adoption, including contract reviews to identify all leases, and determine the transition-date adjustment. However, after transition, responsibility for the day-to-day contract management will ideally sit with another team, such as procurement, or even with multiple teams.

Obviously, organisations will need to design clear processes for how data about lease contracts will be communicated and captured to ensure records are up to date. Whether your organisation is using a system to help comply with the new standard or is managing leases in a spreadsheet, ensuring data is updated regularly will be paramount. You will also need to identify who will be responsible for communicating and capturing information about “lease events” – that is, all leasing activity that affects the lease calculation. This will include new leases, as well as lease contract modifications, extensions, terminations, CPI adjustments and market rent reviews, to name a few. These lease events will affect the balance sheet and profit or loss, so will need to be captured when they occur.

A system is an easy way of automating these updates and controls. If you're using a spreadsheet, agree at the outset how frequently it will be updated for new lease events and the process for doing this. The frequency of updates will likely depend on how often you enter into or change your leases. This might require a regular request to your procurement or property management team to confirm what lease events have occurred. Finally, ensure it's clear what events you are trying to capture, such as new leases, contract renewals or rent reviews.

Standardising accounting judgments after transition

Although day-to-day contract management might sit in one or more teams outside of finance, there are areas where your finance team will still need to be involved, particularly when it comes to the more judgmental accounting policies. For example, that big property lease your organisation just signed in Melbourne has an option to extend for a further 10 years – how will you ensure the right person has thought about whether the option should be included in the asset and liability measures today? Should the discount rate for this lease be the same as the rate the Melbourne office uses to finance their fleet of cars, or is a different rate required for a long-term property lease? Your organisation will need to ensure it’s clear who has responsibility for these types of judgments, and how they should be made.

A robust process to capture embedded leases should be in place from transition onwards. If contract management does not rest with an accounting expert who can review contracts for embedded leases, you'll need to consider building in a control to flag certain types of contracts for review or those with specific features. For example, you might require the contract manager to confirm whether a supplier is required to provide an asset under the contract when it's executed, or even at the negotiation stage. This will help to ensure potential new leases can be identified and flagged when the contract is signed.

Also, think about how frequently the incremental borrowing rate will need to be updated. This discount rate, which is used to measure new leases (and in some cases modified leases), may need to be revisited annually as interest rates move and risk pricing changes. In volatile environments this may need to occur more frequently.

Alongside the discount rate, the new standard has introduced a number of judgments and policy choices, which will of course need to be standardised throughout the organisation. Documenting the policies and keeping them centrally available will help to ensure they are followed consistently.

Finally, it may be helpful to document the structure of your contract portfolio groups – and policies around whether these contain leases; your approach to extension options and whether these are reasonably certain; the discount rate applied and so on. This will be particularly relevant if you are using a lease management system and save you from having to review updates to your leases every reporting period to ensure policies have been applied consistently.

Adapting to the broader business impacts

Beyond financial reporting, the leasing standard will affect a number of areas of your business:

- Budgeting and forecasting process - this may need to change depending on the information needs of your organisation. Ensure you have carefully thought about the implications and agreed how forecasting will look going forward, including how assumptions about future lease renewals will be incorporated into the models. If your organisation has significant goodwill, the new standard will also affect your impairment calculations.

- Capital management policy - this may need to be revisited; for example, if the business is managed to a target leverage ratio, it may need to be adjusted.

- Leasing activity reflected in debt covenants - where this occurs, you will likely need to ensure there are clear policies for contracting and procurement. Do you need to set limits on the duration or value of contracts that contain leases? Is there other guidance around contracting that needs to be developed within the organisation?

- Interaction with other accounting standards – these include impairment, deferred tax and business combinations. The impairment model applied for value in use, in particular, is likely to need to be revised given the changes in how leases affect the balance sheet and cash flows for impairment modelling.

Many of these processes, policies and decisions are likely to need attention as part of your transition project. Decisions made at the commencement of the project could affect the amount of effort required to prepare your leasing calculations on an ongoing basis – for example, the features of the lease system you select will inform the controls you will need to put in place. Keeping one eye on the long-term application of the standard will save effort down the line.

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