Latest Developments around Lease Accounting (IFRS 16)
14/03/2024

CCH Learning:

Hi everyone. Welcome to today's webinar regarding latest developments around lease accounting, IFRS 16. I'm Alison Wood from CCH Learning, Wolters Kluwer, and I'll be your moderator for today. Just a few quick pointers before we get started. So if you are having sound problems today, you can open up the audio panel here and just toggle between audio and phone. And in the handout section you'll find your PowerPoint presentation. And shortly after the session today, you will receive an email letting you know when your recording is ready to be viewed. In terms of questions, pop those into the questions box during the session. I will collate those questions and we'll ask them at the end of today's session. CCH Learning also offers a subscription service, which many people have termed Netflix for professionals. It provides members with access to our entire library of recordings as well as live webinars for a very competitive flat fee.

That's for over 500 hours of content and for CPD purposes, your viewing is logged automatically. Your presenter today is Aletta Boshoff, who is a partner in BDO. She's a national leader in IFRS and Corporate reporting, ESG and Sustainability. Aletta is an IFRS advisory specialist with over 25 years experience in financial reporting and accounting, including IFRS. Aletta's involvement in sustainability and environmental, social and governance reporting is a consequence of her focus on an organization's ability to create sustained long-term value in a rapidly changing world. And managing the risks and opportunities associated with these changes. Aletta puts a heavy emphasis on risk management because monitoring and mitigating risks across all three dimensions, i.e., environmental, social, and governance is an important priority for any company that is serious about sustainability and ESG. So without any further ado, I'll now pass you over to Aletta to commence today's presentation.

Aletta Boshoff:

So good day everybody. Hello Alison, lovely to see you and welcome to the session. As many of you might know by now, IFRS 16 and lease accounting is my absolute favourite topic in the world. When I look at accounting standards and I have to pick the one that brings me most joy, definitely this one. We've spent a lot of years now embracing this new standard since 2019 and we actually have a whole team of people that just focus on lease accounting at BDO. So for us and for our team, this is a big focus. It is a complicated standard, it is really complex. You have to really focus and therefore it's a challenge and maybe that's a big part of why we enjoy the standard so much. The other thing is that a lot of these IFRS accounting standards come in and you initially struggle with them, but you get the hang of it and off you go. IFRS 16 is very different in that it continues to throw up questions and problems as we go along.

It's as if we never get to that hundred percent steady state and even COVID had an impact on the standard and we had COVID-19's modifications brought into the standard. So really interesting standard. Maybe another reason most entities have a lease, whether it's your office, whether it's factories, whether it's storage, whether it's data centres, whether it's leases, leases of vehicles. So most entities in some way or another would be impacted by the standard. So in today's session we'll be looking at the top 10 lease accounting challenges in 2024. So really what we are doing is looking at since adoption in 2019 to 2024 over the five years, how has things evolved? What are still creating problems for our clients? Which are the things that you should really focus on and make sure you've got it right? At BDO, we've picked 10 things to discuss today and I've listed them there.

So if we start with the very first one, incremental borrowing rate, now the coming up with an appropriate discount right is discussed in the standard and the standard says you have to start with, can the interest rate implicit in the lease be readily determined? And if you can, you would use that interest rate implicit in the lease in order to do your calculations. However, if you cannot readily determine that implicit interest rate, that's when you use the lessee's incremental borrowing rate. So what we're seeing in practise, so a lot of entities go straight to the lessee's incremental borrowing rate. And they don't first consider whether the interest rate implicit in the lease can actually be readily determined. So don't rush past that step. Consider whether you can determine it or readily determine it or not.

The other thing that's interesting, if an organisation has a business combination or has a transaction where they acquire another entity or merge with another entity, that would be a time to reconsider an appropriate discount rate. Because if you've got a business combination, the acquirer has a brand new lease coming into the acquirer's financial statements, into the acquirer's financial records. And at that date all leases have to be reset to the incremental borrowing rate at that date.

So with a discount rate, part of it is, do we use implicit interest rate or do we use the lessee's incremental borrowing rate? Part of is, when do we have to update our discount rate? And another part of it is what do we do when there's a transaction? So the discount rate is one to keep an eye on, there's a few tricks that we have to deal with. If you have to use an incremental borrowing rate, so you've passed that hurdle, you couldn't find an interest rate implicit in the lease, what is an incremental borrowing rate? So that's the rate of interest that a lessee would have to pay to borrow over a similar term and with a similar security. So if the lessee went to the bank, borrowed money to buy an asset, so a vehicle or property, so similar security. If I borrow over a property versus borrowing over a vehicle, how does that impact the rate that the bank's willing to give me?

But also over a similar term. So if I have a five-year lease and I'm making monthly payments, you have to compare that to borrowing money from the bank over a five-year period or four or five years. And then the trick is often the bank would require you to pay interest potentially on the loan and only repay the principal amount in five years time. But we have to look here at the similar term, five years, but also a similar payment structure. So with a lease, every payment has a little bit of interest in it and has a repayment of the loan in it. So you have to compare that with a loan where you repay the loan monthly and there's interest in it and there's capital repayment in it. So if I was a lessee and I went to the bank, obtained financing over a similar term, let's say five years, a similar security, the property is security. And my lease payments are monthly and my repayment of my loan to the bank would be monthly. That is the rate of interest that we would argue is this lessee's incremental borrowing rate.

It is the funds that's necessary to obtain an asset of a similar value to this right-of-use asset in a similar economic environment. So this similar economic environment says if you have leases in different countries, one would argue they have different economic environments and therefore different incremental borrowing rates in those different countries. So you can see how a simple definition of an incremental borrowing rate has a lot of practical implication. Similar term, similar security, similar value asset and similar economic environment, same country for example. So if you look at this incremental borrowing rate, you would start with what is the base rate taking into account economic factors. So a similar economic environment in Australia, similar term, five years, similar value asset. So the borrowing rate you get from the bank when you borrow 5 million as opposed to 5,000, somewhat different.

So base rate for similar economic factors, but then you add to that some financing factors. So you would say are there any lessee specific factors because it's about what the lessee would have to pay to borrow. Not what anybody would pay to borrow, the lessee with its specific financial statements, its specific factors, what would that lessee have to pay the bank. The bank don't provide financing to all entities at the same rate. The bank would assess the different entities and consider various factors before they offer you a rate. So therefore for this specific lessee, what would we have to pay to borrow?

And then you also take into account asset specific factors. So if you've got a loan over a vehicle, it would be a higher interest rate as a loan over property. Because to have property as security, so if you cannot make your payments, the bank can repossess the property and they can sell it. And we know property prices always go up in Australia, so property is a really good security as opposed to having a vehicle of security. You drive your new vehicle out of the showroom often it already loses a lot of value.

And I know it was a bit different after COVID because there was such a difficulty to get new vehicles and therefore second-hand vehicles kept their value quite well. These are the things you have to consider, what is your incremental borrowing rate?

Interesting year, remember we've talked about term, just come back to that in practise, many entities say, "Right, we're going to look at the base rate, we look at financing aspects, we look at asset factors." And they come up with an incremental borrowing rate for all of their leases that are in those similar categories. And the one thing they forget is similar term because some leases run for five years, some run for 10 years, some run for 20 years. So therefore what would be an appropriate incremental borrowing rate for five year, 10 year, 15 year, 20 year lease is really important. So incremental borrowing rate really is an interesting aspect. So the question is when do entities need to update that incremental borrowing rate? So some people think or incorrectly think that your incremental borrowing rate have to be updated on a regular basis, let's say every reporting date, and that's not the case.

Your incremental borrowing rate, you determine at the commencement of the lease and you would only update that incremental borrowing rate if certain specific things happen. For example, there's a modification to the lease or there's a reassessment of your extension options that change your expected lease term. So there's very strict rules on when are you required to update your incremental borrowing rate. It's not a case of updating the incremental borrowing rate on a regular basis. For example, every reporting date, no, that's not the case. And then what is the impact of the current interest rate environment on your IBR? I think it's important to understand many entities entered into leases let's say in 2020, and interest rates were very low. Therefore, if you've looked at the previous slide and considered all the factors, potentially incremental borrowing rates were very low and a lot of those leases were booked at a time where incremental borrowing rates were low.

Now that the interest rate environment is high, doesn't mean you have to go and restate incremental borrowing rate on all your leases. But if you now modify a lease agreement at that date of modification, you have to update your incremental borrowing rate to the rate at that date, which we would expect to be much higher than it was at commencement of the lease, let's say in 2020. So the higher interest rate environment doesn't immediately impact IBR of old leases, but it can impact the IBR of those old leases if certain things happen like modifications or a change in the lease term as a result of a reassessment of extension options. So it's something to be aware of and as I've said earlier, keep incremental borrowing rates in mind when you do transactions. Because when an acquirer acquire an acquiree and the acquiree has a lot of leases that they've booked on historical incremental borrowing rates. From an acquirer perspective, these are all new leases to the acquirer's financial statements and therefore at that date you have to restate all those leases to include in the books of the acquirer.

And interestingly, this creates a practical problem because you will now be running two sets of books, one set of numbers for the acquiree based on the original incremental borrowing rates and another set of books. Same leases, but a different IBR for the purposes of the acquirer. So we see that quite a bit, that clients come to us and we have to run two sets of books because there's a perspective for the acquiree and there's a perspective for the acquirer.

So the second item that I would like to focus on would be holdover leases. Now this has been a huge problem and actually the International Interpretations Committee addressed holdover leases in an interpretation, in 2018. Because it led to a lot of divergence and they came out with an interpretation. So determining lease term, what do we mean by holdover leases and how does it interact with lease term? Maybe I should start by saying a holdover lease is a lease. It's a situation where let's say you lease a property for five years and then at the end of the five years you go over in holdover. Usually it means that the lessor and the lessee can give each other notice to end this lease with a 30-day notice period and the lessee would pay the lessor on a monthly basis every 30 days. So this lease can now run for another 20, 30 whatever years on a holdover basis as in you can give me notice or I can give you notice.

It's all within 30 days. It could be that organisations continue to run with these holdover leases and never negotiate an official new lease that could happen. So how do we account for these leases that go into holdover or have these holdover clauses in them? And in particular, how does a holdover clause or entering a holdover period impact determining the lease term? So we are back to the definition of what's a lease term. So the standard defines a lease term as consisting of three distinct parts. You start with the non-cancellable period of the lease. So we enter into a lease for five years. The lessor cannot cancel, the lessee cannot cancel non-cancellable period of the lease, five years. So that's the beginning. Lease term is an absolute minimum five years. And then we consider periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.

So if at the end of the five years we have an option to extend the lease for another five years, the lessee will assess, "Are we reasonably certain to exercise that option?" And if yes, the lease term now becomes five plus five and then finally we consider periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. So for example, it could be that we've got a five-year lease, an option to extend for five years and potentially at the end of the five years there's another option for let's say three years. However, the contract also says in that final period, every 12 months there's an option in there to terminate. So you can have five years, another five years, and that last three years we think we are going to stay potentially. However, we also have this option to terminate at the end of year one, end of year two, end of year three.

So again, we are looking at this and saying, "Are we reasonably certain that we are not going to terminate?" "We don't think we're going to terminate at the end of year one. We don't think we're going to terminate it at the end of year two. We think we're going to terminate at the end of year three, so we won't go in holdover." So potentially the lease term is 13 years, so you have to consider the fixed lease term, non-cancellable period. You have to consider extension options, but you also have to consider termination options. All of that together will give you an idea of what the lease term is. All right, so what's interesting here is this diagram really explains it a little bit further and in particular looks at options and whether we are reasonably certain to exercise these options or not. So let's say in the first step we've got the period in which the lease is cancellable by neither party.

So the first step, nobody can cancel the lease. So it's a lease for five years, nobody can cancel it, end of story. So that's the minimum period of the lease. But then we have to also consider whether there are any termination options. So if you look at the termination options, your termination options can have various forms and let's start at the bottom here. It could be that only the lessor has the option to terminate the lease and in that situation you would include any period covered by a lessor only option to terminate. What that actually means is you disregard the fact that the lessor has this option. So if only the lessor can terminate, we've got another three years. Only the lessor can terminate, we would say add three years to the lease term. So we disregard the lessor's option. If only the lessee has options, then you'll apply your guidance in the standard around whether you are reasonably certain to exercise the option.

So have we made good furniture and fit out? "It's a good location, we don't want to move, it's a reasonable price." Only the lessee has an option, you look at the general guidance and you might say, "Reasonably certain to stay." The one at the top termination option where there's a mutual termination option is the one that created some headaches over the years. Your question is, can the lessee and the lessor each terminate with no more than insignificant penalty? And if you look at an insignificant penalty, you don't just think about what is the financial penalty we have to pay and is that financial penalty insignificant? We consider whether they are economic penalties. So you put it in a positive way, if there are mutual termination options, we consider whether there's an economic incentive for the lessee and the lessor to stay in this lease.

So if we say the lessee and the lessor can each terminate with no more than an insignificant penalty, then we would say that period is not enforceable and we would not include that period in our termination option. However, if we say, "Can the lessee and the lessor each terminate with no more than an insignificant penalty?" We say, "No, actually there is a significant economic penalty, if they terminate." Then we would include that in our lease term and we'll have an analysis based on economic reasons and economically how long we'll stay. Now that is really important and I want to bring it back to holdover leases. So if we have a mutual termination option, which we have in holdover leases, the lessee and the lessor can each terminate with 30 days notice. Your question would be, for example, the lessee. If the lessee has this lease, it's in a really good position. Economically, we want to stay in this lease, it's a good rent, good location, we've put in fit out. Economically, commercially, we want to stay in this property.

In that situation we'll make an estimate of what the expected lease term would be. So even though it's a holdover lease that is just locked in for another 30 days because we've got these economic incentives to stay here, we'll factor that into determining our lease term. So a holdover lease could actually be assessed to have a lease term of let's say 20 years. It's a possibility, all right. A holdover lease that legally just runs for 30 days does not only have a lease term of 30 days, you have to assess what the lease term is. Many people have tried to use holdover leases to get out of the standard by arguing it's a lease term of 30 days, therefore it's a short term lease, therefore we're excluded from IFRS 16's requirements. We've the option, accounting policy choice to be excluded from IFRS 16.

So it doesn't work that way. And there was an IFRIC decision specifically explaining that. Then we'll also consider if you look at extension options, whether we are reasonably certain to exercise those options or not. When you look at determining the lease term, we will look at a number of things. So we'll look at contractual terms and conditions for the optional periods and we'll compare it with market rates. So we'll look at the amount of payments for the lease in that optional period, maybe the amount of variable payments for the lease or other contingent payments.

We look at significant leasehold improvements in number B. We'll, look at cost in respect of terminating the lease. We look at the importance of that property or that asset for the lessee's operations. We look at conditionality associated with the exercise option and the likelihood that those conditions will be met. So there's a number of factors that plays into the assessment of lease term. IFRS 16, although there are a lot of rules in IFRS 16, it's still substance over form. And you don't just look at the legal form to look at the lease term, you look at the substance of the arrangement.

The third one to look at is the renegotiation of holdover leases. So somewhat linked to number two. So for example... And the question is this, what if a 10-year lease of a building expires in May 2023? And from one June 2023 the lease is in holdover and the entity is busy negotiating a new lease. This is what often happens. If this is a property that's really important to you, you'll try and renegotiate a new lease term. You won't just run on a holdover. Often that's not what happens. So we are renegotiating. So the expected new lease term is three years and the expected lease payments is 8,000 per month. So we thinking we'll be able to negotiate to stay here for three years. We currently pay seven and half thousand. We think in future we'll go up to around 8,000. But this is our expectations and these are our expectations on the 1st of June.

Now on the 1st of August 2023, the entity enters into a brand new lease agreement for five years at $10,000 per month. So the question really is our expectation of what our new lease will look like on the 1st of June around lease term and monthly payments were quite different to what we actually negotiated on the 1st of August 2023. How do we reflect these in our financial statements? Now we have to take a stepped approach. So first of all, when you get to the end of your lease and May 2023, you will not merely remove the original cost and the accumulated depreciation. You'll keep it there. You still have that building. It's now fully depreciated based on that original lease term. But you realise that you're staying in this building and you are busy negotiating.

So you put in a modification and because you're now going to holdover, and that modification you'll process on the 1st of June. And you'll say, "Based on latest available information, we have to add a lease liability and therefore also a right-of-use asset based on the net present value of another lease term of three years through paying 8,000 per month and using an incremental borrowing rate on the 1st of June.

And then on the 1st of August when we finally signed the new lease agreement, we will have to say, "Okay, our lease liability previously was based on three years and 8,000 a month. On the 1st of August, we have to base it on five years, 10,000 a month and a new IBR on the 1st of August 2023." So it's kind of a two-stepped approach. You get to the end of your lease. Step one is make an estimate. Step two is true-up your estimate when you sign the lease agreement and you true it up for lease term, for payments and for IBR.

The first item to look at... Sorry, the fourth item to look at is managing ongoing changes to your lease portfolio. And this is an old diagram that we've put up back in 2019 or 2018, but it's still a good one. This diagram we've really tested over the last five years and said, "Let every transaction, let's make sure this diagram can still deal with it." Because we've condensed quite complex paragraphs from the standard into one page, a diagram that fits onto one page. And in this diagram we deal with ongoing changes to your lease portfolio. And at that blue level we are saying four things can happen. You could have new leases in your lease portfolio or you could have re-measurements or reassessments of existing leases. And we give there three examples of how you can re-measure or reassess these existing leases. The third thing that can happen is you can have modifications of existing leases.

So that is changes to the underlying contract. The lessor and the lessee renegotiate and change their contract. And then the fourth thing is you could have termination of leases. This is not the same as the expiry of a lease. If you've got a lease and it reaches its end and it expires. At that stage, your lease liability will be zero. Your right-of-use asset will be zero and we move on. What you'll do from an accounting perspective, you'll remove the historical cost, you remove accumulated depreciation and on you go. A termination of a lease is very different because it's actually an early termination of a lease. Instead of running the lease till expiry date, you decide to terminate it, let's say two years before the end of the lease. And how do we deal with that? So let's go back to the left-hand side.

Those were the four types of changes, but let's go back to the left-hand side, look at new leases. Obviously if we have a new lease, we do all the normal things, net present value of all the payments over the lease term, incremental borrowing rate at that date, we book a new lease liability right-of-use asset. If we have a re-measurement or reassessment, it could be that there's a change in the original assessment of the lease term. So we change whether we think we are reasonably certain to use extension options, purchase options, termination options. Because we change the lease term as a result of fiddling with these options, the lease term will change and therefore we'll have to use a new discount rate. So the discount rate at the date that we do this reassessment. And we don't expect to see a P&L impact because the change in the incremental borrowing rate, the change in your lease term will have an impact on your lease liability.

It can make it higher, it can make it lower and you'll have a corresponding change in your right-of-use asset. The second type of re-measurement that can happen is there's a change in estimate of the residual guarantee. Usually we get this with vehicles, we'll continue to use our original discount rate at commencement date. There will be no P&L impact, which means the change to the liability equals the change to the right-of-use asset. And then again on the third one, if there's a change in an index or a rate including market rent review. So we've got a CPI adjustment, we've got a market rent review. As soon as that happen we have to update all our payments for the rest of the lease term. We have to discount it back and restate our lease liability in our right-of-use asset. Again, you use the original discount, right? And we don't expect a P&L impact.

So what you can see here very clearly is that re-measurements or reassessments of existing leases, we never expect to see a P&L impact as a result of these. So if you do your calculations and there's a profit and loss impact, why? You can see two of them, we stick to our original discount rate, but if we change the lease term because the lease term impacts the incremental borrowing rate, we will update our incremental borrowing rate. If you look at your modifications, your first decision would be, "Should we treat this modification as a new lease or as a separate lease or should we combine it with some existing lease?" And you'll treat it as a separate lease, if there's an increase in the scope, you're adding new assets. And the consideration that you're paying for this new asset that you're leasing is a market-related standalone price.

So you're not getting a special deal because you're adding another asset or another floor in the building. As soon as you get into a situation where there's a decrease in scope or any other lease modification. So that would be, there's an increase in scope but you get a special deal. In that situation, you'll treat all of this as a modification of an existing lease. If there's a decrease in scope, you expect a profit and loss impact. That's why we've put it in red. For all other increases in scope you'll use a new discount rate and there won't be a P&L impact.

And then for terminations of leases, there's a potential profit and loss impact because you are removing your lease liability at that date, you're removing your right-of-use asset at that date and the difference will go to profit and loss. This is a really good diagram to sense check the numbers that you're seeing in your financials. We'll look at CPI adjustments. CPI adjustments of variable payments that depend on an index or a rate. So CPI adjustments are included in the initial measurement of the lease using the index or the rate at the commencement date. So really what they're saying is if we are currently paying $10,000 a month and we will adjust this $10,000 a month with CPI every year, what is the payment today at commencement date? 10,000, end of story.

And then we'll remeasure the lease in the period that the rate or the index changes. So if in 12 months time we have a CPI adjustment and we now pay 1,200 at that date, all future lease payments will be updated to reflect that updated information. So we will not stand at commencement date and come up with an estimate of what we think CPI will be in future. We wait for CPI adjustments to actually come into play. So this is really important. This is different to fixed increases. If there's a fixed increase in a contract, you will factor it into your calculation on commencement date. If it's variable payments, we don't know if it's going to be a 1% CPI, 7% CPI, we wait for that uncertainty to be resolved.

The sixth item that we are looking at, it's where clients tell us that they've got new leases and they say, "Here are the new lease agreement, please put it in your system, please give us the journal entries." However, what they miss is that these new leases are actually modifications as defined by IFRS 16. So what do I mean by that? You have a lease for five years and let's say in the fifth year you start to negotiate a new agreement and let's say six months before the expiry of the original lease. So after four and a half years, you actually sign a new legal lease agreement.

So it's a brand new piece of paper. However, that brand new piece of paper says that you'll continue to use that exact asset that you're currently using. If that is the case, that brand new piece of paper is not treated as a new lease. It's actually treated as a lease modification as defined in IFRS 16. So it's not a new lease for accounting purposes, it's a new piece of paper but not a new lease. We're continuing to lease an existing asset. Now you might say Aletta, "Why make a big deal of this?" Timing is everything here. So if I can give you an example, if you've got an existing lease that expires end of September 2024, and at the end of March 2024, so six months before it expires, you enter into a new lease that will kick in from the 1st of October for the next 10 years.

If you treat that new legal lease, as a new lease for accounting purposes, you will only book that increased lease liability and right-of-use asset on the 1st of October 2024. However, the correct way would be to say when we sign that new lease, it modifies an existing lease, it's already been signed at the end of March 2024. And therefore at the end of March 2024, we have to already increase our lease liability, we have to increase our right-of-use asset, increase our interest expense and depreciation. So at 30 June 2024 it's a very big deal. Do we have new leases that start after year-end that go into the next financial year? Or do we have modifications of existing leases that should be reflected in your 30 June 2024 financial statements. So this is why this is very important and this is an easy one to miss because people just think they've got new leases. Question is, are these new legal leases but you're continuing to use the same asset? If the answer is yes to modification, it has an impact on the timing of recognition of the new lease liability and right-of-use asset.

Number seven, we talked about it earlier or I touched on it earlier and that is expired leases. So an expired lease is different to a terminated lease. Expired lease is at the end of the lease term. The entity no longer uses the asset, so the asset is not returned to the lessor. The entity no longer uses the asset so we return the asset to the lessor. There's no right-of-use asset, there's no lease liability because the right-of-use asset fully depreciated, the lease liability fully repaid. So a lot of people just sit back and say, "Okay, it's the end, there's nothing in my financials, just move on." What is important is in your right-of-use assets, you'll have the original cost of the right-of-use-asset and you will have the accumulated depreciation of that right-of use asset to that date. Therefore, although the net value is zero, you have to go and remove the original cost and remove the accumulated depreciation of that right-of-use asset.

Early terminated leases, and you can see here I've talked about early terminated leases. I wanted to make crystal clear that a terminated lease is an early termination as opposed to an expiry, which is the normal end of lease. So early terminated, we would expect a profit and loss impact because at the date of termination you'll say, "I've got a right-of-use asset, I've got a lease liability, remove both of them from balance sheet." And depending on where the numbers fall, you could have a profit or a loss. Quite often your lease liability that you remove is quite low towards the end of a lease and your right-of-use asset, the asset might be nearly fully depreciated. But there's quite a bit of lease liability left because initially you've just paid interest and therefore the lease liability is higher than the right-of-use asset. Therefore, when you get rid of that higher lease liability and you get rid of the lower right-of-use asset, it'll result in a profit. However, losses can also arise, especially if you terminate these leases fairly early on, it could also happen.

All right then number nine, "make good" provisions. Now this is something that's often been overlooked. I think a lot of people understand, that "make good" provisions should be included in the right-of-use asset in terms of IFRS. That "make good" provision is included in the right-of-use asset, it is subject to depreciation and off we go. Many people in the olden days had a separate account, a leasehold improvement. Leasehold improvements don't really exist anymore because leasehold improvements are part of this right-of-use asset. Now whether you've got it in the right-of-use asset or you have a separate leasehold improvement, the actual impact on depreciation in your balance sheet will be the same. So the debit entry is not the issue here. The issue is the credit entry because although the "make good" provision is included in the right-of-use asset if you look at the debit side of the journal, the credit side of this journal doesn't go in the lease liability under IFRS 16. The credit side sits outside

IFRS 16 lease liability, it's a separate make-good provision under IAS 37 provisions, contingent liabilities and contingent assets.

And you will unwind that liability using the discount rate under IAS 37. So that net present value of that "make good" provision will slowly build up over time and at the end of the lease when you pay the money, it'll be credit cash, debit this "make good" provision and no impact in P&L. So it's important to just understand that although the debit is covered in the right-of-use asset, the credit entry sits outside the lease liability under IFRS-16. Then finally, I would like to talk about subleases. Now it's really important... If an entity has a sublease, it's important to understand that IFRS 16 has not changed anything for lessors. So a lessor would continue to assess whether the asset they lease out is a finance lease or an operating lease like we did in the old days for lessors and lessees. So the lessor will assess, if it's a finance lease it's more akin to a sale of the asset.

The lessee will take over the risk and rewards associated with the asset and the lessor would de-recognise the asset and replace it with a lease receivable instead. With an operating lease, if the lessor assesses that it's an operating lease, the lessor will keep the asset on its balance sheet. It would appreciate the asset on the balance sheet and it'll receive even rental income. The complication is around subleases because for a lessor, if a lessor owns an asset and leases it out, they'll just look at is it a finance lease, operating lease as they've always done. However, if the lessor leases the asset themselves in terms of a head lease and then subleases the asset to somebody else, when the lessor assesses whether the sublease is a finance lease or an operating lease, the lessor will compare the lease terms of the head lease and the sublease.

So for example, I would say I lease a property for 10 years, I sublease this property for 10 years. In that situation because the lease term is identical, it's a finance lease. So I would de-recognise the right-of-use asset and replace it with a lease receivable. However, if I've got a head lease of 10 years and I have a sub lease for a year or maybe two years, I would say this is an operating lease. I'll keep my right-of-use asset on my books and I'll include rental payments as I receive them over the two years. So this distinction on whether a sub lease is a finance lease or an operating lease is an issue for lessors where the lessors do not own the asset that they lease out but instead themselves lease the asset in the first instance. So that's an important consideration to take into account.

So if a sub lease is decided to be a finance lease, you de-recognise the right-of-use asset from the head lease, the cost and the accumulated depreciation. Instead, you would put in place a lease receivable and you would recognise your interest income in future. So it's not a rental payments but interest income that you will be booking in future based on that lease receivable. And there will be an amortisation table and obviously you'll keep the lease liability. Because in your head lease, you have a responsibility to make payments and that's a lease liability, but you also have a lease receivable, you've got a right to receive these lease payments. So this is a finance lease. If you look at an operating lease. So this is where I lease a property for 10 years and I sublease it for a year. I keep that right-of-use asset on my books from the head lease.

I keep the lease liability on my books from the head lease and as I receive the payments from my sub-lessee going forward, I would keep that in my financial statements as a rental income. So really what we've tried to do is step through the 10 common issues we find, just a reminder to look at these and make sure you've got it under control. I think the one thing that we're still seeing is that a lot of people don't have an efficient and effective lease solution. So they're still trying to do this in Excel or fairly manually and therefore really difficult.

A bit of a reminder that at BDO we have a wonderful product called BDO LEAD. It's an IFRS 16 compliant lease software also compliant with US GAAP and we licence it as software as a service. So we make it available to clients to access the software, upload their leases, do their own calculations with it. But other clients would say, "Listen, I don't want to do this." And we've got a team of people that all they do is lease accounting. So you outsource your lease accounting to us at BDO, similar to outsourcing your payroll to an organisation.

When we do the outsourcing, how it works really is every month we would ask you, "Has anything changed in your portfolio, can you please give us all the information?" Then we'll remind you of things that we are looking at, you'll provide the information to us and then do all our calculations and journals and give it to you by the end of the month. You just process your journals, we give you a whole reporting pack to substantiate the journal entries and you can reconcile it to your general ledger. Alison, exactly five minutes left, time to hand back to you and to see if we've got any questions today.

CCH Learning:

Yes, well done Aletta. Very good timing and thank you for all the content there. So we've had two questions come through so far, but just a reminder to the audience, if anyone would like to pop through another question, please pop it into that questions pane. All right, in the interim I will quickly mention our upcoming webinars. So on the 19th of March we are looking at, Turbo-Boost Performance through High Quality Feedback. Also, our tax technical update for the month. Then it is FBT season, so this session is on car parking, then looking at anti-money laundering, so phase two there. And Initial Meeting to Profitable Client and also Practical Issues with the Main Residence Exemption. So if you use the link here you can jump online and see all the details of those sessions. All right, Aletta, let's have a look at these questions here. Okay, so Freya's asked the first one, "So is IFRS 16 the same as US GAAP?"

Aletta Boshoff:

Thank you very much Alison. So it's interesting that the US standard setters and the International Accounting Standards Board have tried to work together to come up with a consistent accounting standard globally. However, in the end, unsuccessful to get to consistency around lease accounting. So IFRS 16 is quite different to where that ended up with the US GAAP topic 842 around lease accounting. For finance, if you're a lessee and it's a finance lease similar, but in US GAAP they still have lessees who can categorise leases as operating leases. And then they do some weird and wonderful things in that they book a right-of-use asset and a lease liability on day one. But going forward they still end up with an even lease expense. So basically they work out an interest expense every year and the difference between your payment and your interest expense is depreciation. So very interesting and quite different. Some aspects are the same but there are some big differences too.

CCH Learning:

Perfect, thank you Aletta. And this is the last question for the moment, just from Brendan. So, "What is the difference between service concession arrangement and leases?"

Aletta Boshoff:

Now, that's a really good question. Often people look at a lease agreement and the lease agreement calls itself, "I'm a lease," and they apply IFRS 16 to it. But if you look very carefully at the lease agreement, although it calls itself a lease legally. From an accounting perspective, it's a service concession arrangement, which is a weird and wonderful thing. There's an actual interpretation issued by that AASB dealing with service concession arrangements, Interpretation 12. So I would say you always have to consider do I have a service concession arrangement and if not, is it maybe a lease? So you don't start as a lease, you start as a service concession. When would you think about service concessions? That is often where you have an agreement to use an asset, often agreement with government to use an asset. And then in that agreement, which they call a lease agreement, they would say, "You have to use this asset for a particular purpose."

So you have to use this asset to provide housing, which is a public service. You can only lease this asset to certain individuals who are on a register maintained by government for example. You can only charge them X amount or a certain percentage of their monthly income. So there are all these restrictions on what you can do with this asset that you are leasing. So in that situation, if you've got these restrictions and you are using this asset for a public service, it's a service concession arrangement and not a lease. So just think about it. Often we find them across not-for-profits, public sector or leases between organisation and public sector.

CCH Learning:

Perfect, thank you, Aletta. All right, that is all the questions that have come through for today, so appreciate you running through those answers and for the presentation as well.

Aletta Boshoff:

Thank you Alison. Thank you everybody. Have a good day.

CCH Learning:

Thanks Aletta. All right, so we will jump to our next steps now. So I'll just ask everyone to take a moment to please compete the feedback survey. It's important that we hear your opinions there. And shortly after the session today, you will receive an email letting you know when your e-learning recording is ready. There'll also be a verbatim transcript, CPD certificate and of course this PowerPoint presentation. So thanks again to Aletta for the session today, and thank you to everyone in the audience for joining us. We hope to see you back online for another CCH Learning webinar very soon.