CHEAT SHEET

THE NITTY GRITTY OF THE NEW LEASE STANDARD

BACKGROUND

2019 sees the start of the roll-out of the new Leases accounting standard (NZ IFRS 16) for for-profit entities that apply NZ IFRS and NZ IFRS (RDR) ("NZ GAAP").

As detailed in previous Cheat Sheets NZ IFRS 16 will result in most current operating leases now being recognised on-balance sheet for lessees.

Also, it should be noted that NZ IFRS 16 may result in certain "non-large" for-profit companies, partnerships and limited partnerships, becoming "large[1]", by pushing them over the asset thresholds, thus triggering a step-up into NZ GAAP.

This Cheat Sheet, together with a quick checklist, has been produced as a high-level overview to highlight various application areas which may require specific attention when transitioning.

NEED ASSISTANCE WITH YOUR TRANSITION?

BDO's *Accounting Advisory Services* department is a dedicated service line available to assist entities with their transition projects onto these new standards. Further details are provided on the following page for your information.

1 - HOW ARE YOU PLANNING TO TRANSITION?

NZ IFRS 16 has two overarching transition options available:

Fully Retrospective Method (FRM)	Modified Retrospective Method (MRM)
▶ Applied on a look-back approach	▶ Applied on a look-forward approach
▶ Comparatives MUST be restated	▶ Comparatives CANNOT be restated
▶ No other transition practical expedients offered	▶ Six additional transition practical expedients offered

Each of the two approaches have their own pros and cons.

The **FRM** for example will be particularly onerous to implement for entities with large and/or aged property lease portfolios, however it does provide fully comparative information (if this is important to stakeholders).

The **MRM** by comparison simply looks to "draw a line in the sand" and get leases onto the balance sheet as painlessly as possible. This does however come at the expense of fully comparative information. Technically speaking, the asset-side on transition is based on a retrospective ("brought-forward") amount from the start of the lease, however a couple of additional practical expedients provide relief from this potentially onerous calculation:

- Ability to simply set the asset-side equal to the liability (plus or minus any accruals), and
- Using hindsight (i.e. actual events) to determine the lease term and associated lease payments (refer to section 3 below) if the brought-forward amount were to be calculated.

Accordingly, the nature and extent of information to be gathered, and management estimates and judgements to be made, is directly dependent on which transition method is adopted.

For an entity to focus its transition approach and mitigate time and cost, it is recommended that entities assess the transition methods upfront, make a clear determination, and progress the approach as soon as reasonably possible.

2 - WHAT LEASES ARE COMING ON BALANCE SHEET?

Certain arrangements may now be leases, while certain leases can be scoped out of coming on-balance sheet. Management will need to assess and make determinations regarding these.

		Relevant to my entity?
Short-term leases	*On an asset-class by asset-class basis, an entity can elect to recognise leases with a maximum lease term of 12 months or less in profit or loss, rather than on balance sheet.*	YES / NO / ?
Low-value-asset leases	*On a lease-by-lease basis, an entity can elect to recognise leases of low-value assets in profit or loss, rather than on balance sheet.*	YES / NO / ?
Lease expiring within 12 months of transition	*Under the MRM transition option, leases that expire within 12 months of transition date are able to be recognised in profit or loss, rather than on balance sheet*	YES / NO / ?
Current *Finance leases*	*Under the MRM transition option, ALL finance leases must remain on balance sheet, even if short-term, low-value, or expiring within 12 months of transition.*	YES / NO / ?
Take-or-pay arrangements	*Previous accounting standards took a "form" over "substance" approach to whether these arrangements were or where not leases, which may change under NZ IFRS 16.*	YES / NO / ?

[1] *NZ companies:* $60m assets, $30m revenue; *Foreign owned companies:* $20m assets, $10m revenue; in the preceding two years.

3 - FACTORS IMPACTING THE *LEASE PAYMENT LIABILITY (LPL)*

Because the LPL represents the net present value (NPV) of future lease payments, determinations regarding: (i) the length of the lease payment stream ("lease term"); (ii) the value of the lease payments in the lease term; and, (iii) the discount rate; must be made.

While this may be straight forward for "vanilla" fixed-term, fixed-rate leases, this is not always the case for other types of leases – in particular, property leases, which may have many of the features below.

		Relevant to my entity?
(I) Lease term		
Renewal clauses	*The lease term is based on management's assessment at the beginning of each lease as to whether it is "reasonably certain" as to if (and when) these clauses will be exercised.* *E.g. for a 5 year non-cancellable lease with a 2 year renewal extension option, if management believe it is "reasonably certain" that the 2 year renewal will be exercised, the lease term is 7 years (i.e. 5 years + 2 years).* *Subsequently, the lease term is updated during the lease term if this assessment changes.*	YES / NO / ?
Termination clauses		YES / NO / ?
Lease roll-over clauses (i.e. post expiry date)		YES / NO / ?
(Ii) Lease payments		
Non-lease components	*On an asset-class by asset-class basis, an entity can elect to either include or exclude payments related to non-lease deliverables in the arrangement (i.e. cleaning, maintenance, security etc).*	YES / NO / ?
Lease payment variations	*Subsequently, lease payments may be subject to increase or decrease by way of fixed % changes, CPI or inflation adjustments, and/or market price reviews etc.* *Only fixed % changes are incorporated, with other variations being adjusted for subsequently when they occur (i.e. their impact is not estimated in advance).*	YES / NO / ?
Residual value guarantee (RVG) payments	*Are payments to the lessor at the end of a lease based on the value of the returned leased item.* *The value of RVG payments must be estimated at the beginning of the lease, and updated during the lease term if they subsequently change.*	YES / NO / ?
Purchase option payments	*Are payments to the lessor to purchase the leased item at the end of a lease.* *Use or non-use of such options, and their value (if not stated) must be estimated at the beginning of the lease, and updated during the lease term if they subsequently change.*	YES / NO / ?
Fully variable lease payments	*Are payments to the lessor based entirely on use or non-use of the leased item.* *Estimates of such lease payments are NOT included in the lease payments.* *E.g. lease payments based on (i) a % of store revenue; (ii) output, (iii) pages printed etc.*	YES / NO / ?
Lease payments denominated in a foreign currency	*If lease payments are denominated if a currency that differs from the lessee's "functional currency", then the LPL must be translated at the period-end spot rate - the same translation is not made on the asset side (rather, the historical rate is used).* *This is because the LPL is a monetary item, whereas balance on the asset-side is non-monetary.*	YES / NO / ?
(Iii) Discount rate		
Incremental borrowing rate	*Unless the lease agreement specifies the interest rate, an entity must use, on a lease-by-lease basis its "incremental borrowing rate" (IBR) to discount the lease payments to their NPV.* *The IBR is NOT equivalent to an entity's WACC, or current average cost of debt, but is instead the market interest rate that the entity would incur if it were to enter into a borrowing arrangement with terms identical to the lease in question.* *Because the terms of an entity's leases will differ in respect of length, amount, underlying item, and jurisdiction, it is likely management will need to determine multiple IBRs.* *Under the MRM transition option, IBRs are able to be applied on a more "portfolio" basis.*	YES / NO / ?

4 - FACTORS IMPACTING THE *RIGHT-OF-USE ASSET (RoUA)*

The Right-of-use asset (RoUA) is equal to the LBL, plus or minus several adjustments detailed below:

		Relevant to my entity?
Initial direct costs	*Costs incremental to signing the lease agreement must be ADDED to the RoUA.* *E.g. finders fees, agent commissions, and certain legal fees.* *Under the MRM transition option, these can be ignored on lease-by-lease basis.*	YES / NO / ?
Removal and restoration costs	*Costs to be incurred for the removal and restoration of the leased item upon return to the lessor at the end of the lease are estimated and ADDED to the RoUA (with an associated provision).*	YES / NO / ?
Prepayments	*Any payments made prior to the lease are DEDUCTED from the RoUA.*	YES / NO / ?
Lease incentives	*The value of any cash payments or other items received are DEDUCTED from the RoUA.* *Note that "rent-free" periods are instead accounted for in the LPL (i.e. $nil lease payments).*	YES / NO / ?
Impairment	*The value of the RoUA is assessed for impairment in the same way as other PP&E – typically this will relate to instances where there is an onerous lease present.* *Under the MRM transition option, the amount previously determined for an onerous lease can be used as the transition date impairment DEDUCTION.*	YES / NO / ?
Lease related balances	*If a lease-related balances been recognised as a result of a past business combination (i.e. for (un)favourable market rent) this is ADDED / DEDUCTED to the RoUA upon transition.*	YES / NO / ?
Sale-and-leaseback balances	*If a balances exist related to prior Sale-and-leaseback transactions, these are ADDED / DEDUCTED to the RoUA upon transition.*	YES / NO / ?
Purchase option payments	*If a purchase option is included in the lease payment s (refer 3(ii) above) then the RoUA is amortised over the expected useful life of the leased item, rather than the lease term.*	YES / NO / ?
Where the entity revalues classes of PP&E	*If an entity revalues classes of PP&E (typically land and buildings), the entity can choose to also revalue the RoUA of all leases of items within that same class.*	YES / NO / ?
Where the entity has *Investment Property* measured at fair value	*If an entity has Investment Property measured at fair value, the entity MUST also measure the RoUA of all leases of property that meet the definition of "Investment Property (i.e. "held to collect rental income and/or capital appreciation", rather than "held for own use") at fair value also.*	YES / NO / ?

5 - OTHER ISSUES

In addition to the above, management will also need to consider the following:

		Relevant to my entity?
Subsidiaries Equity accounted investees (EAIs) *(Associates, Joint Ventures)*	*NZ IFRS 16 must be applied consistently by all entities included within an entity's consolidated financial statements – i.e. (i) applying the same general and transitional practical expedients as the entity, and (ii) from the same date.* *This includes the how the share of profit or loss to be recognised with respect to equity accounting and entity's EAIs.* *Particular care will need to be given where the balance dates of subsidiaries and EAIs differ from the entity.*	YES / NO / ?
US GAAP differences	*US GAAP has different measurement requirements with respect to a lessees leases.* *Particular care will need to be taken where an entity's subsidiaries and/or EAIs have separate US GAAP reporting requirements, and ensure that only NZ IFRS 16 amounts flow into the consolidated NZ IFRS (NZ GAAP) accounts.*	YES / NO / ?
Sub-leases	*On the lessor side, determining whether the lease is an "operating lease" or "finance lease" is now made by reference to the value of the RoUA resulting from the lease on the lessee side.* *Particular care will need to be taken when comparing the lease term, payment, and extent of the lease as lessee and sub-lease as lessor to ensure the correct lessor classification is determined.*	YES / NO / ?
Inter-company leases *(where separate reporting requirements exist)*	*In an entity's consolidated accounts, all inter-company lease transactions are eliminated.* *However if the inter-company lessor is required to prepare their own, separate, (NZ)IFRS compliant accounts, this entity will need to consider whether the sub-lease is an "operating lease" or "finance lease" as detailed above.* *Further, if the inter-company lessor is itself leasing the sub-leased item from another party (including another group entity) this may result in differences in treatment on the lessee side (i.e. on-balance sheet), and the sub-lessor side (i.e. off-balance sheet "operating lease").*	YES / NO / ?
Deferred tax	*In most cases, the tax base of lease arrangements will differ from the accounting treatment, resulting in new deferred tax balances needing to be required.* *Where an entity has operations over various tax jurisdictions, the computation and presentation of gross or net deferred tax assets and/or liabilities may differ.*	YES / NO / ?
Changes in EBIT, EBITDA, Gearing, and Interest expense	*A consequence of bringing lease on balance sheet is that (i) debt increases, and (i) rental operating expense is replaced with amortisation and interest expenses. This results in improved EBIT and EBITDA figures, as well as higher gearing and interest expenses.* *Entities will need to consider other aspects of their accounts and operations that are directly and indirectly impacted by these metrics, and take appropriate forward action where necessary – e.g. banking covenants, staff bonuses, earn-out clauses, enterprise value calculations etc.*	YES / NO / ?

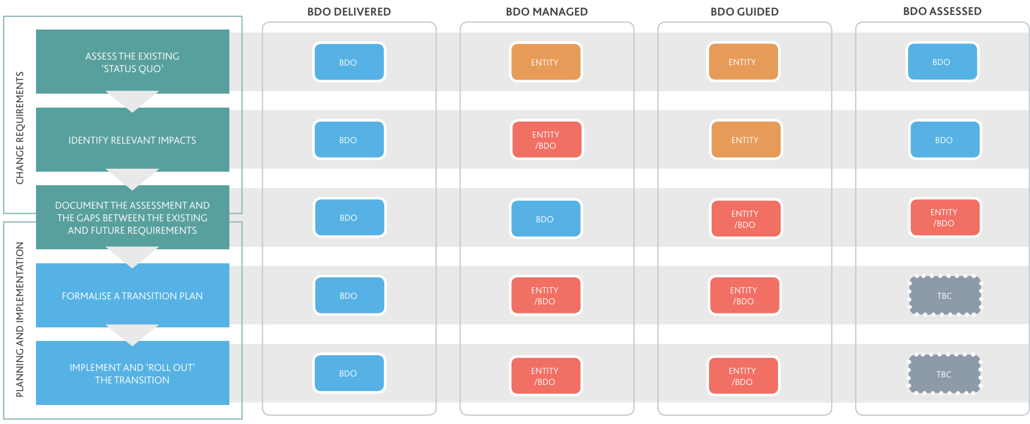
BDO ACCOUNTING ADVISORY SERVICES - TAILORED TRANSITION ASSISTANCE

BDO adopts a flexible approach to assisting entities with their transition to new accounting standards, meaning we can be as involved as an entity requires, based on their own in-house resourcing and expertise at their disposal.

Often entities don't know exactly where to start or focus their energies, and are just wanting to get the ball rolling.

This may be the case if you find you have answered NO or ? to any of the above questions.

We have found our BDO *Guided* and BDO *Assessed* approaches fit well to accommodate this, whilst also retaining the ability to scale up involvement quickly if need be – either way, we work WITH you.



For more information as to how BDO Accounting Advisory Services might assist with assessing the impact of your transition to new accounting standards please contact James Lindsay at BDO *Accounting Advisory Services* (james.lindsay@bdo.co.nz ☎ +64 21 166 0844), and visit our webpage below.

https://www.bdo.nz/en-nz/services/specialist-services/accounting-advisory-services/impact-assessments