THE BOTTOM LINE

Issue 8

HLB MANN JUDD
ADVISORY AND ACCOUNTING

Welcome to the latest edition of our financial reporting publication that aims to keep you in the loop with all the latest accounting and financial reporting developments, and the potential impact they may have on your business.

In the opening issue for 2021, our feature article considers changes to lease arrangements subsequent to commencement and how the accounting differs depending on the type of change involved. We provide an update specific to NFP entities relating to the relief that is available (and not available) when they transition to Tier 2 Simplified Disclosures. And finally, there is a section dedicated to the current reporting season and matters entities should be considering as they prepare their financial statements.

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Accounting for lease reassessments and modifications

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Lease modifications have always been common, however accounting for these changes is more involved under the requirements of AASB 16 *Leases*. Thankfully, clear guidance on accounting for modifications has been included in the new leases standard, so while lease modifications come in many different forms, an understanding of just a few key concepts will address the accounting for all of them.

Preceding instalments of our leases series focussed on the mechanics of bringing new leases onto the statement of financial position for lessees, applying the requirements of AASB 16. Unfortunately, the new leases standard is not a 'set and forget' kind of standard, thus it is important to understand how to account for ongoing changes to leases, which can be many in number over the life of a lease.

AASB 16 addresses various scenarios where the initial terms or related assumptions underlying the lease may change and what the related accounting for any remeasurements would be. Generally, there are two situations when an entity may need to remeasure an existing lease asset and lease liability. These are:

- reassessment of the estimates used in the initial lease accounting; and
- lease modifications

The accounting is different for reassessments and modifications.

Reassessments

Reassessments of leases occur when there are changes in the lease payments (cash flows) based on contractual clauses that were part of the original terms and conditions of the lease.

Changes to the original assessment of the following would trigger reassessments for lessees:

- lease term
- an option to purchase the underlying asset
- expected amount payable under a residual value guarantee
- future lease payments due to a change in the index or rate used to determine those payments.

In the above situations, lessees are required to remeasure the lease liability to reflect the changes to the lease payments. This is done by adjusting the carrying amount of the right-of-use (ROU) asset for the remeasurement of the lease liability. If the carrying amount of the ROU asset has already been reduced to zero, then any remaining amount of the remeasurement is recognised in profit and loss.

As a reminder, when remeasuring the lease liability due to a reassessment, a revised discount rate is used for the first two types of reassessments, while the original discount rate is used for the third and fourth scenarios.

Take note that the above guidance on reassessments pertains to lessees only. There is no equivalent guidance for lessors.

Modifications

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions. Essentially, changes that result from renegotiations and changes to the original terms and conditions of a lease contract, are lease modifications.

Examples of lease modifications include:

- increasing the scope of the lease by:
  - » adding the right to use one or more underlying assets, or
  - » extending the contractual lease term;
- decreasing the scope of the lease by:
  - » removing the right to use one or more underlying assets, or
  - » shortening the contractual lease term;
- changing the consideration of the lease by increasing or decreasing the lease payments.

In terms of timing, lease modifications are accounted for on the effective date of modification, which is when both parties (lessee and lessor) agree to the change.

Lessees must use a new discount rate whenever there is a lease modification. The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term unless this cannot be readily determined. If the implicit rate cannot be readily determined, then the revised discount rate is the lessee's incremental borrowing rate at the effective date of the modification.

A critical assessment that drives the accounting for a lease modification is whether or not the modification creates a separate lease. Let's consider this in more detail.

Separate lease

A modification gives rise to a separate lease if both of the following conditions are met:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount equivalent to the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

If both the above conditions are met, the lease modification results in two separate leases – the original lease and a separate new lease. No accounting adjustment is made to the original lease, while the separate new lease is accounted for in the same manner as any other new lease.

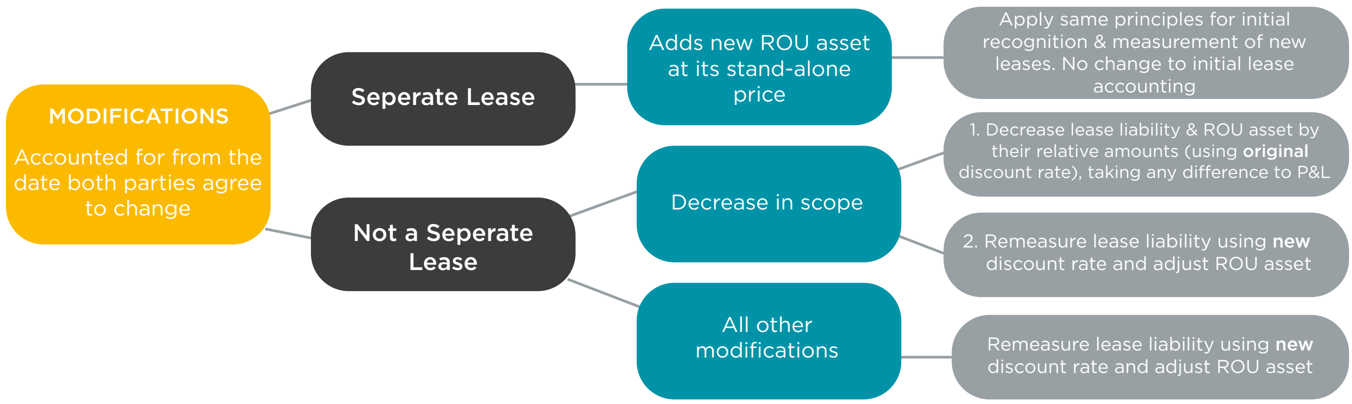
No separate lease

If either of the conditions set out above are not met, the modified lease is not accounted for as a separate lease. The accounting for the modification will depend on whether there is a decrease in the scope of the lease or not.

Accounting for modifications that decrease the scope of a lease involves two steps. Firstly, the lessee reduces the carrying amounts of the ROU asset and lease liability by their relative amounts to reflect the partial or full termination of the lease. Any difference between the decrease in the ROU asset and the decrease in the lease liability is recognised in profit and loss. The second step requires that the lease liability be adjusted again by remeasuring the future lease payments under the modified contract using the discount rate on the date of the modification (i.e. a revised discount rate). A corresponding adjustment is made to the ROU asset, and not profit and loss.

For all other modifications, the lease liability is remeasured on the date of the modification using a revised discount rate, with a corresponding adjustment to the ROU asset.

The diagram below summarises the accounting for lease modifications by lessees:



COVID-19-related modifications

As a result of the pandemic in 2020 and the consequent concessions that lessors were offering to lessees, AASB 16 was amended to provide optional practical relief to lessees to simplify the accounting for changes to lease arrangements that are directly linked to the pandemic.

The amendment to AASB 16 essentially eliminates the need, if a lessee so chooses, to determine whether COVID-19-related rent concessions are lease modifications or not. Instead, the lessee accounts for the rent concession as if the change was not a lease modification. This means the change in lease payments is treated as a variable lease payment in profit and loss in the period in which the event or condition that triggers those payments occurs.

Importantly, to be eligible to apply the optional practical expedient, the following conditions need to be met:

- The revised consideration for the lease is substantially the same as, or less than, the original consideration;
- The reduction in lease payments relates to payments originally due on or before 30 June 2021; and
- There are no other substantive changes to the terms of the lease.

For more details on the amendment to AASB 16 as well as worked examples, refer to [The Bottom Line issue 6].

Let's take a look at a few examples of lease modifications.

AASB 16 contains several illustrative examples relating to lease modifications which readers may find useful. The cases below are based on some of these examples.

Example 1 – Modification that is a separate lease

Lessee enters into a lease for two floors in an office building for a term of 10 years. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to grant Lessee the right to use an additional floor of office space. The additional floor is made available for use by Lessee at the end of the second quarter of Year 6. The lease payments for the new office space are commensurate with market rentals for office space of that size and nature, except for a discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the space to a new tenant (such as marketing costs).

Analysis

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the new right is commensurate with its stand-alone price. In this example, the additional underlying asset is the additional floor of office space for the remaining three and half years. At the commencement date of the new lease (i.e. at the end of the second quarter of Year 6), Lessee recognises a ROU asset and a lease liability relating to the lease of the additional floor. No adjustments are made to the ROU asset and lease liability relating to the original lease of two floors.

Example 2 – Modification that increases the scope by extending lease term

Lessee enters into a 10-year lease for 5,000 square meters of office space. Annual lease payments are $100,000 payable at the end of each year. Lessee's incremental borrowing rate of 6% is used to discount lease payments as the rate implicit in the lease cannot be readily determined. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending it by an additional four years. Annual lease payments remain unchanged. Lessee's incremental borrowing rate at the beginning of Year 7 is 7%. The lease liability immediately prior to the modification is $346,511.

Analysis

As the modification does not convey the right to use additional assets (as the lease is for the same underlying premises), it is not accounted for as a new lease. As a result, the lease is remeasured using the discount rate as determined on the effective date of modification, being at the beginning of Year 7.

Present value of $100,000 a year for 8 years (for Years 7 to 14) using a discount rate of 7% = $597,130

Since the lease liability was $346,511 immediately prior to the modification, it is increased with the difference of $250,619 ($597,130 - $346,511) and a corresponding debit adjustment is made to the ROU asset. There is no impact to profit and loss.

Example 3 – Modification that decreases the scope

Lessee is party to a 10-year lease for 5,000 square meters of warehouse space. The annual lease payments are $50,000 payable at the end of each year. The rate implicit in the lease cannot be determined readily thus Lessee's incremental borrowing rate of 6% is used. At the beginning of Year 6, Lessee and Lessor agree to halve the space being leased (i.e. to 2,500 square meters) for the remainder of the lease. As a result, the remaining lease payments reduce to $30,000 per annum. At the beginning of Year 6, Lessee's incremental borrowing rate is 5%. Immediately prior to the lease modification, the lease liability is $210,618 and the ROU asset is $184,002.

Analysis

This modification constitutes a decrease in scope from the original agreement. Consequently, both the lease liability and ROU asset need to be remeasured on the effective date of modification (being the beginning of Year 6) applying a two-step process.

Step 1:

Lessee determines the proportionate decrease in the carrying amount of the ROU asset. In this case, the leased warehouse space has reduced from 5,000 to 2,500 square meters resulting in a 50% reduction in space. Consequently, the carrying amounts of the ROU asset and lease liability are reduced by the relative amounts compared to their pre-modification carrying amounts. This entails reducing the ROU asset and the lease liability by $92,001 ($184,002 x 50%) and $105,309 ($210,618 x 50%) respectively. The difference between the decrease in the ROU asset and the decrease in the lease liability of $13,308 ($105,309 - $92,001) is recognised as a gain in profit and loss on the date of the modification.

Step 2:

Lessee remeasures the lease liability based on 5 years remaining, annual payments of $30,000 and an updated incremental borrowing rate of 5%. The result is a lease liability of $129,884. Lessee therefore increases the lease liability of $105,309 determined in step 1 above by $24,575 ($129,884 - $105,309) and increases the ROU asset with the same amount. This effectively accounts for the change in the consideration paid for the lease and the revised discount rate.

Transitioning from RDR to Simplified Disclosures

As has been highlighted in issue 6 of The Bottom Line, special purpose financial statements (SPFS) will no longer be an option for certain for-profit private sector entities for years ended 30 June 2022 and beyond. Instead, affected entities will have to prepare general purpose financial statements (GPFS) applying the new Tier 2 Simplified Disclosures framework which will replace the existing Tier 2 Reduced Disclosure Requirements (RDR) framework. This article briefly looks at the transitional relief available to NFP entities transitioning from RDR to Simplified Disclosures.

In issue 7 of this publication, we explained why for-profit entities required to make the change from SPFS to GPFS should consider doing so one year earlier than required. As a reminder, the optional short-term exemptions offered under the changes aim to simplify the changeover from SPFS to GPFS, however some of the relief can only be accessed if the changes are adopted early. The relief being referred to relates to affected entities, in the year of transition, not having to:

- disclose comparative information in the notes where such comparative information was not disclosed in the most recent previous SPFS; and
- restate comparative information where recognition and measurement requirements of Australian Accounting Standards (AAS) were not previously applied.

Importantly, as it stands at the moment, the above transitional relief is not available to NFP entities making the move to Tier 2 Simplified Disclosures. This is because the short-term optional exemptions set out in Appendix E of AASB 1053 *Application of Tiers of Australian Accounting Standards* apply only to for-profit entities.

So what does this mean for NFPs?

NFP entities currently preparing SPFS should not be in a hurry to start preparing Tier 2 GPFS, unless they are required to do so (for example, because their status changes from 'non-reporting' entity to 'reporting' entity). The Australian Accounting Standards Board (AASB) is looking at the NFP financial reporting framework as part of a separate project that is currently underway and is expected to be finalised within the next few years.

Those NFP entities that currently prepare Tier 2 RDR financial statements may want to early adopt the new Simplified Disclosures contained in AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities* to take advantage of the somewhat less onerous disclosure requirements. Irrespective, these entities will have to adopt the new Tier 2 Simplified Disclosures for years beginning on or after 1 July 2021 as RDR will be withdrawn from the same date.

The AASB has noted the inconsistency relating to the transitional relief that is not available to NFP entities. Consequently, it has proposed to extend the relief relating to presentation of comparative information to those NFP entities transitioning from Tier 2 RDR to Tier 2 Simplified Disclosures earlier than when mandatory application of AASB 1060 is required. The necessary amendments to give effect to this proposed change will be included in AASB 1060.

With respect to the relief relating to the restatement of comparative information, the AASB decided against making this available to NFP entities as it was only granted to for-profit private sector entities due to the mandatory removal of SPFS, which does not apply to NFP entities. As a result, NFP entities that do transition early to Tier 2 Simplified Disclosures will be required to restate comparative figures where they did not previously comply with all the recognition and measurement requirements of AAS. This should not pose a problem for NFP entities that currently prepare financial statements applying Tier 2 RDR as they would be applying all the recognition and measurement requirements of AAS anyway. As mentioned previously, transition by NFP entities from SPFS to GPFS will be considered in more detail by the AASB in its deliberations on its separate NFP financial reporting framework project mentioned above.

Lots to think about for December reporters

While COVID-19 continues to disrupt, directors, preparers and auditors are hopefully more prepared for the current reporting season after having to contend with the virus and the knock-on effects for a number of months now. That is not to say this reporting season will be without its challenges, but, as they say, better the devil you know.

Preparers, both listed and unlisted, will have a number of things to think about as they pull their December financial reports together in a COVID-19 environment, some of which we discuss below.

Financial reporting focus areas

In December 2020, ASIC announced the areas that it will give special attention to during its surveillance of 31 December 2020 financial reports. The five main themes, which are consistent to those for 30 June 2020, are:

- asset values
- provisions
- going concern and solvency assessments
- post-balance sheet date events
- disclosures in the financial report and the Operating and Financial Review (OFR)

COVID-19

Continuing impact of COVID-19

ASIC provides examples of factors that need to be considered by directors and preparers when assessing asset values, liabilities, going concern and solvency. These factors may also be of relevance when evaluating the ability of the entity's borrowers and debtors to make good on their obligations to the entity, as well as the ability of suppliers to continue providing goods and services to the entity. Factors to consider include:

Business and economic factors	**Support from governments and others**
Industry-specific factors	**Impact on operating cash flows**
Impact on customers, suppliers and lessees	**Capital raising**
Impact on supply chains	**Short-term versus long-term conditions**
Debt refinancing, covenants and liquidity support	**Management plans and responses to COVID-19**

Asset values

Economic and market uncertainties may result in a broader range of reasonable judgements about asset values and other estimates. Increased attention should be given to the following items by directors, preparers and auditors when it comes to asset values:

- impairment testing of non-financial assets (e.g. goodwill and intangible assets)
- values of property assets
- expected credit losses on loans and receivables
- values of other assets such as inventories, deferred tax assets and unlisted investments

Provisions

Entities should ensure all necessary provisions are raised, with careful consideration being given to matters such as onerous contracts, financial guarantees and restructuring.

Going concern

Given the continuing uncertainty, many entities, especially those operating in industries hardest hit by the pandemic, will have to model various scenarios when it comes to their going concern assessment.

Something else to consider is whether there has been a significant deterioration in economic conditions after reporting date that compromises the going concern assumption. If this is the case, and the going concern assumption is no longer appropriate, the financial report would have to be prepared on a non-going concern basis.

Post-balance sheet date events

Events occurring after reporting date but before the financial statements are authorised for issue should be carefully reviewed to correctly identify those that are adjusting events (meaning they affect reported numbers at balance date) or non-adjusting events (meaning they relate to new conditions that require disclosure only).

Disclosures

There is a strong emphasis on the importance of useful and meaningful disclosures by entities about the business impacts and potential uncertainties created by the pandemic.

Entities will need to exercise judgement in determining the appropriate level of disclosures that tells their unique COVID-19 story to users. It will be about striking a balance between too much information that obfuscates the important stuff, and too little information that tells users nothing. Generic narrative should also be avoided.

The financial report should disclose uncertainties, key assumptions and sensitivities to assist users in understanding the approach taken and potential future impacts. It also allows for comparisons between different entities. Information about probability-weighted scenarios used to support asset values and other estimates should also be disclosed.

ASIC reminds directors that the OFR should complement the financial report, and should explain the underlying drivers of the results and financial position, as well as the risks, management strategies and future prospects. Those factors that are significant and are not related to the pandemic should also be included in the OFR and given appropriate prominence.

In relation to non-IFRS profit measures, these should not be presented in a way that could potentially mislead users. Entities should also take note that where a net tangible asset figure is presented by a lessee (such as net tangible assets per security on Appendix 4D and Appendix 4E for listed companies), a prominent footnote should be included to explain whether some, all or no lease right-of-use assets have been included.

Half-year reporters will not escape the increased disclosure burden. Disclosures will need to be made for significant developments and ongoing impacts of COVID-19 and any other conditions since 30 June 2020.

Other matters

With entities having to make a number of judgements and assumptions in challenging circumstances, it is critical that these get properly documented as and when they are made. This will minimise the risk that hindsight is applied when estimates and judgements are reviewed by others at a later stage.

ASIC's focus areas should be considered in conjunction with its COVID-19 Financial Reporting FAQs which address a host of financial reporting and audit matters and are updated as new issues emerge.

For further details on ASIC's focus areas, refer to the full media release, MR20-325.

Results of latest financial report surveillance program

In December 2020, ASIC also announced the findings from its review of the financial reports of 170 listed and other public interest entities for the year ended 30 June 2020. The latest surveillance program resulted in 'please explain' letters being sent to 27 entities on 58 accounting-related matters.

A summary of the matters covered by the inquiries is as follows:

MATTER	NUMBER OF INQUIRIES
Impairment and other asset values	19
Operating and Financial Review (OFR)	8
Revenue recognition	7
Tax accounting	4
Provisions	4
Non-IFRS profit measures	4
Operating segments	3
Classification of debt	2
Other matters	7
Total	**58**

As can be seen above, impairment of non-financial assets and asset values were responsible for about a third of the inquiries which is not surprising given the ongoing impacts of the pandemic.

As evidenced in the number of inquiries (eight) as well as ASIC's focus areas for the 31 December 2020 reporting season, there is a renewed focus on the OFR, particularly on the extent to which it complements the financial report and tells the story of how an entity's business has been impacted by COVID-19. Directors are reminded of the principles set out in RG 247 *Effective disclosure in an operating and financial review* for the current reporting season.

It is also worth noting that non-IFRS profit measures received more scrutiny after ASIC's repeated warnings to entities to not present non-IFRS information in a potentially misleading manner. This theme spills over into ASIC's focus areas for 31 December 2020 financial reports.

Directors and preparers are strongly encouraged to refer to the detailed media release (MR20-329) as they prepare their 31 December 2020 financial reports.

Reporting deadline extensions

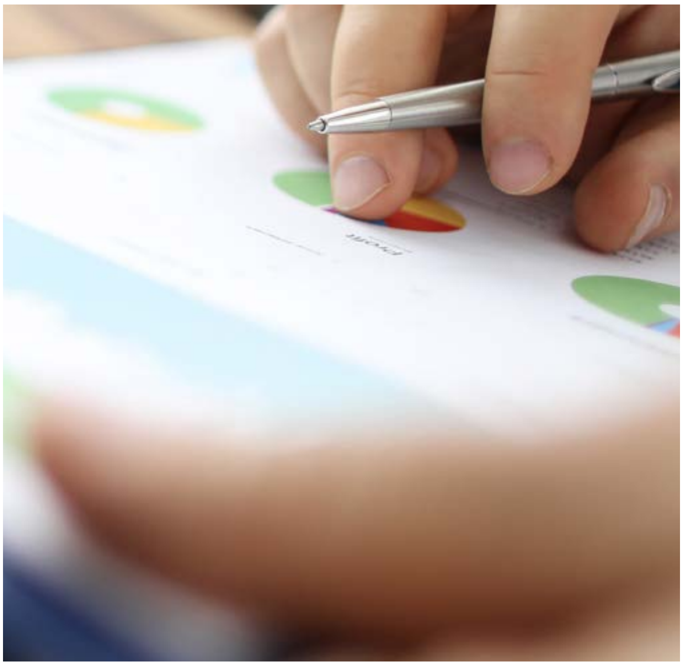
December reporters, both listed and unlisted, have an additional month to lodge their 31 December 2020 financial reports as announced by ASIC in MR20-276.

The extended reporting relief comes as entities continue to deal with the challenges arising from the pandemic, such as delayed reporting processes, working-from-home arrangements and travel restrictions.

The one-month extension covers reporting dates up to and including 7 January 2021, and applies to entities reporting to ASIC under the following chapters of the Corporations Act:

- Chapter 2M: disclosing entities, public companies, large proprietary companies, some small proprietary companies and registered schemes
- Chapter 7: AFS licensees

The relief does not apply to registered foreign companies.



Under ASX Class Waiver Decision – *Extended Reporting and Lodgement Deadlines* (found under 'ASX COVID-19 Class Waivers' and dated 29 December 2020), ASX-listed entities must comply with specific conditions in order to take advantage of the ASIC lodgement extension which are consistent with those that applied to 30 June 2020 reporting periods. These are summarised as follows:

- The Appendix 4E (for full-years) and Appendix 4D (for half-years) must be lodged within the usual ASX deadlines (this is not relevant for mining exploration and oil and gas exploration entities);
- Unaudited or unreviewed financial information must initially be lodged with the ASX where audited or reviewed financial information is not yet available and the ASIC relief is relied on. For entities that are not mining exploration and oil and gas exploration entities, this information would be given as part of the Appendix 4E or Appendix 4D. For mining exploration and oil and gas exploration entities, the information would be provided to the ASX within three months of balance date for full-years, and within 75 days of balance date for half-years;
- The entity must inform the market that the ASIC lodgement extension is being applied. The timing of the announcement must be either prior to, or at the same time as, the lodgement of the relevant Appendix 4E or 4D (or the unaudited or unreviewed accounts, in the case of mining exploration and oil and gas exploration entities);
- The entity must immediately inform the market if there is a material difference between its unaudited (or unreviewed) accounts, and its audited (or reviewed) accounts.

Despite the extra one month given to lodge financial reports, both the ASX and ASIC strongly encourage entities, where possible, to lodge financial reports within the normal statutory deadlines, taking into account the information needs of all relevant stakeholders.

Grandfathered proprietary companies that make use of the one-month extension will retain their grandfathered status. However, the directors' report must disclose the fact that the ASIC relief has been applied to report to members no later than one month after the normal reporting deadline.

In terms of Annual General Meetings (AGM), ASIC continues to adopt a 'no action' position where public companies do not hold their AGMs within five months after financial years that end from 31 December 2019 to 7 January 2021, but do so up to seven months after year end. This no action position also gives those companies that rely on the one-month lodgement relief described above additional time to distribute financial reports to members prior to the AGM.

For reporting periods ending after 7 January 2021, ASIC will continue to monitor how market conditions and COVID-19 are affecting financial reporting and AGM obligations. The media release notes that there is no indication at this stage that further extensions will be necessary.

"ASX-listed entities must comply with specific conditions in order to take advantage of the ASIC lodgement extension, which are consistent with those that applied to 30 June 2020 reporting periods."

Revised Corporate Governance Principles and Recommendations

Listed entities must ensure that their Corporate Governance Statements have been updated to reflect the revisions to the ASX Corporate Governance Principles and Recommendations (4th Edition). The changes apply for the first time to years ended 31 December 2020.

Refer to an article we previously published for an overview of the changes introduced by the 4th Edition of the Corporate Governance Principles and Recommendations.

New accounting pronouncements

There has been a number of significant and complex new accounting standards that entities have had to contend with over the past few years. Readers will be relieved to hear this is not the case for reporting periods ended 31 December 2020.

The only brand new accounting standard to feature for the first time in 31 December 2020 financial reports is quite specific in application, applying only to public sector entities, specifically grantors in service concession arrangements. The standard in question is AASB 1059 Service Concession Arrangements: Grantors.

There are a few amending standards to take note of although they are unlikely to materially impact most entities. Entities that acquired businesses or assets during the full-year or half-year ended 31 December 2020 should familiarise themselves with the updated definition of a 'business' contained in AASB 3 Business Combinations, and the optional concentration test that has been introduced to the same standard. The amending standard that gives effect to these changes to AASB 3 is AASB 2018-6 Amendments to Australian Accounting Standards – Definition of a Business.

The table below lists the new and amending standards that are applicable for the first time to annual and half-year reporting periods ended 31 December 2020:

STANDARD / INTERPRETATION	EFFECTIVE DATE
ALL ENTITIES	
AASB 2018-6 *Amendments to Australian Accounting Standards – Definition of a Business*	1 January 2020
AASB 2018-7 *Amendments to Australian Accounting Standards – Definition of Material*	1 January 2020
AASB 2019-2 *Amendments to Australian Accounting Standards – Implementation of AASB 1059*	1 January 2020
AASB 2019-3 *Amendments to Australian Accounting Standards – Interest Rate Benchmark Reform*	1 January 2020
AASB 2019-5 *Amendments to Australian Accounting Standards – Disclosure of the Effect of New IFRS Standards Not Yet Issued in Australia*	1 January 2020
AASB 1059 *Service Concession Arrangements: Grantors*	1 January 2020 *
Conceptual Framework for Financial Reporting	1 January 2020 **
AASB 2020-4 *Amendments to Australian Accounting Standards – Covid-19-Related Rent Concessions*	1 June 2020
NOT-FOR-PROFIT ENTITIES	
AASB 2019-4 *Amendments to Australian Accounting Standards – Disclosure in Special Purpose Financial Statements of Not-for-Profit Private Sector Entities on Compliance with Recognition and Measurement Requirements*	30 June 2020 ***

* Originally 1 January 2019 but deferred to 1 January 2020 by AASB 2018-5
** Only applicable to for-profit private sector entities that have public accountability and are required by legislation to comply with AAS
*** Effective for annual reporting periods ending on or after 30 June 2020

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