Financial requirements: Treatment of lease assets

ASIC Consultation Paper CP 336

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1. Introduction

1.1 About Aware Financial Services Australia Limited and Aware Super

Aware Financial Services Australia Limited (AFSAL) is the responsible entity for the Aware Investment fund and is also the comprehensive advice provider for Aware Super which is its ultimate parent entity.

Aware Super (the new name for First State Super) has been the fund for people who serve the community since 1992. We're one of Australia's largest funds and we're continuing to grow.

We merged with VicSuper and WA Super in 2020. Aware Super manages approximately $139 billion in savings for more than one million members located across the country. As part of this, we manage more than $31 billion in retirement assets supporting over 67,000 people in retirement and a small defined benefit fund ($1.1 billion). Our members – teachers, nurses, public servants and emergency services officers – work in roles that breathe life into our community and they expect us to do the same, investing in ways that do well for them, and good for all.

Aware Super is committed to investing for the long-term, being a top performing fund, and providing our members with the right advice, services and support to feel confident about their retirement.

As responsible entity of the Aware Investment Fund, AFSAL is required to comply with the net tangible asset (NTA) requirement as set out in *Class Order (CO 13/760) Financial Requirements for responsible entities and operators of investor directed portfolio services.*

AFSAL is a lessee in approximately 32 leases with terms of between 12 months and 6 years.

1.2 Submission

Background

AASB 16 requires a lessee to recognise all leases over 12 months in its balance sheet as both a right-of-use asset and a lease liability. The asset aspect of a lease is intrinsically connected with the corresponding liability aspect of the lease because they both stem from the one lease contract. The initial measurement of the asset and liability is based on calculating the present value of lease payments using the applicable discount rate. Both the asset and liability aspects of a lease are accounting depictions of the same contractual terms and, therefore, are intangible in nature.

The right-of-use asset is depreciated over the remaining life of the lease and the value of lease liability changes primarily based on interest on the lease liability less lease payments made.

Under the current methodology to calculate the net tangible assets (NTA) to meet the financial requirements under CO 13/760, the right-of-use asset is excluded but the lease liability is included in the NTA calculation. This is despite both the asset and liability arising from the same underlying contract. This outcome leads to very onerous capital requirements for AFS licensees as the lease liability reduces the NTA available to meet the financial requirements without any offset from the right-of-use asset.

Reducing the qualifying NTA increases the risk of licensees breaching the financial requirement per CO 13/760, or may require licensees to source additional capital to offset the lease liability. In its extreme, this could result in the operating business being under-capitalised and therefore unsustainable over the long-term as available capital is consumed by meeting the financial requirement.

Impact on AFSAL

The current financial requirements, which require the exclusion of right-of-use assets from the NTA, have created the following challenges for our business:

- We have had to issue additional share capital to ensure that we have sufficient qualifying net tangible assets to remain compliant with our AFS licensee financial requirements. This additional share capital has been material to both AFSAL, and to our parent.
- This additional capital is a performance drag (reducing returns to our members) as it is limited in how it can be deployed to earn a return given its need to meet the financial requirement.

B1Q1 Do you agree with our proposal? If not, why not?

We are very supportive of the intent to address the unfavourable impact of CO 13/760 on balance sheets prepared as per AASB 16. We welcome the proposal to amend the 'excluded assets' definition to provide that a right-of-use asset is not an excluded asset, but suggest that this should be the minimum action taken and that consideration should also be given to an alternate option as outlined in B1Q2.

Considering the proposal under this consultation, we believe that the proposal would materially address the unfavourable outcome arising from the application of CO 13/760 on balance sheets prepared under Australian Accounting Standards, including AASB 16.

We agree with the assessment presented in the proposal. While it is generally reasonable for ASIC to disregard intangible assets for the purposes of calculating NTA, it may be unreasonable to include the liability aspect and exclude the asset aspect if both aspects are intangible in nature and stem from the same contractual rights and obligations of the lessee under a lease.

However, the current proposal does not fully address the implications of CO 13/760 in the way it intersects with AASB 16, as it does not address the mismatch that emerges between the value of the right-of-use asset and the value of the lease liability subsequent to the initial recognition of a lease contract under AASB16. The mismatch is driven by the differential between the depreciation of the right-of-use asset and the movement in the lease liability through interest and repayments. This mismatch will continue to skew the NTA available to meet the financial requirements for the life of each lease.

B1Q2 Are there other options we should consider that might adequately address the concerns about potential unfairness? If yes, please specify.

An alternative option would be to consider excluding both the right-of-use asset and the lease liability from the calculation of the NTA. This would be consistent with the proposal in the following respects:

a) Consistency in the treatment of the asset and liability arising from the same underlying contract.
b) This approach would fully mitigate the impact of the mismatch that emerges between the value of the right-of-use asset and the value of the lease liability subsequent to the initial recognition of a lease contract under AASB16.

B1Q3 Do you agree that changes should be made to the ASIC instruments and the existing requirements in RG 166? If not, why not?

Yes, for the reasons outlined above.

Summary

We thank ASIC for the opportunity to comment on ASIC’s proposal to address the unfavourable impact of CO 13/760 on balance sheets prepared as per AASB 16. We support the proposal to amend the ‘excluded assets’ definition to provide that a right-of-use asset is not an excluded asset. Finally, we ask ASIC to consider our suggestion of excluding both the right-of-use asset and the lease liability from the calculation of the NTA.

We are of the view that these amendments will improve both operating efficiency and capital efficiency.