Accounting Alert – Aged Care Industry

Impact of AASB 16 *Leases* on residential aged care accommodation arrangements

This Alert is to consider the accounting effect of applying the new Accounting Standard AASB 16 *Leases* to the residential aged care accommodation arrangements of aged care providers. AASB 16 became effective on 1 January 2019 and applies for the first time for the financial years ending 30 June 2020 for entities with a June financial year-end.

The general view is that these arrangements are likely to be leases within the scope of AASB 16. AASB 16 retains the distinction between operating leases and finance leases for lessors. These arrangements will be operating leases and thus have no effect on the statement of financial position.

The effect of the standard on arrangements that involve refundable accommodation deposits (RADs) (or Bonds for accommodation arrangements that commenced prior to July 2014) may have a significant impact on income and expenses within profit or loss for many aged care operators. The significance to particular entities will vary depending on their proportion of RADs and daily accommodation payments (DAPs).

A RAD represents an upfront deposit paid by the resident to the operator which is interest free and refundable in its entirety when the resident leaves the facility or dies. On the other hand, a DAP is a daily equivalent of the notional return the operator could effectively earn, or the interest cost it could avoid on the RAD not paid.

This Alert explains the impact of AASB 16 on these arrangements.

Does the arrangement contain a lease under AASB 16?

The accommodation arrangement is a contract with a resident that includes provisions for the room details, fees, charges and payments. The residents will pay either a RAD, DAP or a combination of the two. Relevant aspects of the contract that will result in it containing a lease within the scope of AASB 16 are:

- Contracts are executed in respect of a specific private room or a specified portion of a shared room;
- The operator may only substitute the resident into a different room in limited situations (such as with the agreement of the resident; where the resident's care needs change, requiring independent medical assessment if the resident disagrees; or to repair or improve the room and the resident has the right to return to it);
- The resident enjoys the exclusive use of the identified private room or specific portion of a shared room; and
- The resident has the right to determine within reason how the room is used (notwithstanding restrictions on the resident's right to use the room, and the reliance on the operator for the provision of care services).

Where these circumstances apply, the arrangement contains a lease within the scope of AASB 16 because:

- There is an identified asset because the room is specifically identified in the contract (refer AASB 16.B13);
- The operator does not have a substantive right to substitute the room throughout the period of use (i.e. the total period of use of the room under the contract). As the operator's ability to substitute the resident into a different room without the resident's consent is limited to situations where the resident's care needs change or to repair or improve the room and the resident has the right to return to it, this is not throughout the entire period of use (refer AASB 16.B14(a) and B18);
- The resident has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use by having exclusive use of the asset throughout the period (refer AASB 16.B21); and
- AASB 16 acknowledges that rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (refer AASB 16.B24(b)(i)).

Residential aged care accommodation arrangements will be classified as operating leases by aged care operators given the expected period of the arrangement relative to the lives of the underlying assets.

Applying AASB 9 Financial Instruments to the RAD liability

The financial liability for the RADs is initially measured at fair value. Because the financial liability has a demand feature, the fair value cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (refer AASB 13.47). At the commencement of each day of residence the operator only has certainty over the RAD being without interest payable for that day. This is because in the event of death of the resident interest will be payable from the following day.

AASB 9 deals with the remeasurement of a financial liability where changes in estimates of payments or receipts occur, including due to expected changes in timing of payments (refer AASB 9.B5.4.6). The RAD liability should be discounted each day for one day, with interest then added back to the demand amount overnight.

Accounting for the lease and financial liability

The interest-free nature of RADs is considered to be non-cash consideration. The definition of a lease in AASB 16 includes the need for consideration. AASB 16 does not directly consider the possible types of consideration, but it references AASB 15 *Revenue from Contracts with Customers* in relation to allocating the consideration to components (refer AASB 16.17). AASB 15 deals with non-cash consideration and there is nothing to suggest that consideration in AASB 16 is different to that in AASB 15 (refer AASB 15.48 and AASB 15.66-69). Non-cash consideration should be measured at fair value (refer AASB 15.66).

The adjustment to discount the financial liability under AASB 9.B5.4.6 should be recognised as lease income, and the corresponding addition to the financial liability should be recognised as interest expense. This will need to be repeated for each day during the financial period.

The overall accounting effect is to increase lease income and interest expense by the same amount based on the average RADs balances (or Bonds for accommodation arrangements that commenced prior to July 2014) during the financial period.

Measurement of interest expense and lease income

One aspect where significant judgement may be involved is the measurement of the lease income and interest expense.

A common view is that this should be a risk-adjusted discount rate specific to the provider. The Maximum Permissible Interest Rate (MPIR), which is a Commonwealth Government set interest rate used to calculate the DAP for applicable residents, is an observable rate that is common for all entities. The DAP may be viewed as the interest charged on the unpaid RAD. For most entities, this is likely to not be materially different to a more specific risk-adjusted rate.

During 2019/20 the MPIR has been:

July to September 2019	5.54%
October to December 2019	4.98%
January to March 2020	4.91%
April to June 2020	4.89%

Further information

If you wish to discuss any of the information included in this Technical Accounting Alert, please get in touch with your local Grant Thornton Australia contact or a member of the National Assurance Quality Team at national.assurance.quality@au.gt.com.