LEASE ACCOUNTING CHANGE: TIME FOR ACTION

IN LESS THAN 18 MONTHS' TIME, THE NEW LEASE ACCOUNTING STANDARD COMES INTO EFFECT. BRINGING ALL OPERATING LEASES ONTO THE BALANCE SHEET, THE CHANGES FOR LESSEES COULD BE SIGNIFICANT, AS PAUL LIPPITT AND ARMAGHAN HAQ EXPLAIN

Published by the IASB in January 2016, IFRS 16, *Leases* is designed to bring transparency and comparability to financial reporting. It is applicable to organisations reporting under IFRS for accounting periods beginning on or after 1 January 2019, and replaces IAS 17.

The new standard is set to impact lessees more than lessors, since the accounting remains substantially the same for lessors. That said, the changes in lessee accounting under IFRS 16 could impact lessors as lessees' needs and behaviours alter.

Impact on lessees

The major change for lessees is that all operating leases must be reported on balance sheet through the creation of a right of use (ROU) asset and corresponding liability. The ROU asset is calculated based on the present value of future rental cash flows discounted at the rate implicit in the lease or, if this is not available, the incremental borrowing rate – and depreciated over the remaining lease term.

What's more, interest is charged on the lease liability to maintain a constant underlying rate of return. This means there will be a higher amount charged to profit and loss (P&L) at the beginning of the lease than at the end.

Two available exemptions to the new rules include leases with a term of 12 months or less to run, and low-value leases, ie with a value of $5,000 or less when new.

KPI	Measures	Calculation	Effect of IFRS 16
Gearing	Long-term solvency	Financial liabilities/equity (debt-to-equity ratio)	**Increase –** because financial liabilities increase
EBIT	Profitability	Earnings before interest and tax	**Increase –** because the depreciation added is lower than the lease rental excluded from operating income
EBITDA	Profitability	Earnings before interest, tax, depreciation and amortisation	**Increase –** because lease expense is eliminated from EBITDA
EBITDAR	Profitability	Profit before interest, tax, depreciation, amortisation and rent	**No change –** because all lease-related expenses are excluded
ROCE	Profitability	EBIT/equity plus financial liabilities	**Depends** on the characteristics of the lease portfolio (EBIT, as well as financial liabilities, will increase)
Net operating cash flow	Solvency	N/A	**Increase –** because operating lease payments relating to principal are moved to financing
Asset turnover	Profitability	Sales/total assets	**Decrease –** because lease assets are part of total assets

Effect on key ratios

Naturally, the changes to lease accounting under IFRS 16 will impact certain key performance indicators (KPIs) and measures, as summarised in the above table.

Organisations with large-value leases, such as property, expensive plant and equipment, are likely to be most impacted by the changes.

This may include retailers and other companies with significant property portfolios, as well as airlines and those operating in the oil and gas sectors.

Stakeholder management

In addition, the lease accounting changes have implications for a diverse group of stakeholders. Corporates therefore need to carefully manage communications to ensure the right messages are received and understood. For example, although creditworthiness has not fundamentally changed as a result of implementing IFRS 16, this may not necessarily be apparent.

As such, it may be prudent to have conversations with stakeholders well ahead of transition to IFRS 16, and to manage their expectations accordingly. The following list is by no means exhaustive, nor in any specific order, but provides a starting point:

- **Debt capital providers.** Consider the effect on banking covenant measures. Potentially, these will need to be renegotiated, but in the meantime, a short-term solution may be the inclusion of a 'frozen GAAP' clause (where not already in place).
- **Suppliers.** Will they be concerned about an increase in gearing/higher reported net debt? Will they seek shorter payment terms as a result?
- **Lessors.** Consider whether there is scope to renegotiate or restructure existing and future property leases. There may be opportunities to reclassify arrangements as service contracts, but will this work on a practical level,

for example, store rent linked to turnover?

- **Auditors.** Key assumptions will need to be agreed prior to implementation, for example, appropriate discount rate, interpretation of lease versus service contract, application of portfolio approach to particular asset classes. An open, early dialogue would be sensible.
- **Shareholders.** The calculation of the transitional adjustment may be important to shareholders as they look for certainty of future dividends and earnings growth. They may also need to understand the increase in reported net debt.
- **Rating agencies.** While operating leases are already taken into account in credit ratings, the agencies will expect the impact of implementing IFRS 16 to be broadly similar to their calculations. Early engagement may be appropriate to ensure there are no surprises.
- **IT and systems.** A practical challenge associated with IFRS 16 will be identifying all relevant contractual terms within existing lease agreements. There may also be systems, as well as data, gaps: can the current accounting software accommodate discounting calculations, for instance? Companies may potentially need to buy a suitable package or develop an in-house IT solution.
- **Management and staff.** Bonus payments may be based on a range of performance measures, including EBITDA. This may require a review of targets, given EBITDA is expected to increase.
- **HMRC.** The treatment of lessee tax relief under IFRS 16 is still to be determined. However, HMRC favours retaining the current taxation system rather than moving to an accounts-based approach. A consultation document is expected in the autumn, with the final decision due to be announced early in 2018.

Preparing for conversion

The earlier entities begin to understand what impact IFRS 16 may have on their financials, systems and business, the better prepared they will be to iron out potential issues and reduce implementation costs and manage compliance risk.

There are a number of important issues to consider in planning the transition to IFRS 16. This includes deciding whether to take a fully retrospective approach on implementation, or a modified retrospective approach (where comparative figures are not restated). If it is the latter, there are two choices to consider: either the ROU asset and liability are valued the same (potentially leading to an initial adverse impact to P&L) or the ROU asset is calculated as if the new rules had always been in place, time apportioned for the expired term (potentially leading to an adverse impact to reserves, but an improved P&L outlook).

Other points to bear in mind include:

- Is the impact of reported performance measures fully understood?
- Are the options available identified and the business, systems and financial impact of these options ascertained?
- Is the additional data that needs to be collected identified?
- Can the systems cope? Are there adequate controls in place?
- Do staff members have the right skills to complete the transition?

There are operational challenges to consider as well. These include knowledge transfer, change management and project planning – as well as getting the numbers right. Meanwhile, external challenges might include releasing the right information to the market at the right time, and maximising the business opportunities during the implementation process.

Time to act

Implementation of the new lease accounting standard has the potential to fundamentally change financial, operational and strategic decision-making in the context of operating lease arrangements, particularly for lessees that have a significant exposure to property and large value leases.

Key decisions need to be taken around transition to IFRS 16, with implications for reported profit, reserves and financial ratios. Stakeholders will need to be managed to ensure they understand the impact of the change and do not reach incorrect assumptions about future creditworthiness.

Further, there is a significant amount of preparation needed to enable finance teams to properly account for leases under the new rules. We believe it is imperative that impacted businesses start planning now for the required changes in order to be better prepared to iron out potential issues and reduce implementation costs and compliance risk.

Changes in the US

In addition to the changes that IFRS 16 brings, treasurers with US operations need to be aware of the FASB's new accounting standard ASU 2016-02 Leases (Topic 842). Although the boards were aiming to fully converge, their final standards differ in some key areas. To illustrate, while both international and US accounting standards will result in all leases being accounted for on balance sheet, the FASB decided to have a dual classification model for lessees: finance leases and operating leases. Lease classification affects measurement of the ROU asset, lease expense and income statement presentation.

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