Australia Property Insights

New lease accounting standard Commercial property implications

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Contents

- A new accounting Standard has potentially significant implications for Australian entities that lease office, retail and industrial property. Entities with large numbers of leases, such as retailers, banks or some government agencies, are likely to be most impacted by the change.
- The new Standard, AASB 16 *Leases*, was approved in February 2016 and comes into effect in less than three years, after 1 January 2019. The Standard is likely to materially change the way leases are administered and accounted for.
- The change will require most leases (real estate as well as other operating leases such as equipment and vehicle) to be capitalised and presented on balance sheet as a right-of-use asset and lease liability. This is a significant change from the current rule which allows many leases to be used as a form of off balance sheet financing.
- The change is expected to be felt throughout companies from the ‘C suite’ to the operational level with implications for real estate strategy, lease administration, credit ratings, financial metrics, debt management, capital requirements and executive remuneration.
- The new Standard is likely to result in a significant administrative burden and require possible changes to real estate policy, loan covenants and remuneration packages. However, AASB 16 *Leases* should not result in major changes to the wider real estate leasing market as the majority of leasing decisions are not driven purely by accounting objectives.

Areas potentially impacted by AASB 16 *Leases*

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The new standard: AASB 16 *Leases*

What is the change?

The International Accounting Standards Board (IASB) issued a new Standard, IFRS 16 – *Leases*, in January 2016 which replaces IAS 17 – *Leases*.

The Australian equivalent, AASB 16 *Leases*, was approved in February 2016 by the Australian Accounting Standards Board (AASB) and will be applicable for annual reporting periods beginning on or after 1 January 2019. For Australian lease holders, this might include financial years ending December 2019 or June 2020. Earlier application is permitted provided AASB 15 *Revenue from Contracts with Customers* is also applied.

Key features of the change include:

- AASB 16 requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.
- Leases will no longer be classified as either operating or finance, with all leases treated as finance leases.
- Leases will be brought onto companies' balance sheets. A lessee is required to recognise an asset - the right to use a leased asset, as well as a lease liability - the obligation to make lease payments.
- Leases will be 'capitalised' by recognising the present value of the lease payments and showing them as lease 'right-of-use' assets.
- If lease payments are made over time, a company also recognises a financial liability representing its obligation to make future lease payments.
- Rent and lease expenses are replaced with depreciation and interest expenses.

Why the change?

The change was designed to provide clearer and more comparable details of a company's financial position. The AASB report the change should provide more reliable information about lease obligations with "*less need for "rules of thumb" and guesses about the impact of lease obligations on a lessee's debt and gearing/leverage*".

How will it impact lessees?

Where a company has significant off balance sheet leases, the main impacts are expected to be:

Information gathering and control

Companies will need to keep and maintain detailed records of individual leases. Updates to data will be needed at all lease events, including indexation, rent reviews, service of notices and even lapsed notice periods.

Companies should ensure appropriate lease administration systems and procedures are in place to meet disclosure requirements of the new Standard.

Financial statements

Changes relating to financial statements include:

- Balance sheet items:
  - Increase in assets due to capitalising the right-of-use of the asset.
  - Increase in financial liabilities due to reporting the obligation to make future payments.
  - Decrease in equity as asset value generally reduces faster than liability.
- Income statement items:
  - Operating costs will fall as straight line recognition of lease expenses over the life of the lease will no longer apply.
  - Depreciation will increase with a charge for the lease asset.
  - Finance costs will increase with an interest expense from the lease liability. This reduces over the life of the asset as lease payments are made.
  - EBITDA increases as lease costs become a finance rather than operating cost.
  - Increase in operating profits as operating expenses are reduced.
  - Increase in financial costs.

Accounting ratios

Balance Sheet ratios such as interest cover or EBIT / EBITDA ratios may change as a result of AASB 16.

For example, interest coverage and return on capital employed ratios could fall as a result of the change.

This may impact loan covenants and remuneration schemes that reference the ratios.

For some financial institutions with significant leases e.g. banks, regulatory capital requirements could be impacted by asset and equity reporting changes.

Lease structure and negotiation

Under the new Standard, some lessees may choose alternate lease structures to reduce balance sheet liabilities. The definition of lease payments excludes incentives, certain variable payments, such as turnover rent, and the term only includes options that are reasonably certain of being exercised. To reduce balance sheet liabilities, companies may seek to structure leases with more variable components and shorter terms. Any changes, however, would need to be balanced against the business risk of increased uncertainty.

Own verse lease

From an accounting perspective, the changes to lease accounting standards will narrow the difference between leasing and owning property. Both will result in a liability on the balance sheet.

While Individual companies may reassess the benefits of leasing vs. owning assets, the practical benefits of leasing assets will remain unchanged:

- Operational flexibility.
- Regular, fixed lease payments.
- Reducing residual and obsolescence risk.

- Alternative source of finance.

We do not expect a significant move away from leasing. However, for some occupiers, a change in property ownership policy may be justified.

Sale and Leaseback

Sale and leaseback is a common method of raising capital 'off balance sheet'. By selling an asset to an investor (removing the asset and liability from the balance sheet) and leasing the asset back at an agreed rent (the payments for which were 'off balance sheet'), financial statements show improved equity and reduced debt. Occupiers often recognise a significant accounting profit at the time of the transaction, due to the difference between the net book value and the sales price achieved.

Under the new standard, this structure will no longer be 'off balance sheet', nor will occupiers be able to recognise the full profit between net book value and the sales price in their financial statements. Nevertheless, there are a number of wider benefits to sale and leasebacks:

- Reinvestment of capital in the core business.
- Alternative source of finance.
- Reduction in residual and obsolescence risk.
- Retention of occupational security for a fixed period.
- Source of long term financing.
- Realisation of full asset value.

Under the new standard, there will be a reduced accounting benefit to undertaking sale and leasebacks. The question in the future will rather be one of closer alignment to property strategy and of effective deployment of capital, i.e. can you release value from real estate and invest the capital raised at a higher rate of return through your core business?

Gearing and loan covenants

For companies with significant off balance sheet leases, AASB 16 may impact gearing, requiring loan covenants to be renegotiated.

HR issues

Remuneration schemes linked to financial performance or financial ratios may need to be reviewed or renegotiated.

How will it impact lessors?

Lessor accounting requirements in AASB 16 are substantially unchanged from AASB 117 *Leases*. Lessors will continue to classify their leases as operating leases or finance leases, and to account for those two types of leases differently.

While lessor accounting remains largely unchanged, a thorough understanding of the impact on tenants should assist in lease negotiation. Potential negotiation points include lease term, incentives and their quantum over the term of the lease, fixed and variable payments, lease and non-lease components within a contract and lease options that are reasonably certain of being exercised.

Actions to take

The new Standard's effective date is three years away, however, it is recommended companies with significant off balance sheet leases use the time to analyse the impact of the change and implement any new systems or policies required. These may include:

Education

- All divisions and levels in a company from the 'C suite' through to the operational level should be educated on the change and its implications.
- Specific project teams may need to be created to manage the change.

Data collection

- Ensure appropriate data can be collected and procedures are in place to meet disclosure requirements of the new Standard.
- This may require compilation, review and recording of all lease agreements.
- Decentralised databases must record similar metrics.

Systems

- Existing lease management systems may not record required data or integrate with financial reporting systems.
- Review systems to ensure they meet reporting requirements.
- Upgrade as required.
- Budgets should provide for transition resources and software.

Corporate policy

- Review potential changes to real estate strategy and policies regarding lease structure, own versus lease and sale and leaseback.
- Review impact of change on financial metrics. Adjust or renegotiate affected areas, such as loan covenants or remuneration structures, as required.
- Initiate policies for discount rates, documentation, impairment, and database diligence.

Conclusion

The new Standard represents a significant change in the way leases will be recognised in financial statements. While individual real estate decisions may be impacted, we do not expect this to translate into major changes as the majority of leasing decisions are not driven purely by accounting objectives. However, AASB 16 *Leases* is likely to result in an increased administrative burden and possible changes to real estate policy, this suggests lessees should ensure they are ready for the new Standard.

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