The business impact of a new global accounting standard on commercial leases in Australia

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Introduction

A new global accounting standard, known as IFRS16, will come into effect in Australia and globally[1] on 1 January 2019 and radically change the way leases are recognised in financial statements with a range of ramifications for the commercial, retail and industrial leasing and the capital transaction sectors.

The major changes that will be introduced as part of IFRS16 require Lessees to recognise a "right of use" asset and liability equal to the present value of all certain future known rental payments under the lease. The exceptions to this rule are short term leases less than 12 months and low value assets worth less than $US 5,000.

This will bring an end to leasing real estate and other asset classes as a means of off–balance sheet financing for Lessees. The result is that there will be major implications for lessees' financial statements, including impact on gearing ratios, profitability, EBIT, EBITDA, tax and management remuneration.

In addition, there are a number of important business considerations for lessees including the need for lease abstraction, portfolio management and lease accounting systems which will be necessary to calculate and update their financial accounts going forward.

Lessors will be largely unaffected by this change, except in the case of Lessors who have ground leases and sub-leases, as they will be caught by the change. For example, Lessors in the ACT where there is no freehold title will need to adopt IFRS16.

The implications for the commercial real estate leasing market are still to some extend unknown, however our research has shown that there will likely be a change in lessees' requirements particularly in retail property, as the balance sheets of these types of businesses will swell dramatically and their below and above line Profit and Loss Statements will be dramatically affected.

Some of the likely changes to leasing requirements are listed below:

Impact	Reason
Demand for Greater Net Leases	Several outgoings can be stripped out of the calculation, as they are treated as service charges.
Shorter Lease Terms	Reduces lessee's Right of Use asset and liabilities.

[1] US Gap Standards will continue to make a distinction between finance (capital) and operating leases. Finance leases in the US are similar to IFRS16, however without a requirement to reassess variable lease payments.

Increasing Requirement for Options	As the take-up of options into the initial liability must be reasonably certain.
Increasing hold over and leases for a year or less	To avoid recognising an asset and liability.
Demand for leases that have conditional payments e.g leases based on turnover only	Leases that do not have known or conditional rental payments could be excluded from the calculation.
Change in incentive structures	Greater demand for rent free as opposed to contribution to fitout, as this reduces the right of use liability.
Possible Reduction of Sale and Lease back as a transaction method	The new standard reduces the gain on the sale of the building by the lessee, as the gain is measured by the difference between the sale price plus the right of use asset, minus the right of use liability and the fair value of the building.

Table 1- Summary of Potential Changes in commercial leasing as a result of IFRS 16

Overview

In 2016, the International Accounting Standards Board issued IFRS16 - a new model to recognise all leases regardless of whether they are operating or finance leases on balance sheet. The idea behind this was relatively simple – Leases are long term contractual obligations to pay money and therefore should be treated the same as any other company liability. Thus, began the demise of using operating leases as a form of off-balance sheet financing.

The transition date for implementation of this accounting change is 1 January 2019, however in reality, most Australian companies who report on a June financial year basis will need to have these standards adopted by 30 June 2020.

The purpose of this technical paper is to analyse potential impacts on the commercial real estate sector resulting from IFRS16 and offer some practical implications. For technical accounting, tax and legal advice please consult an appropriately qualified professional.

Impact on Commercial Leasing

Office and Industrial Leasing

For the majority of commercial office and industrial leasing, IFRS16 will have relatively little impact as most of these leases are held by companies with single or relatively few leases and the impact therefore will be more administrative rather than market changing. There could however be some market preference by Lessees' for lease deals that minimise the right of use asset and liability and these are shown in Table 1 above.

Retail, Childcare, Bank Branches, Medical and Other Chains

The biggest impact will be in chains of businesses that have a large number of leases required to operate their business. Their balance sheets will swell dramatically and their below and above the line Profit and Loss Statements will be dramatically affected.

A recent PWC global study[2] revealed that the retail sector will be one of the industries hardest hit. It estimated that there will be a 90 per cent increase in liabilities for all retailers, resulting in an average 41 per cent increase in EBITDA as a direct result of the implementation of this new accounting standard. This significant blanket increase will result from the lease liabilities, as 95 per cent of all retailers operate in leased premises. Similarly, the increase in EBITDA will stem from the fact that rental expenses, which typically represent between 5 to 30 per cent of a retailers P&L cost, will be replaced with amortisation and interest expenses of the liability, which are below the line and excluded from EBITDA.

Boards and C Suite executives of these larger companies will no doubt be scrutinising property leasing more heavily, as it effects their balance sheets and therefore a range of financial ratios including gearing.

The market requirements for leasing in these sectors are likely to be impacted with Lessees' looking for ways to reduce their liabilities or, in some circumstances, avoid or delay incurring additional liabilities.

Changes in Deal Structuring

Net v Gross Leases

IFRS16 allows for the recoverable outgoings component to be separately identified into 'contractual' and 'service' outgoings of the contract.   Certain outgoings within a lease are deemed to be service components of the lease, such as maintenance, and therefore can be expensed rather than capitalised.

If leases are gross or semi-gross, it much makes it harder for a lessee to strip out these costs, as they are unknown.

Incentives

Under IFRS16, a Lessee is required to amortise a contribution to fitout or cash payment by the Lessor over the term certain of the contract, unlike rent free forms of incentives, which reduces the rent until it expires. This can have an impact on the Right of Use Liability calculation. Consider the following example below:

Lessee A and B enter into a Lease on 01/01/2019 with identical lease terms of 5 years, with 5% increase and net rental of $100,000 per annum with no options. Entity A receives a contribution to fitout of $100,000 payable at the beginning of the lease and Entity B receives a rent free of $100,000 for the first 12 months of the lease.

From a Lessors' cash perspective, the two deals are very similar[3], as they are both equivalent to 10% (unescalated) over the term certain of the lease.

Lessors' Perspective

Year	Lessee A	Lessee B
Year 0	-$ 100,000.00	
Year 1	$ 100,000.00	$ -

[2] PWC IFRS16: The leases standard is changing. Are you ready? – Page 8
[3] This scenario for Lessee A treats incentives as a negative cash payment.

Year 2	$	105,000.00	$	105,000.00
Year 3	$	110,250.00	$	110,250.00
Year 4	$	115,762.50	$	115,762.50
Year 5	$	121,550.63	$	121,550.63
Total Cash Received	$	452,563.13	$	452,563.13

Assume that both Lessees A and B adopt the same incremental borrowing (discount) rate of 8% per annum. All things being equal, Lessee B's right of use Liability is reduced by approximately $13,000 by taking rent free as opposed to a contribution to fitout.

Lessees' Perspective

	Lessee A			Lessee B
	Rental Payment	**Amortisation of Incentive**	**Payment after Incentive**	**Payment after Incentive**
Year 1	$ 100,000.00	$ 20,000	$ 80,000.00	$ -
Year 2	$ 105,000.00	$ 20,000	$ 85,000.00	$ 105,000.00
Year 3	$ 110,250.00	$ 20,000	$ 90,250.00	$ 110,250.00
Year 4	$ 115,762.50	$ 20,000	$ 95,762.50	$ 115,762.50
Year 5	$ 121,550.63	$ 20,000	$ 101,550.63	$ 121,550.63
NPV @ 8% Right of Use Liability			$358,093.18	$345,354.79
Difference			$12,738.39	

In reality, Lessees may still prefer a cash incentive or contribution to fitout, as they would otherwise need to borrow the money to fund their fitout.

Lease Durations and Deal Structuring

One of the more difficult to predict elements of the IFRS16 change is what will happen to lease durations?

<u>Possible Rise of Hold Overs and Shorter-Term Leases</u>

For renewal of leases with fully depreciated fitouts there may be a rise in hold overs and or shorter-term leases to reduce the liability going forward. This could especially be the case for underperforming stores.

For new leases, there may be a requirement for shorter term leases with more options, as options must be reasonably certain of being exercised before they are included in the right of use Asset and Liability.

There may be an additional requirement for break clauses within leases. Under IFRS16, if a Lessee incurs a penalty for terminating if reasonably certain of exercising this right, then this cost is

calculated as part of the Right of Use liability. In other words, given leases are now a balance sheet item, Lessees may seek to transfer some of their balance sheet risk to Lessors.

Conditional Payment Leases

Under IFRS16, variable lease payments linked to sales or Lessee's equity are excluded from the Lease Liability calculation. For example, turnover rent in shopping centres would be excluded. If a Lessee has a pure turnover deal then none of these payments are included in the Liability.

Use of Derivatives in Leasing Contracts

Interestingly there could be a rise in derivative products which link the payments for rent based upon the equity value of the business in return for a structured payment to the Lessor. In other words, swaps which allow lessees to exchange their liability in return for providing certainty of rental payments back to the Lessor. I am aware of at least one company in the market that is already offering this service.

Sale and Leasebacks

An area which could be impacted is the use of sale and leaseback as a means of realising profits on the sale of corporate real estate properties. IFRS16 reduces the profit on the sale of the building by the Lessee, as the gain is measured by the difference between the sale price plus the Right of Use Asset less the Right of Use Liability and the fair value of the building. The accounting treatment of this is complex, however, regardless of the profit reduction, it does free up cashflow for the building owner who then leases back, so it is unlikely to disappear altogether.

An interesting variation on this maybe the rise of purchase options contained within a lease. Purchase options are treated the same way as lease options and must be accounted for if the Lessee is reasonably certain to exercise that option. In order to reduce the Right of Use Liability and realise a greater gain on sale, the Seller/Lessee may structure their leaseback with more lease options including a purchase option.

Practical Implications

There is a relatively short timeframe to get prepared for these changes, so action is required in the immediate future from Finance, IT and Property Departments.

Software that automates the extraction of critical data from commercial leases together with accounting and property systems will need to be implemented.

Strategic decisions will need to be formulated and there are a number of global specialists who are providing tools and assistance with the strategy and implementation to deal with IFRS16.

Conclusion

The introduction of IFRS16 – Bringing Leases on Balance Sheet will eliminate the long-standing practice of using leasing as a means of off balance sheet financing. There will be a range of implications for the commercial property market post 1 January 2019 with the retail property sector to be the most heavily impacted. Boards and C Suite executives of these larger companies, will be scrutinising property leasing more heavily, as it effects their balance sheets and therefore a range of financial ratios including gearing.

Changes to the demand for lease structuring could occur and therefore appropriate planning and strategic for this change is highly advised.

References

IFRS16: The lease standard is changing Are you ready? PWC 2016

Leases: A guide to AASB16 Deloitte 2016

About the Author

Simon Fonteyn is an accredited retail specialist valuer. He is the founder of three companies; LeaseInfo (www.leaseinfo.com.au), the largest online retail data provider in Australia; IPS Consultants, a specialist valuation and advisory business; and Digital Contracts, a high-tech system for the extraction of data from commercial contracts.