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Accounting for change - are you ready?

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We will soon be 12 months from perhaps the most radical impact on real estate leases and property leasing strategy in over 60 years. January 1st 2019 finally sees the introduction of the International Accounting Standards Board's (IASB) IFRS16, and preparation will be important.

IFRS16 will bring all leases (as Lessee - Lessor accounting is largely unchanged) on to corporate balance sheets and thereby radically change the reported financial shape of many corporates, whilst introducing ramifications that no company should ignore.

Now is the time to engage with your accountants/ auditors to review preparations for this wholesale change in the reporting of lease liabilities - and liaise with your real estate advisers to ensure you are armed with the data and specialist property knowledge that you will inevitably need to have to hand.

What are the changes?

After years of consultation, the IASB have finally implemented their proposals to secure greater transparency for companies' leasing commitments in company reports and accounts, which will become effective January 1st 2019.

All lease commitments, which include those for cars, photocopiers, even jumbo jets and power plants, will henceforth be treated as a form of financing (and therefore debt) and will come on to balance sheets. Previously, real estate leases have predominantly been treated as 'operating leases' and their impact has been expressed only 'in year' as a rent expense in the P&L.

Every lease held by a company (with minor exclusions) will need to be appraised and will enter the balance sheet during 2019:

i) as a liability, effectively a sum equivalent to the capitalisation of the rent liabilities for the unexpired term (at a company's marginal cost of borrowing) and,

ii) as a 'right of use asset', initially a similar value.

The changes will see a significant expansion of a company's balance sheet, but most significantly a potentially dramatic increase in debt, with a knock on effect for gearing and other ratios.

For companies with multiple leases, such as retailers and pub operators, this could have a significant impact on performance measures, share valuation, loan covenants, executive reward schemes, etc. Further impact arises from the way that the two sides of the asset and liability are 'unwound' over time, which impacts operating profits in the early periods, but enhances EBITDA. (Your accountants should offer advice on this matter).

So what does this mean for your portfolio?

We expect that the impact for real estate decision-makers will be far reaching:

Firstly, it will be critical to ensure capture of essential data regarding leasing commitments, which will now be required by auditors. The rent component of a contract will need to be separated from

Continued >

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any 'service' elements (relatively easy for a traditional lease with rent and a service charge, but more difficult for inclusive leases).

Secondly, sound decisions will need to be made to justify treatment of lease breaks, options, rent reviews, indexed and turnover rents, when the 'value' of each lease is initially assessed. Reassessment later, because for example a break option is not, as initially anticipated, then exercised, could be at a cost.

Thirdly, in our view, the unforeseen consequences will need to be considered carefully. Some of these will relate to wider (non-property) impacts, such as breach of loan covenants, re-pegging of executive reward schemes, etc, but there will be a knock-on for real estate.

Possible consequences which need to be considered:

- Will it drive more shorter term leases, to keep balance sheets in check?
- Will it see a reduction in companies' leased footprint overall, as more radical steps are taken to manage the balance sheet impact? (The serviced office providers and co-working operators are certainly banking on this.)
- Will it further the pain for physical retailers when compared with their 'virtual' online competitors?
- Will it drive more freehold ownership? If a company is to inflate the balance sheet anyway then why not own a real capital asset?
- Will it drive different decisions in relation to future growth and the exercise of renewals and breaks, because accounting implications will now be added to existing operational considerations? (Some argue that greater cross-functional input from businesses will drive better decision making).
- For international operators, might it push global locational decisions towards countries with favourable environments, that for example allow deductions of interest payments against profits?
- Will past sale and leaseback decisions need to be reassessed, and existing leases renegotiated to lessen their accounting impact?
- Will negotiating strength at a break or expiry be impacted because a counter-party can identify your intentions from your company's report and accounts?

This will be a voyage to a new world for all.

Just as the introduction of tenants' security of tenure (England & Wales) changed the relationship between landlord and tenant in 1954, so these changes will transform the way that lessees view and manage their leases in the future.

Rapleys is supporting our clients in undertaking thorough reviews of leased portfolios, to capture all relevant data and to drive early decisions around their initial and longer term accounting treatment.

We are experts in the proposed changes, having been involved in consultations at each step of the emerging standards since 2010.

Please call us if there is any aspect of these changes where you believe our knowledge and expertise may be valuable to you and your business.

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