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Michael Evans and Daniel Miller explain what a new lease-accounting standard means for commercial property

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In January 2016, the International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS) 16, the new lease-accounting standard with which all companies reporting under IFRS will need to comply by 2019.

The standard?s development has been protracted (see Figure 1), but now private companies, public bodies and charities will all need to understand the impact of changes and be ready to implement them.

Real-estate teams may have to prepare for the change even earlier. An elective reporting option comes into effect in 2018, meaning that companies can opt to report under the new standard. So although the standard becomes mandatory in 2019 ? still more than 2 years off ? it will fast become a priority.

At present, operating leases are treated as being off the balance sheet whereas all finance leases are on. The new standard removes this distinction and all leases are treated as on the balance sheet. In effect, an occupier?s obligation to pay rent will have to be recognised as a liability, while a corresponding asset, also known as a right-of-use asset, is recognised as well. The new standard will lead to an increase in both total assets and liabilities. It dramatically affects the profit-and-loss account and financial ratios such as gearing levels, as well as creating enhanced disclosure obligations.

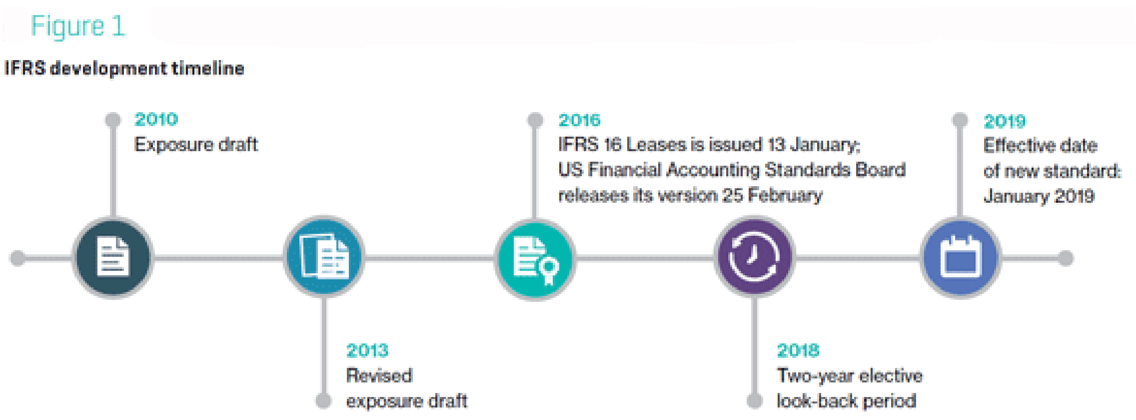
Why the change?

All leases create assets and liabilities, but as most are not reported on a company?s balance sheet, this leads to an inaccurate picture of its financial position.

Analysts sometimes manipulate the information to estimate the liabilities arising from activities that are off the balance sheet, and this can result in a multiplier of as much as 8 times annual lease expense. However, these estimates are uncertain and may not reflect the true picture.

The examples of 2 US retailers, Circuit City and Borders (see Figure 2), illustrate the problem. Both showed operating lease commitments significantly in excess of their reported debt, which meant that the gearing of the companies looked substantially different depending on whether the lease commitments that were off the balance sheet were taken into account. Both companies have since gone bankrupt.

The purpose of the new standard is to ensure that all lease liabilities are on the balance sheet and fully visible. The IASB has estimated that there is a total of more than $3tr globally in real-estate obligations that is off the balance sheet, representing in excess of 85% of companies? commitments or up to 66 times the value of debt on balance sheets. The issue is global, and all companies that report under IASB rules or the US generally accepted accounting principles will be affected.



What are the effects?

The changes will increase the obligations most dramatically for companies that rely heavily on leasing for their operations, such as retailers, leisure operators, service companies and banks. As a result of the incoming standards, businesses are likely to experience the following:

- inflated assets and liabilities following the inclusion of all leases on the balance sheet;
- a higher income statement treatment in the early years of the lease; with the IFRS, there will be a higher charge to the income statement because of the amortisation and interest charges, which will reduce over the life of the lease until there is a change in the terms and it is reassessed;
- the need to collect the data and calculate the impact may result in a significant administrative burden for companies.

Figure 3 offers an example of the financial impact of the new standard. It represents a 7-year office space lease where the annual base rent is $500,000 with fixed uplifts at 3% a year. In effect, the rent obligations to the end of the term are present-valued to today to determine the right-of-use asset and liability. These are then unwound in the financial accounts as amortisation and interest expense, in much the same way as a repayment mortgage works. This results in a higher charge in the earlier years of the lease.

The IASB has estimated that there is more than $3tr globally in real estate obligations that is off the balance sheet

The new standard is also likely to have a substantial impact on the appetite for sale and leaseback arrangements. This approach has been used by many businesses as a way to raise capital and also to recognise a gain in the income statement at the time of sale, but it will no longer be so financially advantageous for businesses since the leaseback will also now be on the balance sheet.

Similarly, after 2019 it will not be possible to recognise all the gain on the sale of the asset immediately; the next 2 and a half years therefore present an opportunity for property owners to carry out sale and leasebacks and recognise all the gain on sale upfront.

This works best where companies have been recognising their assets at historical cost. Consider an example where the net book value of an asset is ?10m and the sale and leaseback proceeds are ?20m, being the fair value. Currently, the gain that could be recognised immediately is ?10m, excluding other costs. Under the new lease standard, however, the gain that it will be possible to recognise is limited to the amount that relates to the part of the underlying asset that has actually been disposed.

Assuming that the present value of the lease payments is ?15m, then ?5m can effectively be attributed to the underlying asset. This amounts to 25% of the total proceeds of ?20m, which is then applied to the total gain of ?10m. The result is that a gain of only ?2.5m can be recognised upfront. The rest of the gain of ?7.5m is effectively recognised over the course of the lease.

So, what would have represented a gain of ?10m under the old rules is now turned into a gain of ?2.5m under the new rules.

It could therefore be beneficial to take advantage of the window of opportunity presented by the next 2 and a half years to recognise the whole gain on a sale and leaseback under the existing rules.

Figure 2

Lease commitments v reported debt of US retailers Circuit City and Borders. Source: IFRS, August 2014

Retailer: Circuit City (USA)

$4,537m Operating lease commitments (undiscounted)	**$50m** Reported debt	**9,074%** Operating lease commitment as proportion of reported debt

Retailer: Borders (USA)

$2,796m Operating lease commitments (undiscounted)	**$379m** Reported debt	**738%** Operating lease commitment as proportion of reported debt

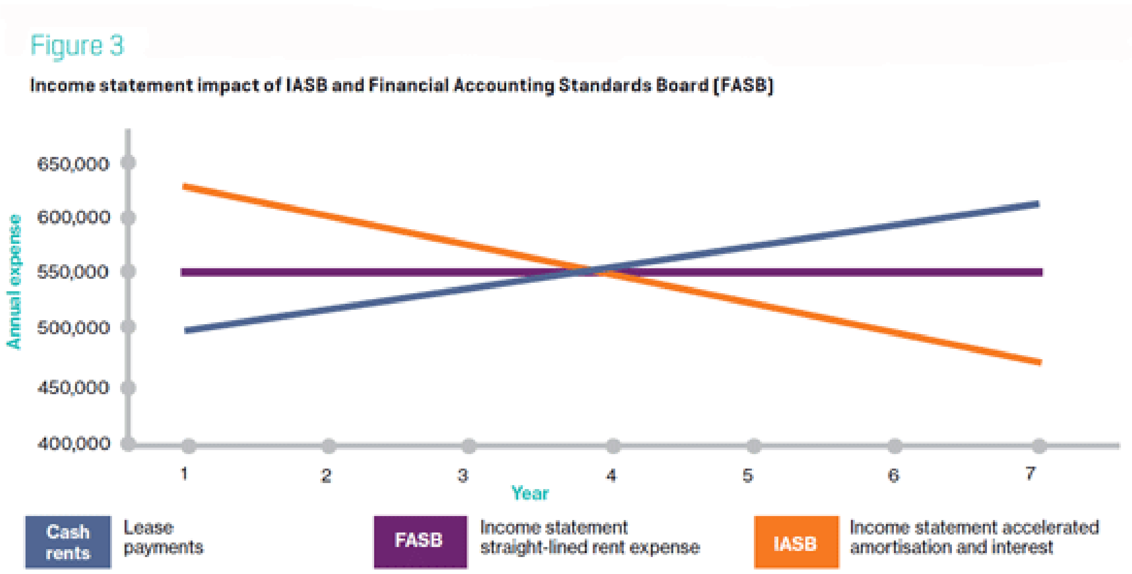
What do businesses need to do?

There is a need to start preparing now for the changes to ensure there is adequate time to identify the resources, systems and processes that will be required to collect the data, analyse the portfolio and prepare the accounting entries. Businesses should begin by analysing the impact of their leased property portfolio on their financial statements. Armed with this information, they can evaluate strategies for reshaping their portfolio.

There are alternative methods to transition from the existing leased estate to the new arrangements, and each will have different implications for the balance sheet. Capital reserves, which are especially important for banks and insurance companies, and the profit-and-loss account will both be affected in particular. Assessing the impact of these different methods and establishing which works best for your organisation is crucial.

Looking more broadly at the commercial real-estate market, the impact may be seen in a number of ways, with businesses considering the following options and alternatives:

- shorter-term leases to reduce balance sheet and profit impact on their financial statement: short-term leases ? that is, those lasting less than 12 months ? are exempt under the new standard requirements;
- more turnover rents: rents that are uncertain, that is, by being linked to turnover, will not need to be recognised on the balance sheets, and could therefore be attractive to occupiers;
- a possible move towards property ownership: depending on business maturity and lifecycle, this may be advantageous for some firms, given that there will no longer be an advantage to keeping leasing off the balance sheet.



Given that all leases will be on the balance sheet in future, it may be that there will be a move to more structured leasing products that are better aligned to the financial objectives of an organisation, such as strip-income products, credit tenant leases, ground rents and so on. This may be particularly relevant for the core properties belonging to an organisation.

However, there is also likely to be significant growth in serviced office space and co-working as organisations seek greater agility in their portfolio, and also benefit from these arrangements being off the balance sheet.

Real-estate teams should be looking to work closely with the wider business and develop a plan to implement the new standard, understand what information is available and where the gaps are.

This is a revolution in accounting for leased property. It represents a huge opportunity for commercial real-estate teams to take a leading role with senior management in identifying the financial impact of their portfolio and developing strategies that best meet the strategic and financial objectives of the business in the future.

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Further information

- Related competencies include Accounting principles and procedures , Property management accounting
- This feature is taken from the RICS *Property journal* (December 2016/January 2017)