IFRS 16: Are you ready for the change to leases?

Finance directors need to consider solutions capable of dealing with the new lease accounting requirements, says Azim Khan, director of AIS Consulting.

Although IFRS 16, the new leases standard from the International Accounting Standard Board (IASB), took effect on the 1st of January, many companies may not have got up to speed with it yet. After all, there's been plenty of issues such as Brexit dominating the thoughts of CFOs, finance directors and other leaders in recent months. But all companies that access assets using rental or lease contracts will be affected by the new standard, so finance leaders will need to be across the new standard, sooner rather than later.

Modernising Finance

In essence, the new standard removes the distinction between operating and finance leases. Now a new leased asset and its corresponding liability (the obligation to pay rentals) will now need to be included on the balance sheet.
The new standard will increase transparency and comparability. Currently, analysts adjust financial statements to reflect lease transactions that companies hold off-balance sheet. The new standard means analysts can scrutinize a company's own assessment of its lease liabilities, calculated using the prescribed methodology in the IFRS.

While the IASB published IFRS 16 Leases in January 2016 with an effective date of the 1st of January 2019 very few companies are ready or understand the full implications for their business of implementing the standard.

Far-Reaching Consequences

IFRS 16 will gross up balance sheets and change income statements and cash flow presentation. Rent expenses will be replaced by depreciation and interest expense in the income statement. This means all companies that lease major assets will see an increase in reported assets and liabilities and the larger its lease portfolio, the greater the impact on its key reporting metrics such as gearing and EBITDA. The new requirements may also affect covenants, credit ratings and borrowing costs.

Business Data and Processes

In addition to the changes required to the accounting and reporting systems the new standard may also impact other business operations, processes, systems and data.
Companies need to take a holistic review of the requirements for IFRS 16 and assess the impact on its entire business and take a cross-functional approach to implementation. Changes to the lease accounting standard will require lessees to have significantly more data on their leases given the on-balance sheet accounting requirements.
It is up to the finance director to prepare the business and understand what impact the new standard may have strategically so they can fully understand the issues and costs of complying with the new standard.

Who will be Affected?

Companies in every industry sector use leasing, as a means to obtain access to assets and the type and volume of leased assets and the terms and structures of the lease agreements can differ significantly. Big-ticket leases can include property, planes, trucks, and plant and equipment. Almost all businesses use leases for a variety of less expensive assets such as cars, computer equipment and fixtures and fittings.

PwC conducted a global lease capitalisation study to assess the impact of the new leases standard on reported debt, leverage, solvency, and EBITDA for a sample of more than 3,000 listed entities reporting under IFRS across a range of industries and jurisdictions. The research identified the minimum impact of capitalising existing off-balance sheet operating leases based on commitments disclosures in entities' published financial statements in 2014.

Of note 98% of retail companies said the standard would result in a meridian increase in debt, while 47% and 42% of airlines and professional services firms said the same. In these three sectors respectively 41%, 33% and 19% of firms said there would be a meridian increase in EBITDA.

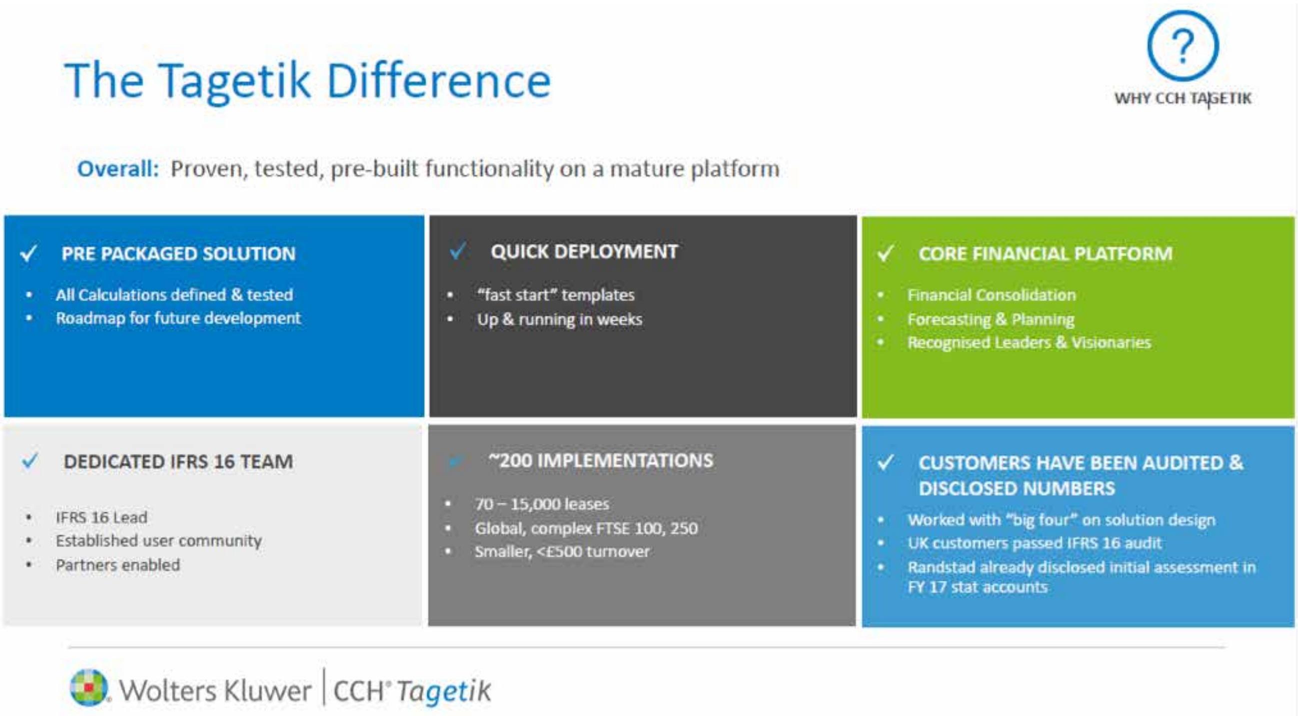
Industry	Median Increase in debt	Median Increase in EBITDA
All companies	**22%**	**13%**
Retailers	98%	41%
Airlines	47%	33%
Professional Services	42%	15%
Health Care	36%	24%
Wholesale	28%	17%
Transport & Logistics	24%	20%
Entertainment	23%	15%
Telecommunications	21%	8%

Source: PwC global lease capitalisation study

New IT systems and robust processes and controls needed

For those companies that do not already have an in-house lease information system the cost to implement and continue to comply with IFRS 16 could be significant. Many finance managers use spreadsheets to manage their leases. With the complexity of the new leases standard bringing all leases on balance sheet, using spreadsheets may no longer be cost-efficient or exacting enough. Given that operating leases have historically been off-balance sheet, the data requirements under the new regime will increase significantly. Furthermore, increased disclosure requirements for leases will also require additional data collection.

Furthermore, increased disclosure requirements for leases will also require additional data collection. Extracting lease data from lease contracts or siloed operational or other 'systems', may prove difficult and time consuming, particularly if an organisation is spread across global jurisdictions, meaning that gathering, validating and standardising lease data across the group could be a major effort. Companies may now need to implement software solutions for lease data management and lease engines to perform the lease calculations required by the new leases standard. Finance directors need to consider sustainable lease software solutions that are capable of dealing with the new lease accounting requirements.



The CCH Tagetik solution can be fully integrated with an existing reporting and management information system and provides a good level of functionality from a finance perspective, automation of data; controls and validations; auditability of lease and finance balance level information; workflow and process management; whilst still providing lease management information the required IFRS 16 output.

Sources and references:

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https://www.pwc.com/gx/en/services/audit-assurance/assets/i-frs-16-new-leases.pdf

About AIS Consulting

AIS Consulting UK LTD is a financial consulting and advisory firm in the heart of London focusing on financial and operational planning, performance management and regulatory reporting (CPM) across the UK. Established in 2001, and with a great client list of FTSE100 and FTSE 250 organisations – AIS have been advisors and delivery partners in well over 100 corporate performance management projects. Their UK CPM benchmark analysis was launched by CIMA (Chartered Institute of Management Accountants) and a close alignment with CCH Tagetik has seen AIS become specialists not just in design and implementation but also as training partners for the future of CCH Tagetik specialists.