IFRS 16 and operating leasing

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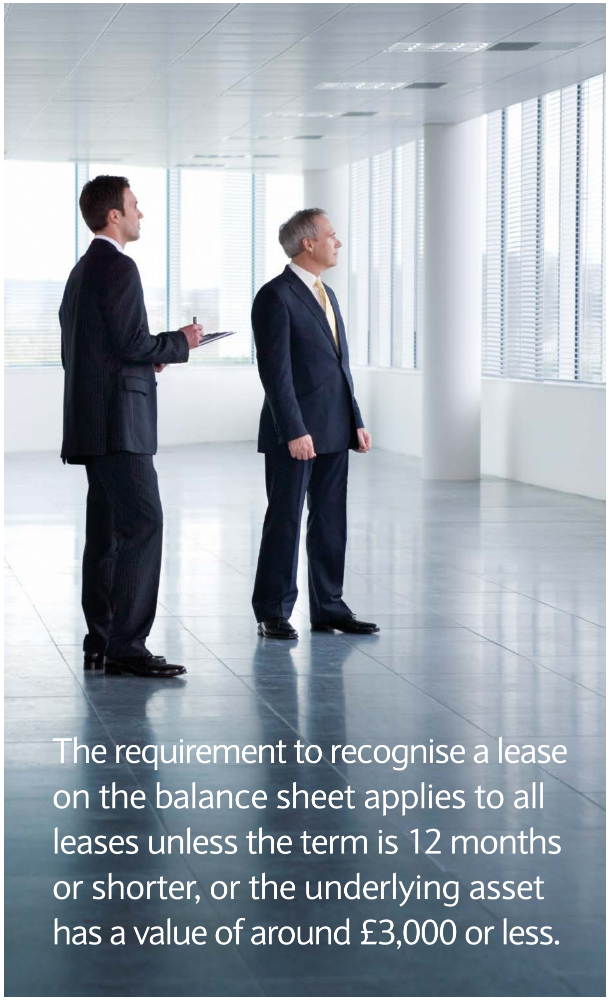
IFRS 16 will change the way that companies recognise leases on their balance sheets, and impact on loan covenants, but it won't change the benefits that leasing brings.

The long-awaited accounting standard, IFRS 16 – Leases, will finally come into effect on 1 January 2019. It replaces the existing leasing standard, IAS 17, and will affect every company applying IFRS that either rents or leases assets.[1]

Under IAS 17, operating leases are not recorded on the balance sheet, although lease payments appear as expenses in the profit and loss account. Going forward, however, companies will need to record a lease as a liability on their balance sheet, at the present value of the future lease payments. They also need to record an asset that reflects the company's right to use the leased asset over the lease term. The requirement to recognise a lease on the balance sheet applies to all leases unless the term is 12 months or shorter, or the underlying asset has a value of around £3,000 or less.

The objective of the new standard is to provide a basis for users of financial statements to assess the amount, timing and certainty of cash flows arising from leases. IFRS 16 will impact commonly used financial ratios and performance metrics such as EBITDA, net income and operating profit. It may also affect companies' financial covenants, as lessees are likely to see their balance sheet liabilities (debt) increase. There will also be a corresponding increase in their operating profit and EBITDA because lease expenses will be reclassified as interest and depreciation instead of operating expenses. The impact of this reclassification will be most significant for those companies that have the greatest exposure to operating leases – for example, the retail, airline and shipping industries. So where will this impact be felt?



Impact on loan covenants

Financial covenants within current loan documentation are generally based on 'frozen' accounting principles (the accounting principles in use by the borrower at the time that the loan was negotiated). Therefore, the way they are calculated will not change when IFRS 16 comes into effect and renegotiation will not be required prior to refinancing. Nevertheless, to demonstrate covenant compliance after the implementation of IFRS 16, borrowers will have to restate their accounts to reflect the 'frozen' accounting principles. In addition, loan agreements will typically make provision for renegotiation of the covenants if they are affected by new accounting principles.

A company's leverage under the new accounting treatment may increase or decrease depending on the profile of its lease portfolio, while other earnings-based covenants, such as fixed charge cover, may become less relevant.

Most loan agreements also include restrictions on how much additional debt a company can raise. These restrictions may be exhausted, or exceeded, as a result of IFRS 16 once leases that were formerly treated as operating expenses have been reclassified as debt. Borrowers could either amend these provisions to reflect the impact of IFRS 16 or carve out former operating leases from their debt calculations after 1 January 2019.

[1] Companies operating under FRS 102 will not be affected because the Financial Reporting Council has deferred the decision on whether to adopt IFRS 16.

Greater transparency could result in some notable winners and losers.

Credit analysts will already be taking into account available information on companies' operating lease portfolios to complete their analysis. The introduction of IFRS 16 will bring much greater clarity in this respect, however, and allow more accurate assessments of a company's financial position against its peers.

Comparability will also be improved between companies that lease assets and those that borrow to buy them, while also reflecting the differing financial impact of the two approaches. There will be little impact on borrowing costs for most companies, although greater transparency could result in some notable winners and losers.

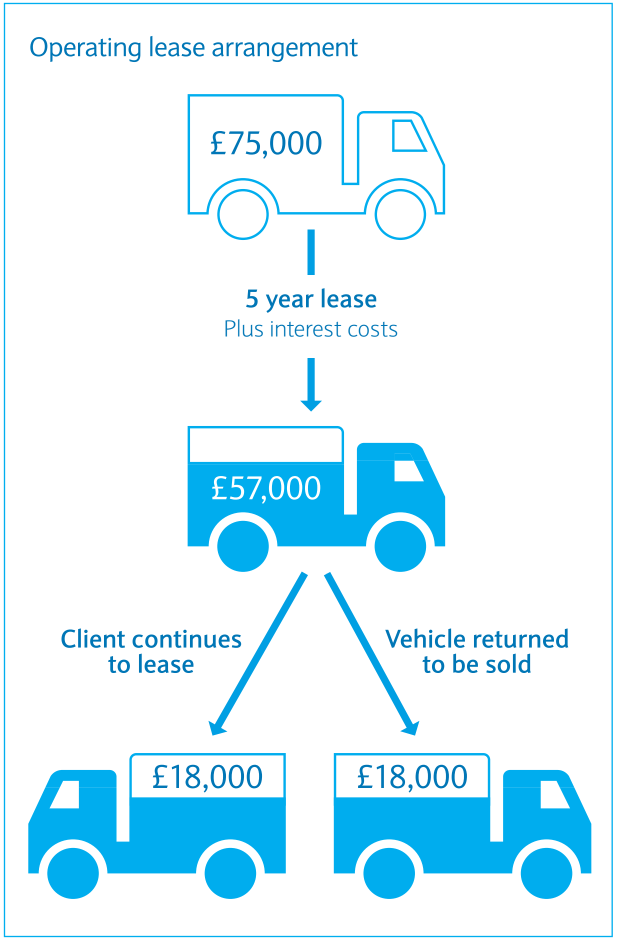
Impact on asset leasing

While IFRS 16 will have the effect of growing companies' balance sheets, it will not change the fact that leasing assets, such as vehicles, IT equipment and specialist machinery, rather than owning them, continues to offer a number of important business benefits.

Reduced total cost of ownership and improved cashflow

Operating leasing allows a company to have use of an asset without having to pay the full price of the asset. Instead, it pays the price of the asset minus the asset's residual value (what the asset is worth after depreciation).

For example, a company might want the use of a heavy commercial vehicle worth £75,000 for a period of five years. With an operating lease arrangement, it could pay £57,000 in lease payments, plus interest costs, over that period on the basis that the residual value of the vehicle after five years will be £18,000.



At that point, the company may return the vehicle to the lessor to be sold, sell the asset on the lessor's behalf, or continue to lease the asset for a further period. A leasing arrangement tends to work best in circumstances where assets have a fixed period of use. Examples might be vehicles or transport and logistics fleets, where maintenance costs rise over a certain age, or IT, where a regular refresh of assets is required to keep up with the latest technological changes.

Financing diversification

Companies can take advantage of leasing to broaden their funding options. They should not view the fact that leases will be recognised on their balance sheet as a drawback. Furthermore, under IFRS 16 it is only the lease values that are capitalised, not the residual values.

Cost and resource efficiencies

When a company leases an asset from a lessor, it typically saves time and money because it does not need to run its own asset management and asset disposal team. Instead, the lessor manages and disposes of assets on behalf of the company. In fact, in the large corporate leasing market, companies can benefit from asset leasing as part of a broader asset management service offering. With vehicles and IT in particular, the offering can encompass services such as asset procurement and replacement, maintenance and servicing, management information, and online asset management systems. Using an asset management service brings the further benefit of cost certainty, since the lessor will typically charge a fixed monthly fee that covers all these services.

Risk management

Leasing can reduce a company's financial risk, particularly if it is using the asset specifically to deliver services to a customer under a fixed-term contract. It can lease the asset specifically for the length of the contract. Then, if the contract is not renewed, the company will not be in the position of owning an asset that it no longer needs. In addition, if a company parts ways with its customer, it may be able to transfer the lease for the asset directly to the customer, provided the customer meets the lessor's credit criteria.

Potential to share the profit when the asset is sold

In some circumstances, a lessor might agree to share any profit made on an asset when it is sold. This usually happens if the company that leased the asset is actively involved in disposing of it, or where there is a residual value risk-sharing arrangement.

Consumers are comfortable with the idea of asset use as a service thanks to the widespread adoption of mobile phones. Instead of buying stand-alone handsets, individuals are more likely to make monthly payments over a fixed term, to cover the cost of both the handset and network usage. Companies are increasingly following the same principle, particularly in relation to assets that have a specific use period, such as cars, vans and heavy commercial vehicles, or assets that suffer from rapid technological obsolescence, such as computers and IT servers.

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Although banks play an important role in leasing by providing the underlying finance to companies that want to lease assets, they are not set up to provide all the associated services that a company will require, such as asset procurement, maintenance and disposal services.

That's why Barclays Asset Finance works with a wide range of reputable third parties that can supply all these additional asset services. It means we can offer our clients the best of both worlds – the funding expertise of a bank, combined with the service expertise of a specialist asset provider.

Next steps

IFRS 16 will affect most companies due to its impact upon key financial metrics utilised by stakeholders across corporate finance. We would be delighted to help you through this transition, whether that be in regard to how lenders will look at your business under the new standard, what it means for your loan documentation going forward, or how Asset Finance can benefit your business.

Further reading

To find more detail on IFRS (International Financial Reporting Standards), see: http://www.ifrs.org

To find out more about how IFRS 16 will affect your company's borrowings, or how leasing assets can benefit your business, speak to your Relationship Director.

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May 2018. BD07147.