How will the proposed new accounting standard for leases affect retailers?

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The new accounting standard for leases will put almost all leases on the balance sheet and change the profile of lease expenses each year. The retail industry is expected to be the industry most affected by these changes.

Following multiple drafts in recent years, a final standard is expected to be issued in early 2016 and to be effective in 2018 or 2019. As it will affect all pre-existing leases, retailers will need to consider its impact on any existing long-dated leases and on new agreements or extensions.

At the moment, many retail leases are treated as operating leases and expensed over the lease term. Only finance leases, where the retailer has the risks and rewards of ownership, currently result in an asset and liability being included on the balance sheet.

The proposed new standard will remove the distinction between operating and finance leases, meaning that almost all leases will result in an asset and a liability on the lessee's balance sheet. There are expected to be two exemptions – short-term leases (less than a year) and small assets. All other leases will be brought on balance sheet, including retail store leases. This article explores how the proposed new standard will affect retailers' accounting for leases and their key metrics, as well as the wider impact it is expected to have on their business.

Key highlights

- The new leasing standard is expected to become effective in either 2018 or 2019 but include pre-existing leases.
- Almost all leases will be recognised on the balance sheet and the pattern of income statement expenses will change.
- Retailers are expected to be the most affected industry, with an average increase in interest-bearing debt of around 213% expected. (*Source: 2010 PwC global lease capitalisation research*).
- Detailed analysis is required now to make informed decisions about lease agreements, loan facilities and shareholder communications.

How will the accounting change?

Under the proposed leasing standard, it's expected that all leases – other than the two exemptions discussed – will be recognised on the balance sheet. Retailers will book a lease liability for the minimum value of future lease payments and a corresponding "right-of-use" (ROU) asset, inflating both sides of the balance sheet equally on day one of a new lease. The income statement expense recognition will change in two ways: first, in the way it is presented in the income statement and, second, in the timing of costs recognised in each year of the lease.

The lease liability is equivalent to a principal and interest loan – in the early years there is a significant loan balance and a larger proportion of the payment is interest expense (shown in the income statement). In the later years, there is a

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smaller loan balance and more of the payment is repayment of capital (reducing the balance sheet liability).

Retailers will have a large portfolio of leases with differing renewal and expiry dates. The portfolio effect may reduce the income statement volatility from the proposed new standard but the timing of significant renewals may still cause variability in expenses each year.

What will be the impact of implementation on key accounting metrics?

As well as new leases, retailers will have many pre-existing leases when implementing the proposed new standard. Existing leases will either be fully restated or accounted for as an equity adjustment. Under either method the new accounting treatment will immediately affect a range of key metrics monitored by stakeholders including:

- Net debt and gearing – this metric will increase. The lease liability will be included in net debt calculations but the ROU asset will be excluded. This could affect debt/equity ratios, thin capitalisation and debt covenants.
- Net assets – this metric will decrease. The lease liability and ROU asset will both be recognised but the ROU asset will be amortised straight-lined whereas the lease liability will unwind more slowly in the early years. The ROU asset recognised on implementation will be less than the lease liability, reducing net assets.
- EBITDA – this metric will increase. The rental operating expense will be removed and replaced by interest, depreciation and amortisation.
- EBIT – this metric will increase. Part of the lease cost will become interest expense, which is excluded from EBIT.
- PBT – the impact on this metric will change with time. On implementation, existing leases will be re-calculated and so the annual expense could be higher or lower depending on how far through each lease you are.

In future periods, the impact on each metric will be less certain. Existing leases will see a gradual decrease in interest expense, lease liability and ROU asset over time but this picture will be complicated by new leases and renewals of leases, which will vary year-to-year.

When key leases, or a large number of leases with similar expiration dates, are renewed, there will be a significant increase in the debt on balance sheet overnight and increased interest expense in the following years. Retailers will need to carefully manage their lease renewals and forecasted lease positions so as to communicate clearly with stakeholders and set market expectations.

What are the wider potential business impacts?

The new accounting treatment could have knock-on impacts in various other areas that retailers will need to consider, including:

- Debt covenants – Although many debt agreements have clauses about changes in accounting standards, the covenants may still need to be re-negotiated or calculations prepared on both bases.
- Share-based payment metrics – Performance hurdles may need to be re-negotiated, with complex accounting implications.
- Dividend policy – The initial equity adjustment and revised profile of P&L expense may affect the ability to pay dividends.

- Thin capitalisation – The changes to net debt and net assets will affect thin capitalisation calculations and could affect the tax deductibility of interest.
- Lease negotiations – While accounting should not be the key driver in commercial lease negotiations, market behaviour may change towards shorter lease tenures, which will minimise lease liabilities, as well as lease incentives that give preferred accounting outcomes.

What areas may affect the lease liabilities recognised?

When calculating the lease liability, retailers will need to consider the following areas:

- Contingent rent – Rent that is contingent on turnover but is reasonably certain to be payable may need to be estimated and included in calculating the lease liability, adding estimation risk and variability.
- Renewal / purchase options – Renewal options that are market-priced but reasonably certain to be exercised, such as landmark properties, may need to be included in the calculations. Renewal or purchase options that are not market-priced will also need to be considered, as they would be under the current standard.
- Other services received under lease agreements – Often lease payments include other services, such as insurance and maintenance. Under the current standard, both the lease element and the other services are expensed with the same profile. The proposed new standard will require these other services to be split out and excluded from the lease liability if the fair values can be reliably estimated and allocated.

Retailers may need to prepare multiple calculations: historical calculations for covenants, new calculations for financial reporting and also US GAAP calculations which will be similar, but not identical, to the proposed new global standard applicable in Australia.

What can I do now?

There will be a significant administrative burden for retailers in capturing all of the information required to calculate the lease liability, even with the exemptions for short-term leases or small assets. Lease agreements have various complex and inter-related elements that will need to be analysed across the portfolio of leases.

Although the proposed new standard is unlikely to apply before 2018, a detailed analysis of its impacts is required now to make informed decisions. After all, most businesses will enter into and renew contracts extending into 2017 and beyond, both for leases themselves and contracts affected by financial key performance indicators such as loan facilities and share-based payments arrangements.

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