Report

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IFRS16– what will the future bring?

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New lease accounting standards – come into effect on 1 January 2019

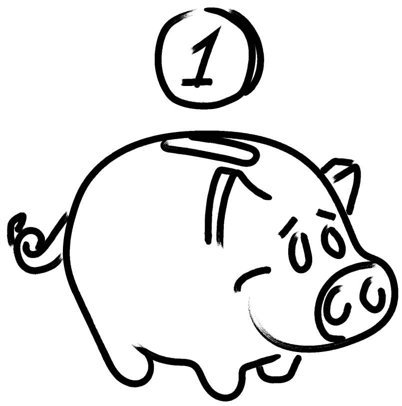
After years of discussions, a new accounting standard for leasing – International Financial Reporting Standard 16 (IFRS 16) – was published in January 2016 by the International Accounting Standards Board (IASB) and is applicable for accounting periods beginning on or after
1 January 2019 (early application is permitted in the case of entities which introduce IFRS 15 on revenue recognition).

From the perspective of lessors (i.e. the owners of buildings) the changes introduced by IFRS 16 are not significant and, apart from sublease arrangements, lessors will not be subject to major adjustments on the transition date.

How will these changes affect office tenants?

Significant changes have, however, been introduced for the lessee recognition model (for instance regarding tenants of office buildings) and IFRS 16 is expected to have a noticeable impact, particularly for entities which keep a large portion of their financing as 'off-balance sheet' items in the form of operating leases. The operating lease accounting model will no longer be available, apart from for short-term leases (with a non-cancellable lease term of up to 12 months) and agreements covering low-value assets (while the threshold has not been explicitly defined, the IASB interpretations indicate an amount of USD 5,000). All other lease contracts must be recognised in the balance sheet in a similar way as that is currently applicable to contracts meeting the criteria for finance leases. The lessee would recognise, respectively:

- on the liabilities and equity side, the present value of future lease payments over the non-cancellable term of the agreement;
- on the assets side, a right of use asset equal to the initial value of the lease liability adjusted for, inter alia, initial direct costs, lease incentives and reinstatement costs.



The new model introduced by the IASB gives rise to a number of additional considerations that need to be addressed by entities for the correct initial and subsequent recognition of the financial impact of lease contracts in their financial statements, including:

- Defining the non-cancellable terms of leases, which must include all periods covered by contractual options within a given lease if the entity is reasonably certain of exercising them (for example early break options, renewal options, etc).
- Applying, on a lease-by-lease basis, relevant rates with regard to discounted future lease obligations to their current value. The lease standard assumes implicit lease rate as the first choice or, alternatively, the incremental borrowing rate of the lessee. However, the rate chosen should at all times be specific to the term for which the lease has been concluded.
- Including in the lease payments relevant cost types (variable lease payments based on turnover are out of scope here, while those linked to an index or rate would trigger reassessment when the lease payments are adjusted).

Getting ready?

The lease accounting changes are more than just a 'real estate' or 'accounting' issue. The new reporting process will involve entire businesses, including operations, accounting and finance, along with the real estate, IT, legal and tax departments. The critical first step towards planning the new reporting process is to involve all of the parts of a business while identifying potential areas of impact.

The below mentioned aspects should be taken into account when becoming compliance-ready for the lease accounting changes:

- creation of a project plan with clear roles and division of tasks;
- identification of the teams responsible for the process;
- developing a complete database of lease agreements (for both real estate and equipment);
- the data, and identification of its sources, needed for the new reporting requirements (which will involve the accounting, finance and real estate departments and others);
- selection of suitable lease database and system/software for accounting purposes;
- analysis of the effects of the change in terms of:
    - EBITDA growth,
    - EBIT growth,
    - growth of fixed assets,
    - growth of liabilities,
    - deterioration of bank covenants, and
    - changes to the operating cash flow value in the cash flow account.

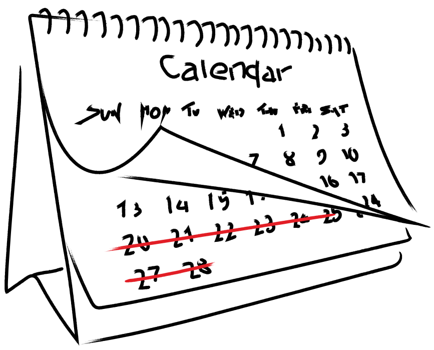
The actual introduction of accounting changes may seem complicated and costly; however, the risk can be minimised if the preparations are started well in advance and along with the planned communication strategy for all stakeholders. It is important that all involved parties are aware of the dimension and scope of the tasks which are required from them and dedicate the appropriate resources to performing those tasks. Collecting and validating the necessary data and creating a new process that will support new standards from the moment they enter into force will be among the most time-consuming tasks.

The possible impact on the real estate market

Shortening lease terms

Due to the fact that the new accounting regulations indicate a necessity to transfer lease obligations to a company's balance sheet, pressure to shorten the terms of leases may be felt. In Poland rental agreements are currently usually concluded for a five-year period. So break options, e.g. the option to terminate the contract after three years, may become more popular.

On the other hand, the new IFRS16 accounting standards may have a positive impact on older office buildings, as landlords of those are more willing to offer shorter rental periods than the owners of recently completed or planned office developments. A three-year lease concluded for an older asset will have a smaller financial impact on a company's balance sheet.



„Sale and lease-back"

Sale and lease-back transactions will, in JLL's opinion, also be affected by the new changes introduced by IFRS16: arrangements where the seller of an asset leases back the same asset from the purchaser will be even more rare. One should note that such solutions have never been popular on the Polish real estate market, and new lease accounting rules may result in even further limitation of sale and lease-back deals.

The owned property vs. leased property

The new IFRS16 may result in the opposite situation than described above, namely that companies will look to acquire their own property or to build space for their own use rather than leasing it. However, one should take into account that the process of securing a plot and constructing an office building is rather complicated and time-consuming, and it requires specialist knowledge. Furthermore, construction activity is not interesting for the majority of companies or does not constitute their primary activity. The acquiring of an existing office building designated for own use is possible, but sellers will require a price which is similar to that for a fully-rented development, or will offer only a small discount on such a price. An important issue arising from such a solution is also connected with difficulties in adjusting the size of a building to the actual needs of a company, and thus the probable need to rent the surplus space, and to manage the tenants of such spaces. The purchase may also be complicated because only a limited number of investors are willing to sell partially vacant investments for a discounted price. Companies could, for example, acquire partially leased properties and occupy the remaining vacant space, but the chances of finding such a building on the market are very low. One should also take into account that owning properties, as compared to leasing office space, is not a flexible solution, particularly when company increases its headcount and thus needs to provide a larger office to meet the requirements of its employees.

In our opinion, these restrictions will constitute a significant barrier for companies considering the purchase of properties, although we do not, of course, rule out a certain amount of activity in this market segment.

A possible solution that will certainly emerge in the real estate market is the development of entities that will lease substantial parts of office buildings (entire floors or several floors) or even entire properties for, for example, 10 years and then rent out that space for shorter periods of time. It can be assumed that dedicated operators renting out large areas in specific office buildings will appear. In order to minimise the risks related with subleasing activity, and in exchange for offering potential tenants flexible rental periods, such space may be offered at rents higher than the market average. Some companies have already taken their first steps towards such activity.

Co-working projects, which usually offer very small office spaces, mostly to freelancers and start-ups, and recently more often to even large corporations, operate on a similar basis.

For potential investors, property leased by the aforementioned companies will be characterised by a higher risk factor than that for a building with a typical signed lease agreement and occupied by a well-known corporation with an established market position. This situation will last until the operators of such spaces gain a strong and stable market position, along with suitable brand recognition, which may take several years.

Co-working

The new IFRS16 accounting standards may even result in the faster development of flexible and co-working office spaces.

The main advantage of the providers of such office spaces is that they can offer short and flexible leasing agreements. The co-working sector is already experiencing record-breaking growth, and developers have noticed the significant potential of this type of product and started to invest in it.

With the introduction of new accounting standards we believe that this type of office space will gain in attractiveness over the next few years, including among larger corporations, as such projects offer the chance to sign short-term leases of less than a year in length, which under IFRS16 do not have to be included in a company's balance sheet.

The new accounting standard will gradually change the Polish office market. However, one must remember that demand for office space in our country is constantly growing, particularly in cities outside of Warsaw. The overall impact of the new accounting regulations on take-up volumes should be limited, as the majority of companies here will continue to rent offices and not start their own developments. The main change will be to the flexibility of lease agreements, to which the market will slowly adjust.

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