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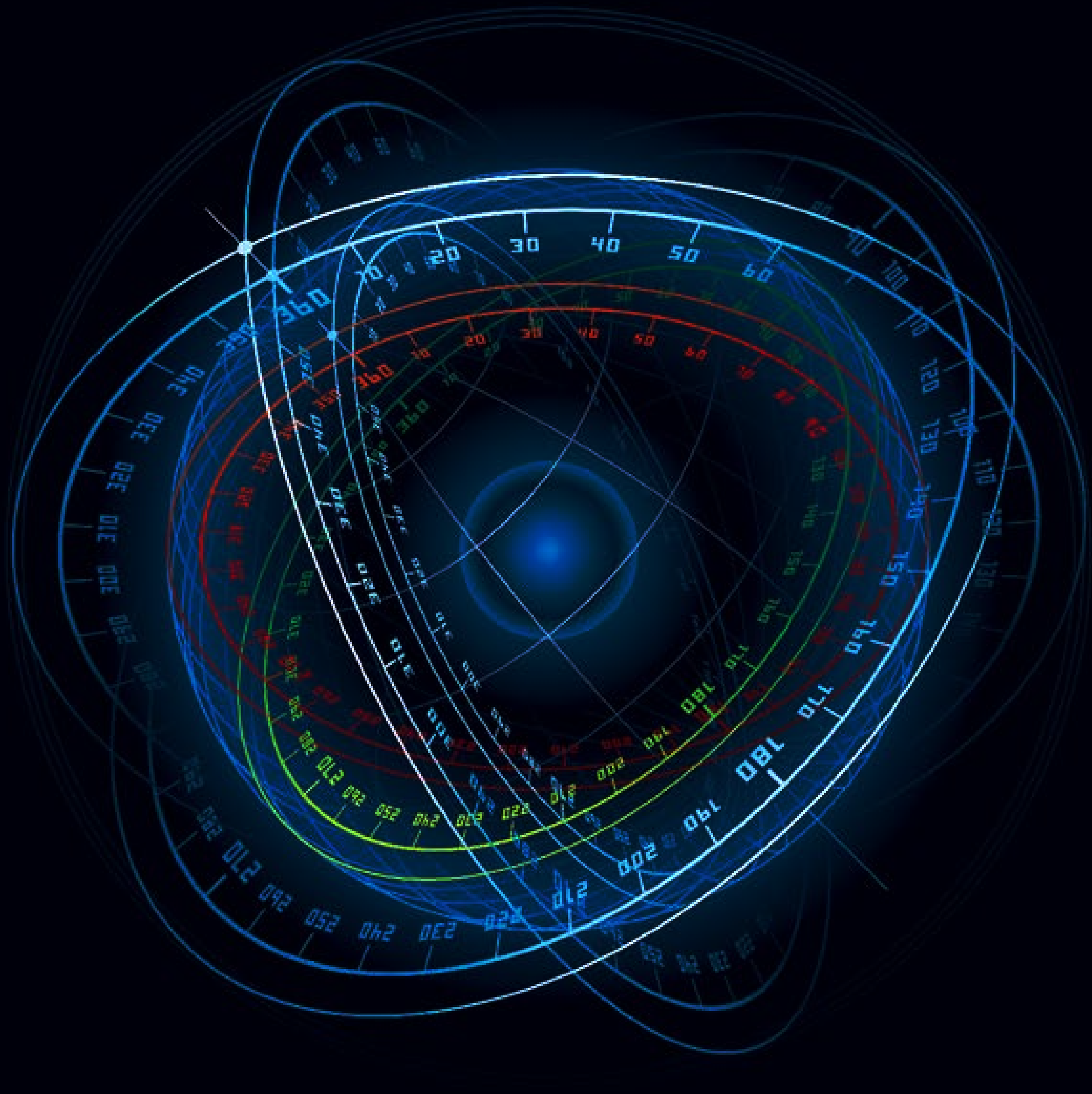

The Party is Over

IFRS 16 Leasing Assets and Off-Balance Sheet Financing

October 2017

Introduction

The new lease accounting standard – IFRS 16 – will bring all leasing assets on-balance sheet, which may significantly affect companies' key performance indicators, loan covenants and regulatory capital requirements.

Deloitte estimate in excess of R500 billion of future operating lease commitments will need to be capitalised by the JSE's Top40 companies come 1 January 2019. The sectors hardest hit by the effects of IFRS 16 include mobile telecommunications, personal and household goods, health care and real estate.

Mobile telecommunication entities can expect their assets to increase in the region of 30% – 35%, with corresponding liabilities rising by up to 50%.

Companies in the financial services industry may see third party liabilities increase by up to 1% of their current base exposure. Although this may not seem high, an accumulation of the effects of other regulatory requirements such as IFRS 9 and Basel III, will contribute to the ever-increasing capital requirements that these companies will be required to hold.

The effects of IFRS 16 will arguably hit the personal and household goods sector the hardest. The majority of these companies have significant operating lease commitments via retail outlets nationwide and globally. Deloitte estimates existing balance sheet liabilities to rise by up to 80%, which could materially breach loan covenant ratios that may be in effect.

Companies have long been permitted to exclude operating leases from their balance sheet. As a result, the Informed Investors, who are users of financial information may have struggled to determine the true financial obligations of a company. IFRS 16 now requires all operating leases, barring the exceptions of leases of low value assets and short-term leases, to be recognised on-balance sheet. This poses the risk of a breach in loan covenants come implementation date.

The ramifications of IFRS 16 are not limited to the balance sheet. Regardless of whether companies pay constant annual rentals, there will be a front-loaded expense in the income statement for most leases with operating lease expenses now requiring a split between depreciation and finance charges. This will undoubtedly affect key performance metrics including EBIT & EBITDA.

"One of my great ambitions before I die is to fly in an aircraft that is on an airline's balance sheet."

– Sir David Tweedie, Former Chairman of the IASB

In addition to altering the reported numbers, IFRS 16 is expected to significantly change the composition of the balance sheet. This is particularly relevant for companies with extensive operating leases as a core-financing element of their operations. The airline and retail sectors come to mind.

*https://www2.deloitte.com/za/en/pages/financial-services/articles/a-reporting-comparison-for-the-informed-investor-in-south-africa.html?id=za:2em:3cc:awa_FSIBS:fsibs_cl_email

With the looming effect of the new leasing standard around the corner, Deloitte poses the following questions to management teams in preparation for 1 January 2019:

1. Do you know which of the entity's contracts are, or contain, leases?
2. Are your systems and processes capturing all of the required information?
3. Are systems and processes capable of monitoring leases and keeping track of the required ongoing assessments?
4. Have you considered the use of IFRS 16's recognition exemptions and practical expedients?
5. Do you know which transition reliefs are available, and whether you will apply any of them?
6. Do you know what discount rates you will be using for your different leases?
7. Have you considered the impact of the changes on financial results and position?
8. How will you communicate the impact to affected stakeholders?
9. Have you planned when you will consider the tax impacts?
10. Have you considered whether your leasing strategy requires revision?

Deloitte introduces a proprietary tool for leasing. The Deloitte developed technology enhances the extraction of relevant data from lease contracts, maintains and stores historical records, automatically calculates the impact in terms of the requirements of IFRS 16 and generates the financial accounting journal entries for the client's reporting systems.

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