MAIA FINANCIAL

IFRS 16

CHALLENGES AND OPPORTUNITIES IN THE NEW LEASING STANDARD

Introduction

The IASB has published IFRS 16, the new leasing standard which comes into effect on 1 January 2019. This whitepaper outlines the findings of research undertaken with Australian corporates on their readiness for the new International Financial Reporting Standard 16 (IFRS 16).

In January 2018, Maia Financial conducted 250 interviews with Australian corporates to understand their plans for IFRS 16, a change which will have a significant impact on how organisations account for leases on their balance sheets.

The research found that organisations have a high level of awareness of the new standard, but many are yet to further analyse how it will change the way they engage with assets. Whilst businesses recognise IFRS 16 exists and that it's coming, there's still a significantly lower level of understanding on the more detailed impact of the new standard.

IFRS 16 is part of a greater shift in the way organisations engage with their assets, and it will encourage a trend to other asset procurement models

BALANCE SHEET TRANSPARENCY

IFRS 16 upon its implementation means that virtually all assets (with exceptions for smaller assets and those on leases of 12 months or less) will need to be shown on balance sheets, a move which will affect certain key financial ratios and performance metrics which are in common use. Under the IFRS 16 standard, a lease is underpinned by a definition of having the "right of control of an asset throughout the period of its use."

IFRS 16 is part of a greater shift in the way organisations engage with their assets, and it will encourage a trend to other asset procurement models.

THE TREND TO ACTIVE ASSET MANAGEMENT SERVICES

In a world where many organisations are facing capital and budgetary pressures, there is a growing preference for outsourced active asset management models.

If structured appropriately, active asset management may have the added benefit of aligning with assets as a service and the fees for these services may be accounted for as an operating expense through the recipient's income statement.

In short, while ownership of assets is increasingly being tested and displaced by outsourced active asset management, IFRS 16 may in time prove to be one further factor that reinforces this trend.

THE NEW STANDARD AT A GLANCE AND ITS IMPACT ON LESSEES

- All assets will be recognised on the balance sheet, with an exemption for assets of low value. The threshold is expected to be $5000*.
- Exempt are assets with lease terms of 12 months or less.
- Metrics such as EBITDA, EBIT, operating profit, ROE, and operating cash flows will be affected. This could have a flow on effect on credit ratings and impact on the ability to raise funds.
- Reported levels of debt and leverage are likely to increase for most organisations.
- There will be no difference between finance and operating leases under the new model.

* This figure is yet to be confirmed by the IASB.

The results of our research

Maia Financial interviewed 250 Australian businesses in January 2018, conducting direct telephone interviews with Chief Financial Officers, Business Owners and Company Accountants.

The organisations had annual turnovers from $50 million per year and upwards and were divided into three segments: $50 million to $100 million annual turnover, $100 million to $250 million, and $250 million and above. They were also divided into ten industry sectors.

JAPANESE FARMERS USE CLOUD TECHNOLOGY

In Japan farmers lease devices to increase fertility of cows, but what they pay for is the data which they produce and not the devices themselves.

Farmers need to manage their herds of cattle and this includes knowing the optimal time for insemination.

This window happens once every 21 days and for between 12 to 18 hours. When the cow is in this state, known as estrus, they walk more steps.

Enter technology giant Fujitsu with its cloud based GYUHO SaaS solution, which is a waterproof pedometer on the cow's leg. This sends data about the cow to the cloud, from where the information is relayed to the farmer by text message.

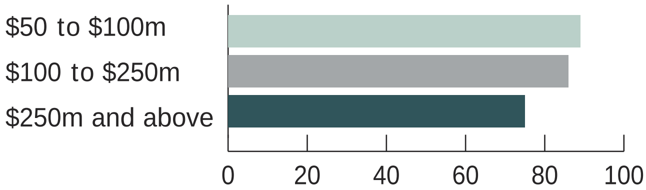
Using this information has boosted fertility levels on one farm from 44 per cent per impregnation to 90 per cent.

The farmers are paying to lease the equipment and not buying the equipment outright, this will now need to be shown on the balance sheet.

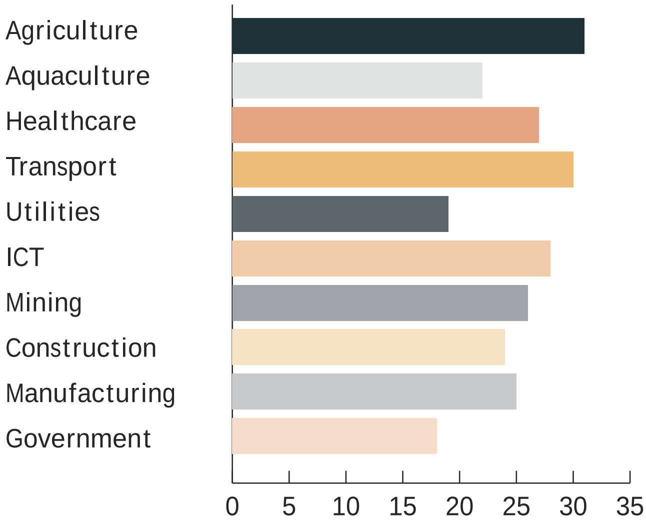
One of the key exemptions in the new standard is for lower value assets, with an expected threshold of $5000 or less when new. Only 47.2 per cent of interviewees said they were aware of this exemption.

Research sample demographics

Segment by annual turnover



Industry sector



Out of the total number of organisations interviewed, 97.2 per cent said that they were aware of the IFRS 16 changes.

Awareness was higher among larger organisations. Where 100 per cent of those with $250 million and above turnover were aware, the figure for the smaller $50 million to $100 million segment was 93.3 per cent.

Being aware of the standard, however, does not mean that an organisation has rigorously examined the impact. A total of 19.2 per cent of organisations said they were yet to assess the impact of the changes, with the figure for the smaller segment is 40 per cent higher.

While 93.3 per cent of the main Finance Executives in organisations with revenues of $50 million to $100 million are aware of IFRS 16, 40.4 per cent are yet to assess its impact.

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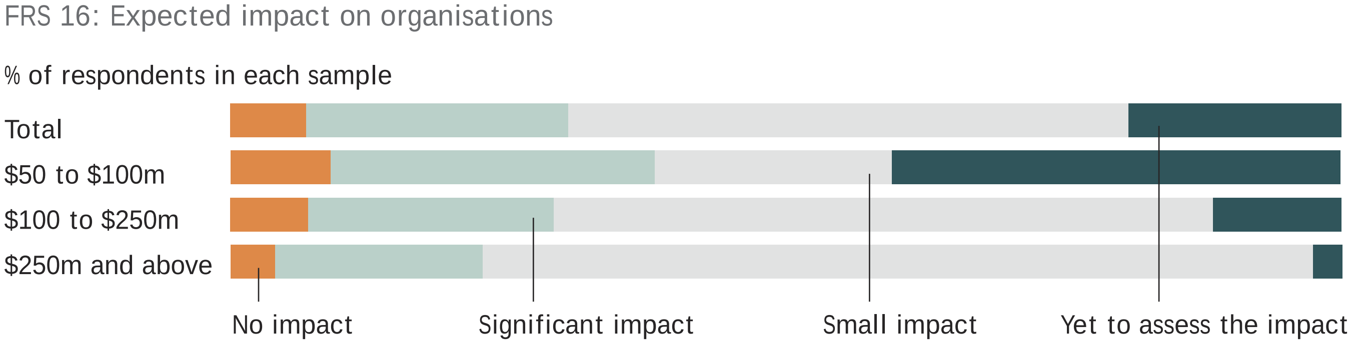
What is the IFRS 16 impact?



Just over half of the organisations interviewed (50.4 per cent) believe the impact of IFRS 16 on their operations will be small.

A further 23.6 per cent describe its likely impact as significant, while a much smaller 6.8 per cent believe it will have no impact at all.

Smaller organisations ($50 million to $100 million turnover) believe they will be more impacted, with 29.2 per cent saying the impact will be significant and only 21.3 per cent describing the likely impacts as small.

SECTOR DIFFERENCES

The Maia Financial research was able to compare responses from 10 different industry sectors, including the Government sector.

Capital intensive sectors such as Transport, Agriculture, Construction and Utilities are more engaged with the IFRS 16 changes, largely because they believe it will have a higher than average impact on them.

Where a total of 23.6 per cent of respondents said they anticipated the impact of the changes would be "significant," the figure in the Construction industry, for example, was 33.3 per cent. The result was the same 33.3 per cent in Transport, 25.8 per cent in Agriculture and 26.3 per cent in Utilities.

Where an average of 9.6 per cent of all businesses believe the new standard will have a "significant", impact on their credit profile, the results were higher in the Transport sector (13.3 per cent), Construction (12.5 per cent) and Utilities (10.5 per cent).

In the Agriculture sector 38.7 per cent said IFRS 16 would impact on their credit profile and ability to raise funds, compared with a total average of 28.4 per cent.

Agricultural organisations were also more likely to have considered options in how they fund and use critical business assets. 70.9 per cent from this sector say they have done this, against an average of 63.6 percent. In the Transport Sector, the figure was 76.7 per cent.

How are organisations reacting?

IFRS 16 will affect financial metrics and performance metrics such as gearing, current ratio, asset turnover, interest cover, EBITDA, EBIT, operating profit, net income, EPS, ROCE, ROE and operating cash flows.

These changes may affect loan covenants, credit ratings and borrowing costs, and could result in other behavioural changes.

While a total of 61.2 per cent of organisations say they have considered the impact on EBITDA, the balance of nearly four in ten have not.

EBITDA is the one metric which has received the most attention. 54.4 per cent have analysed the impact of the new standard on their financial gearing, while less than half — 48.8 per cent — have investigated RoA.

IFRS 16 could also have potential impacts on an organisation's credit profile. When asked for their assessment of this, 28.6 per cent of all organisations interviewed believe IFRS 16 will have a "minimal" impact on their credit profile and their ability to access funds, while 20.4 per cent say they won't be impacted.

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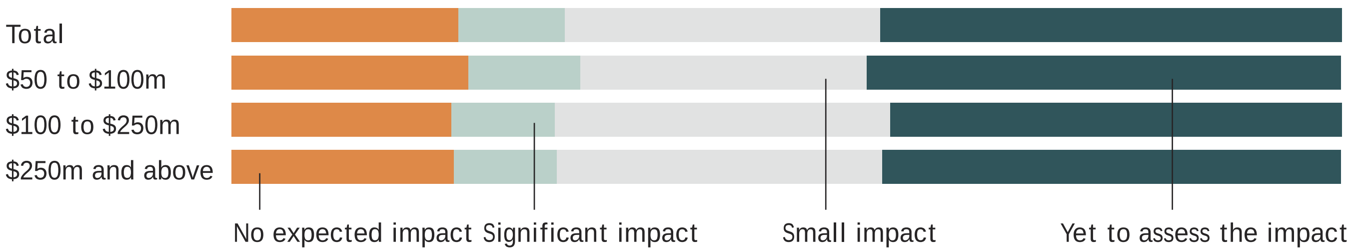
Yet 41.6 per cent of all organisations say that they are yet to assess how their credit profile will be impacted. A further 9.6 per cent have done the assessment, and say the impact on them will be "significant."

IFRS 16 could also result in organisations reporting higher levels of debt. In response to this, 30.0 per cent of organisations say that reporting higher debt levels would undermine their ability to raise funds, and another 18.8 per cent say they would respond by restructuring their debt.

While 12 per cent don't believe their debt levels will increase, once again nearly 39.2 per cent yet many organisations are still considering its full impact.

Impact of IFRS 16 on credit profiles, and ability to access funds

% of respondents in each sample



Options for engaging with assets

IFRS 16 has the potential to change the way organisations engage with and use critical business assets, and the majority of Australian businesses have considered different options.

Across the board, a total of 63.6 per cent of organisations say they have considered options, but once again the result is much higher for larger corporates.

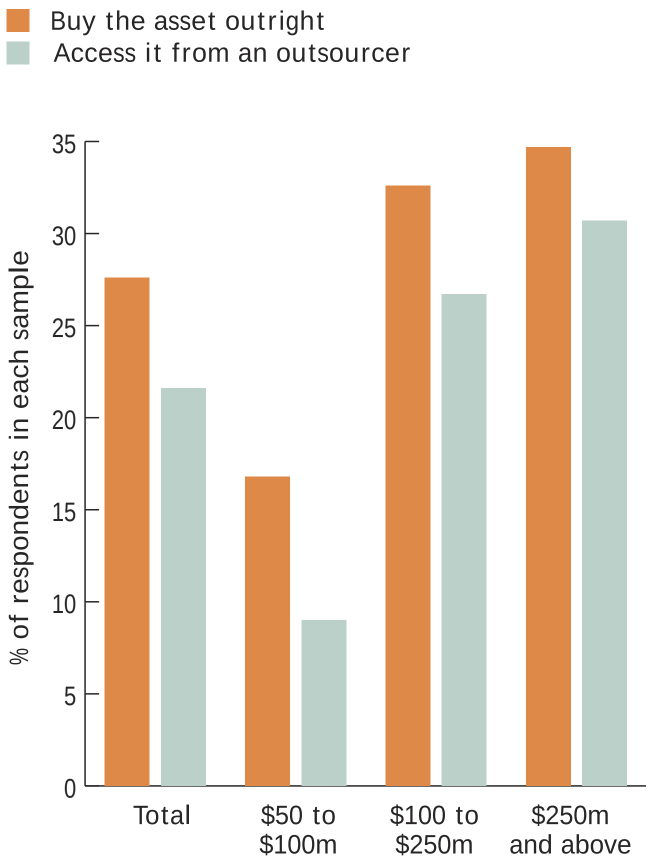
Of organisations with revenues of $250 million a year and over, 90.6 per cent say they have considered alternatives, while the result from the smallest segment ($50 million to $100 million) was 32.6 per cent.

The asset as a service model has some traction in these considerations. Asked to nominate which options they have considered, 21.6 per cent of all respondents said they had considered "obtaining the benefit of the asset from an outsourced supplier."

The most popular response to this question was from the 27.6 per cent who said they would be likely to buy the asset outright.

A significant proportion of respondents are yet to engage with this issue, with 36.4 per cent saying they were yet to consider any alternatives.

Options considered



Impact on IT expenditure

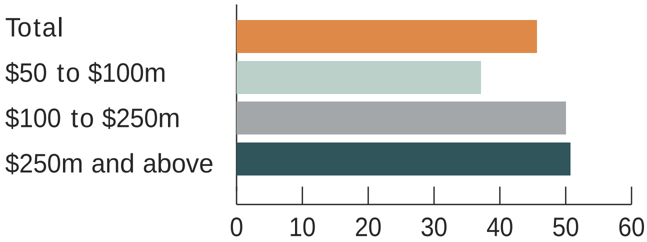
Organisations are split on whether they believe the new standard will add to their costs and compliance burden.

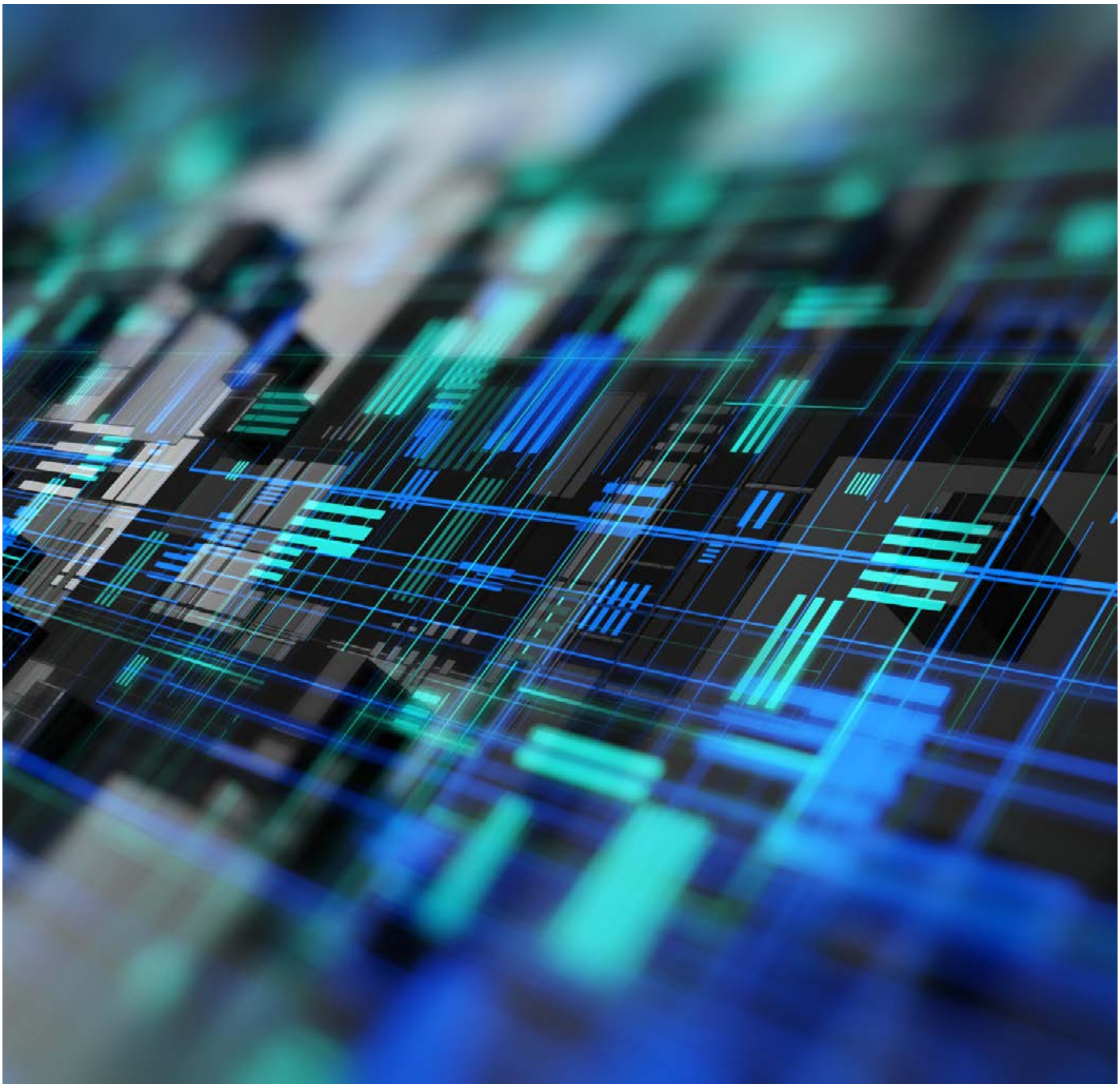
Across all organisations interviewed, 45.6 per cent believe IFRS 16 will require new investment and costs around IT and processes.

Among larger organisations, 50.7 per cent of those with $250 million or more in turnover are expecting higher costs, against only 37.1 per cent of businesses in the smaller segment.

Organisations expecting increased IT costs

% of respondents in each sample





Consultation will drive progress

Many Chief Financial Officers and Finance Managers are thinking about IFRS 16 only internally.

A majority are yet to reach out to their auditors, Consultants, Advisors or Finance Providers and have discussions on the implications of the new standard.

Across all organisations, only 41.6 per cent say they have had any of these external discussions.

Unlike some of the other research questions, this response was consistent across organisations of all sizes and across all sectors.

Six out of ten organisations are yet to receive an external viewpoint, or take advice, on how the changes will impact them.

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Maia Financial's research shows that whilst awareness of IFRS 16 is high, particularly for larger organisations, many are yet to assess the detailed impact.

The cost of IFRS 16 is likely to be larger for companies with material off balance sheet, however the significance of the cost will vary depending on the size of a company's lease portfolio. Whatever your views on the new standard, businesses should start planning sooner rather than later.

ABOUT MAIA FINANCIAL

Maia Financial is a leading, independent provider of asset finance and leasing solutions. Established more than 25 years ago, we have financed billions of dollars' of assets across a range of sectors, and business sizes. Our focus is on supporting businesses to achieve greater productivity and growth through effective management of their assets, and we are prepared to invest in helping you do this via a residual position in the assets. Our team is driven to deliver solutions that meet your business needs and which provide operational flexibility. This includes the ability to acquire, change or expand your asset base as the need arises.

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