IFRS 16 – friend or foe?

We all know that today the leasing process in most companies does not enjoy the same level of attention, resources, or automation as other finance functions. Poor controls, decentralization with inappropriate accountability, ineffective or inconsistent business processes, and incomplete information systems result in financial errors, cost leakage due to penalties and overpayment. More importantly, lack of visibility into the portfolio weakens strategic decisions. All of these issues exist despite the fact that the accounting for operating leases is fairly easy and straightforward under International Accounting Standards-17 Leases.

The recent FASB and IASB lease accounting changes will have a great impact on the way the finance department operates. After 2019, IFRS 16 will require companies to gather significantly more information to be compliant. The lessee will have to recognize the assets and liabilities on the balance sheet for both finance and operating leases with terms exceeding 12 months. This increases the risk for errors in an already flimsy process. It is fair to say that many companies are not happy with the new leasing standard. Critics of the new regulations foresee that bringing these assets on the balance sheet will distort reported figures owing to the huge impact it will have on the company's operations, taxes and financial position.

Besides reporting, other elements too make this an unfriendly change for those impacted.

Under IFRS 16 "a contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration" [IFRS 16:9]. This is a very generic definition, and it is clear that some of the assets subject to IFRS 16 are 'disguised' in the contracts. As a result, these are not categorised as lease contracts. This makes it very difficult for companies to understand the impact of the regulatory change. Therefore, as a start, all service contracts need to be subjected to a thorough analysis to determine the applicability of IFRS 16.

While the mechanics of the accounting can be debugged fairly quickly, the initial challenge will most likely be a data issue—collecting the contracts, abstracting the data, creating a database, and most importantly maintaining it on an on-going basis. This is a tedious activity that someone in the organisation must take ownership of and will not be an easy decision.

While real estate leasing process and portfolio are highly scrutinised and decently managed due to the high-value contracts, they only account for 5% of the total number of contracts. On the other hand, equipment leases are generally highly decentralised, involving many stakeholders and spreadsheets. The equipment leases are the tricky bit of the equation, but there is also good amount of cost-saving opportunity. Without getting into too many technicalities, the two main opportunities that arise from this recurrent situation are the lack of sourcing focus and competition for the lease spend and end-of-term savings.

Most companies with defined procurement processes source their capital equipment quite well. However, most overlook the financing (or lease) part of the transaction, since it is not considered a strategic sourcing category. The supply market of lessors is very different from the supply market for equipment. Quite frequently, companies just accept lease terms provided by the finance team of the equipment distributor without going through the sourcing process. Even a simple bid technique can bring estimated savings of seven percent.
Having the right number of financing partners will help better negotiate rates and clauses and it will make the whole process easier and more standardised.

Another cost-saving opportunity comes from a common practice in the financing industry. It is not a secret that most lessors attempt to make most of their margins at the end-of-term and they seem to be doing a good job. In a decentralized leasing process with no ownership and loose controls, it is very easy and quite common to miss end-of-term notifications, resulting in automatic extensions, penalties, and overpayment. The overpayment at a net present value could exceed the purchase cost of the equipment by 125 percent in a scenario where the lessee would decide to buy.

In short, it will be tough for the finance team to implement the new regulations from a judgement perspective, but also from a communication perspective, due to the many data points required from various functions to avoid financial errors. This would generate a significant extra effort to even get started.

Managing these leases without a structured process, strict controls, a comprehensive data repository and an effective workflow tool for other stakeholders such as Procurement and Treasury would be very challenging to say the least.

Compliance will thus not come at a cost. Instead, it will come with on-going savings.

On the other hand, since there is a significant potential of cost savings, the finance executives might find some good support in the Procurement organization and Operations Leaders to create a business case enabling optimization of the leasing processes.

If done properly, redesigning corporate leasing operations to become compliant and adopting the best practices can improve leasing financial performance and yield savings. Depending on the size and other factors, these savings may pay for costs of compliance, generating a return.

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Denisa Mares is a part of the Wipro Corporate Services Solutions team, focusing on Finance and Accounting services. With an experience of more than 10 years in finance outsourcing and shared service domain, Denisa has been designing successful processes and delivery models across multiple industries under global delivery environments.

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