Managing your leases during tough economic times

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Current economic climate

After a decade of sustained growth and stable economic conditions, there is no denying that the 2020s have brought repeated shocks to the market. In 2020, because of the emergence of the Covid-19 pandemic along with some of the worst bushfires in Australia's history, Australia experienced its first recession in almost 30 years. Likewise, the GDP of New Zealand and the United States has decreased in the first quarter of this year and economists are increasingly warning of a recession in 2023.

Given this climate of economic uncertainty, the team at Nomos One have been thinking about what actions property and finance teams may elect to take to reduce their risk profile, and how these strategies can best be implemented.

Cash is king

When the global market becomes more challenging, senior leadership often fall back on this adage. To reduce financial risks, leadership look to cut costs across their business, with every expense item being carefully examined. Procurement teams often switch from buying to leasing as an easy way to reduce significant upfront costs. Under this approach, the business retains a similarly sized asset portfolio (creating as little disruption to operations as possible) but contract terms and rates of expenditure are more flexible which allows for more strenuous cost-cutting measures to be introduced.

In particular: restructuring lease terms becomes a popular topic of conversation amongst property teams. Management may feel a lot more comfortable entering into lease agreements with shorter terms, or with the flexibility for the lessee to exit the contract at notice. While the certainty of entering into agreements with longer fixed terms can be of benefit, these are less likely to be prioritised over being able to rapidly shift procurement strategy in line with changing market conditions. And, if the economic climate deteriorates further, they will look to reduce cashflow by exiting agreements at the next available opportunity.

Challenges with implementing a more aggressive leasing strategy

Restructuring your asset portfolio to increasingly favour short-term leases is a lot easier said than done, and property teams will immediately face several challenges in managing their portfolio. Throughout the rest of this article, we look at these challenges in greater detail.

1. Which options to exercise, and which to terminate?

Where an organisation elects to begin reducing their property portfolio, this question is often at the front of mind of whoever maintains the portfolio. Property managers need to identify two things rapidly: which leases can be terminated while keeping business disruption to a minimum; and what are the legal implications of exiting any of these agreements as a priority? After all – a large surrender payment is the last thing that management are likely to want when cashflow is under a microscope.

To ensure that property teams can make the right decisions in these situations, a couple of things need to be prioritised. First – property teams need to access high-level information around their lease portfolio in a manner that is digestible, usable and tailored to their needs. Details such as renewal dates, payment details and information about the property being leased need to be immediately accessible. Businesses which track key information around their leases in Excel will immediately find themselves on the backfoot. When these details are captured in spreadsheets, property teams are exposing themselves to a risk of information becoming stagnant and out of date. Multiple spreadsheets are likely being used by different team members, meaning that decision-makers have no single source-of-truth to inform decisions. Property teams need to consolidate all information within a single process or platform to ensure that managers are making decisions based upon accurate data.

Second – document management processes need to be cleaned up, so that property managers can access source documentation and easily identify their contractual obligations. If your business elects to exit an agreement, it is vital to have easy access to all contractual documents relating to the lease. Details matter in these kinds of situations, and incorrectly following an option notification process could result in the automatic renewal of a further term. Property teams often struggle with lease documents being located on local folders or within emails; and ensuring that these agreements are stored within a central repository can make a massive difference in helping property teams implement their business' procurement strategy.

2. What are the accounting implications of these changes?

As property teams implement their changing procurement strategy, it is vital to keep other internal teams informed – especially finance. The introduction of IFRS 16 (AASB 16) has resulted in a need for finance and property teams to closely align their operations, and that is going to be particularly necessary if businesses change their leasing strategy due to an economic downturn. Property teams might not always be aware of what implications their actions may have within the accounting space, so here are a few things to be aware of from the accounting perspective.

The calculation of a lease liability (and corresponding right of use asset) is based around three measures; the expected minimum lease payments, the expected term and the interest rate. The expected payments are not always as straight forward as you would think. Rent reviews, whether they are fixed, CPI or market reviews, all could change the regular rent amount being paid, and IFRS 16 requires users to determine these payments over the full expected term.

The expected term of the lease contract – not just the contractual term – includes the options which a business is reasonably certain to exercise. Property teams will be continually assessing any upcoming renewal and exit options, however because the expected lease term is used in the calculations, the finance team needs to be kept up to date with these assessments looking forward. This becomes more important when more contracts with flexible terms are signed up to.

Interest rate is the other key component of an IFRS 16 lease calculation, and this is often a measure that reflects a business's incremental borrowing rate (IBR) – though it could be a rate implicit in the contract. A business's IBR is most commonly a reflection of the business' rate that they would likely incur if they had to arrange financing for a purchase of the equivalent asset being leased. This rate impacts the amount of interest expense being incurred and reflects the cost of financing instead of purchasing the leased asset. During turbulent economic times, interest rates move more and more frequently. When interest rates fluctuate, businesses will require the lease calculation rates be updated too and this could be a time-consuming task for those with large leased-asset portfolios.

3. Integrating your lease management and lease accounting processes

So far, we have discussed lease management and lease accounting as separate priorities. The truth is: these processes are deeply interconnected, and the actions of lease managers will directly impact a finance team's ability to comply with their reporting requirements. As discussed above, an agreement's expected term and payments are vital components of the lease liability calculation. These details are vital for effective reporting, but they do not sit within a finance team's direct control. Changes to the rent or term length will be negotiated directly between the landlord and a business' property or procurement teams, and there is no guarantee that updated details will be passed through to finance following the completion of this negotiation. This can create real problems for organisations, especially ones who might be completing their IFRS 16 calculations through Microsoft Excel. These organisations require lease administrators to pass through updated details to their finance teams, and if those lease administrators do not engage with their counterparts in finance, there is a risk that a business' IFRS 16 calculations will become out of date. That risk will be amplified when property teams do not clearly understand their involvement in the lease accounting process.

An easy way to mitigate this risk is to invest in a shared platform which can be used across your property and finance teams. If your business is considering purchasing lease management or lease accounting software, we would encourage you to consider Nomos One. Nomos One is software specifically designed to help businesses govern their leasing portfolio. It is a system which is easy to use, helps finance teams to report under IFRS 16, and allows for agreement and asset reporting. Importantly, it is designed to be a platform that can be used by both property and finance teams. Property teams can complete and document changes to their agreements using a simple 4-step workflow, which will automatically update the system's lease calculations. This ensures that finance teams always have visibility across their portfolio, with updates happening as soon as they are entered by a property manager. As a cloud platform, there is never a risk of team members working off different, out-of-date spreadsheets – Nomos One's reporting suite will always display the most up-to-date information about a business' lease portfolio. Nomos One also is a SAAS (software-as-a-service) business, meaning that the system is periodically updated to address any developments under the standard or across the industry. These features (alongside many others) will help to ensure that your business can navigate any tough times which might be ahead.

If you have questions about this white paper or wish to explore Nomos One as a software solution, please get in touch with us here.

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