IFRS 16 – New Lease Accounting Standard

1 February 2016

The International Accounting Standards Board has issued a new accounting standard on leases, IFRS 16.

The main change introduced by the standard is that all leases will be brought onto the balance sheet, increasing the visibility of companies' assets and liabilities.

The new standard is effective for accounting periods commencing on or after1 January 2019 for companies preparing their accounts under International Accounting Standards. Early adoption is allowed.

LESSORS AND LESSEES

The new standard covers both lessors and lessees. The changes under the new standard for lessors are fairly minor. The following analysis will therefore cover lessees only.

THE OLD RULES

Under the old rules, a lease was classified as a finance lease and reported on a company's balance sheet when the lease was economically similar to purchasing the asset. All other leases were classified as operating leases and not reported on the balance sheet, and the lease expense was typically reported in the income statement on a straight line basis.

CLASSIFICATION UNDER THE NEW RULES

Under the new rules, all leases are effectively classified as finance leases.

BASIC ACCOUNTING TREATMENT FOR ALL LEASES

The new treatment broadly follows the old rules for accounting for finance leases. All leases are capitalised in the balance sheet. The amount capitalised is the present value of the lease payments and a corresponding financial liability is recognised. The asset is depreciated with the charge appearing in the income statement in the usual way. The unwinding of the discount gives rise to an annual interest charge.

SERVICE CONTRACTS

Service contracts do not fall within the scope of the leasing standard. They will continue to be dealt with separately, the cost and liability being recognised once services have been provided. Where a contract includes both a lease and a service contract, but does not attribute values to each element, judgement will be required to apportion the cost between the two elements.

EXEMPTIONS

The new standard does not require a lessee to capitalise an asset held under a short-term lease (ie less than twelve months) or for low value assets. There are rules to counter the use of the short-term exemption for certain leases with variable terms which may last for more than one year.

EFFECTS OF THE NEW STANDARD

Where a company has significant leases that were treated as operating leases under the old rules, the new rules are likely to give rise to the following changes:

BALANCE SHEET

Non-current assets and financial liabilities will both increase.

INCOME STATEMENT

Over the longer term, the overall charge to the income statement is unlikely to change under the new rules. However, whereas under the old operating lease rules the cost of a lease was charged on a straight line basis, the new rules will typically see a higher charge in the early years due to higher interest costs and depreciation charges exceeding lease payments in those years.

FINANCIAL METRICS AND DEBT COVENANTS

Many financial metrics including key financial ratios will be affected. Gearing ratios and EBITDA will generally increase whereas current ratio and asset turnover will decrease.

Many credit agreements include debt covenants based on financial ratios and other figures taken from the income statement and balance sheet. It is fairly common for agreements to allow a borrower to continue to calculate covenants based on accounting standards in place when the loan was executed. However, where this is not the case and for loans taken out in future periods, covenants will need to be considered under the new rules.

This summary covers the main changes under the new standard. There are further points that have not been covered in this summary. If you need more information or guidance, please contact us and we will be happy to help.

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