Issue 8 – February 2016

New Lease Accounting Standards

What is happening?

After a ten year review, the International Accounting Standards Board (IASB) has now published a new International Financial Reporting Standard 16 Leases (IFRS 16), which requires lessees (customers leasing an asset) to recognise assets and liabilities for most leases on the balance sheet. Lessor accounting remains generally unchanged. IFRS 16 will supersede the current lease standard International Accounting Standard (IAS) 17.

Will the changes affect my company?

The new lessee accounting rules will only apply to entities in the UK that report under EU adopted IFRS. Further detail is provided in the table below:

Reporting Standard Used	Are the new rules applicable?
UK Generally Accepted Accounting Practices (UK GAAP), Financial Reporting Standard (FRS) 101	Will be expected to apply IFRS16 once the European Union (EU) endorses this standard.
FRS102	Will only need to apply IFRS 16 if and when the Financial Reporting Council amends this standard.
IFRS for SMEs	Adoption is expected to follow thereafter but no timescale has been published.

What happens today?

Previously, a lessee would have to determine whether the lease is a finance lease or an operating lease. This is effectively done by assessing whether substantially all the risks and rewards incidental to ownership have been transferred. Contract hire arrangements are usually classed as operating leases because the risk and rewards of vehicle ownership remain with the leasing company.

Assets under finance leases and the corresponding obligations to make lease payments have to be recognised on the company's balance sheet.

Operating leases are generally charged to the profit and loss account on a straight line basis and referred to as "off balance-sheet" as the company does not recognise any asset on its balance sheet. Companies, however, have to make disclosures of operating lease commitments in the notes to their financial statements.

What is the new approach?

The new approach to lease accounting for lessees is to recognise the right of use asset and a lease liability on the balance sheet. For short term leases i.e. leases that are 12 months or less term (without an option to purchase) and leases of low value assets, there is an optional exception available to lessees to continue treat as currently i.e. recognising rentals as incurred.

The recognition of such assets by lessees is regardless of whether the lease is a finance or operating lease under the current accounting standard.

What types of the lease will have to be reported?
The calculation of the right of use asset is based on the financial components of the lease rental. This principle will apply to most assets being leased, such as property, certain office equipment, and motor vehicles. Some leasing companies may already include the details of the finance component in the invoice. If this is unavailable, then the lessee will be permitted to use an estimated figure which needs to be supportable.

What about costs relating to maintenance, fleet management and other service costs?
Charges for other services such as fleet management, vehicle service, maintenance, repair and accident management will need to be separately identified and accounted for as the standard only requires lessees to report leases and not service agreement. It is prudent to ensure these items are fully agreed with the lessee's auditor

What about contingent costs items that are related to the usage of the lease – i.e. excess mileage or de-hire charges?
While there is no specific guidance on these type of charges, costs that are regarded as contingent payments based on the use of the asset do not need to reported, and these should be agreed with the lessee's auditor.

What is the right of substitution?
The standard does not regard as "leases" – arrangements where the supplier of the asset has a substantive right to substitute the asset being used by the other party. This means that the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from the exercise of its right to substitute the asset. The substitution rights however require careful consideration and evidence of practical application.

Can a vehicle fleet be accounted for on a portfolio basis?
Rather than accounting for leases individually, there is scope to account at the portfolio level. Lessees applying this approach will need to demonstrate that there would be no material difference if each leased asset was considered separately.

What if the vehicle leased is not-material?
As with all accounting standards, preparers do not need to apply the new standard if amounts involved are not material. Judgement and consultation with the company's auditors would be needed to ensure this is correctly applied.

What if the original lease term is extended?
If the lessee has a formal option to extend the lease term, and it expects to do so, then the lessee would be required to calculate the value of the asset and include the period of the extension on its balance sheet.

In practice, as most vehicle leases are fixed-term closed end leases without formal options to extend, this requirement is unlikely to affect many lessees. If the leasing company has informally permitted their customers to continue using a vehicle after the lease term has expired – whilst awaiting delivery of a new vehicle, for example – the lessee does not have to account for the rentals for the period of informal use as a right of use asset. Instead the rentals in the informal extension period will be charged direct to profit and loss, as for leases than are less than 12 months (see below). This treatment will have to be agreed with the customer's auditor.

What about short term leases or rental vehicles?
Lessees renting or leasing vehicles for 12 months or less can elect to not apply the standard as there is an optional exemption available. In doing so, the lease payments for such items (i.e. leases less than 12 months) will continue to be charged directly to the profit and loss account.

When will the changes take place?
The effective date for the new standard is **1 January 2019**. Early application is permitted for companies that also apply IFRS 15. This will be subject to EU endorsement. The new standard will apply to the lessee's financial statements for periods beginning on or after 1 January 2019.

What transitional rules are in place?
Affected lessees will not have to report any leases that are to expire within 12 months from the effective date. If lessees view existing contracts as a service today and not as a lease then these can be ignored, but the new lease standard will apply to all new contracts that are entered into on or after the effective date.

Should lessees be concerned with the new standard?
Probably not - the changes will not affect the cash flows of lessees or the key benefits of leasing, which include, but are not limited to, the transfer of residual value and service, maintenance and repair risk to the lessor, and constant cash flows up to the end of the lease term.

The vehicle leasing industry has proved its value, sheltering firms from the risks associated with vehicle values and importantly ensuring that their working capital is freely available and not tied up in having to buy their own company vehicles.

While no one likes change, the global economic climate has made it imperative that a complete picture of a company's assets and liabilities is available to investors and users of company accounts.

Key benefits of leasing
Leasing will continue to provide businesses valuable benefits, including:-

- Fixed monthly payments
- Freeing up capital for investment and growth
- Removing activities associated with legal ownership – asset purchase and disposal;
- Access to latest technology;
- Complementary services by lessors such as maintenance;

These operational benefits have nothing to do with accounting, and they will continue to exist because they are valuable and the market will demand them. Reporting leases on a balance sheet does not take that value away.

What should lessees be doing now?
Affected lessees may wish to speak to their auditors or accountant to fully understand what changes will need to be made with the way the company prepares and reports its accounts. This may also lead to a requirement for system changes to accounting IT systems.

Useful links on the IASB website
Press Release
Effects Analysis – This describes the likely costs and benefits of IFRS 16 as well as providing detail on the new standard
Project page – Includes all the historic documents and links to the full standard (the full standard is available for a charge).