The new lease accounting regime

Landlords and tenants need to understand the impact of the IFRS 16 standard

ON LEASES

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In January 2016, the new international accounting standard for leases – IFRS 16 – was unveiled. It replaces accounting requirements introduced more than 30 years ago and is a major development in the way companies must account for lease liabilities on their balance sheet. In essence, real estate lease liabilities – ie the full rent due under the entire lease term – will need to be shown on a tenant company's balance sheet.

Compliance with the new standard is not required until 1 January 2019 but it is important for landlords and tenants to give proactive consideration to the implications of the requirements now. The changes introduced by IFRS 16 will not be relevant for companies currently using UK standards (such as the new FRS102) until they are updated to follow suit at some point in the future.

Current accounting treatment

Under the current international accounting standards, leases (of real or personal property) are classified as either operating leases or finance leases.

A finance lease is a lease that transfers to the tenant substantially all the risks and rewards of ownership of an asset. Finance leases of real estate will, with a few exceptions, only generally arise where the lease is clearly designed as a way of funding the eventual purchase of the land, for example by means of an option to buy the landlord's interest for a nominal sum after all rents have been paid. Consequently, most real estate leases are not finance leases but operating leases.

Finance leases must be shown on the tenant's balance sheet. On one side of the balance sheet the lease (ie the right to use the property throughout the term of the lease) must be shown as a depreciable capital asset, much as if the tenant were the outright owner. On the other side of the balance sheet, all future payments under the lease must be shown as corresponding liabilities. The longer the lease term, the greater the liabilities.

Operating leases, ie most real estate leases, meanwhile, do not currently appear on the tenant's balance sheet. Instead, the rent that the tenant pays merely appears in the tenant's income statement (ie the profit and loss account). Longer term liabilities under the lease are ignored.

New accounting treatment

Under IFRS 16, the distinction between finance leases and operating leases will disappear and all leases will be treated in the same manner. This new treatment is broadly similar to that currently seen for finance leases, so tenant companies will need to recognise an asset (being their right to use the underlying asset), and a liability (their obligation to pay for that asset) on their balance sheet.

Impact of the new regime

From 2019 full liabilities under real estate leases will need to be shown on the tenant's balance sheet. The new regime will also have an impact on a tenant's reported profit in its accounts.

Although IFRS 16 will not always have a major effect on reported net assets, it may make a substantial difference to gross assets and gross liabilities, changing ratios that are based on these figures. In particular, the recording of major new assets and the associated liabilities will change gearing ratios, showing a company's total debt as higher than before. For companies with financial covenants in existing finance documents based on total debt levels, the increase in total debt due to IFRS 16 could lead to breaches of those covenants.

Companies at risk of breaching their financial covenants with the introduction of IFRS 16 need to plan ahead and seek advice. Where necessary, companies should negotiate with lenders to reset the financial covenants entirely or agree some carve-out of the effects of the accounting change.

Consequences for real estate leases

Tenants may seek to limit the impact on their balance sheet by pushing for shorter leases. The new regime does not recognise tenant break rights as a way to limit the liabilities on a balance sheet unless that break right is more likely than not to occur. All the relevant facts and circumstances should be considered which could include factors such as the importance of the property to the tenant's business, costs of terminating the lease (eg relocation costs) and so on.

In practice, tenants may push for shorter leases with options to renew, which would reduce the rental liabilities on their balance sheets. This would only work if the options are not reasonably certain to be exercised. Tenants may push for protected leases under the Landlord and Tenant Act 1954 and rely on statutory renewal rights at lease expiry.

Additionally, it is possible tenants may seek longer rent-free periods instead of other incentives. For example, will they prefer longer rent-free periods to cash fit-out incentives to reduce balance sheet liabilities? In practice, it is unlikely the accounting policy will drive the commercial deal to this extent. Also, it is uncertain whether this will achieve the accounting aim anyway.

Landlords are likely to face increasing pressure for shorter lease terms. Perhaps there will be an increase in serviced office space demand to minimise rental liabilities on balance sheets.

The new regime will encourage market rent reviews over fixed rent reviews to minimise the liability. However, there will be less certainty over the amount of future rent increases.

Overall, tenant companies will need to consider how the IFRS 16 changes will affect their business and plan for the legal and accounting changes sooner rather than later.

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