

Leasing under IFRS 16

(Lecture B1119 – 15.38 minutes)

Entities applying IFRS or FRS 101 will be required to adopt IFRS 16 for periods of account beginning on or after 1 January 2019 which will change the accounting treatment for leases. The main change will affect the treatment for the lessee.

Currently, lessees and lessors are required to make a distinction between finance and operating leases. Where the lessee has substantially all the risks and rewards incidental to the ownership of an asset (a finance lease) it recognises a finance lease asset and liability on its balance sheet. Where the lessee does not have substantially all the risks and rewards incidental to the ownership of the asset (an operating lease) it recognises lease payments as an expense over the lease term. This treatment will continue under the Financial Reporting Standard 102 (FRS 102), the main Financial Reporting Standard applicable in the UK and Republic of Ireland.

The new accounting standard will remove the distinction between finance leases and operating leases for a lessee. Going forward under IFRS 16 a lessee will recognise all leases on its balance sheet other than certain exempted leases which are of low value or are short term.

Lessors will still need to distinguish between operating and finance leases in establishing how to account for the lease in their books – there should be no substantive change to the way they recognise the lease when converting to IFRS 16.

This measure introduces legislative changes to ensure that certain rules which relied upon the distinction between finance and operating leases for lessees will continue to operate as intended to ensure that taxation of lessees is broadly consistent regardless of which accounting framework is adopted.

S53 FA 2011 was introduced in anticipation of these accounting changes but before the new accounting standard was settled. S53 has the effect of disregarding for tax purposes most changes in the accounting treatment for leases after 1 January 2011 (unless the new method was similar to existing UK GAAP). That legislation is now repealed. This removes the requirement that a lessee, adopting IFRS 16 recalculate for tax purposes its lease accounting using the frozen accounting policy.

Changes to long funding leases

The long funding lease rules in Part 2 of CAA 2001 provide that where a plant or machinery lease is in substance a funding lease for the lessee (because the effect of the lease is substantially equivalent to the lessee having borrowed funds to acquire the asset) the lessee is entitled to claim capital allowances on the asset even though they are not the legal owner. The changes ensure that those rules will continue to apply as intended for an IFRS 16 lessee. This is achieved through a lessee using IFRS16 having to determine if they would have accounted for the lease as a finance lease had they been required under GAAP to determine if it was a finance lease or not (ie if the distinction had existed).

The legislation is amended so that there is no deemed disposal and reacquisition where a long funding lease is reclassified upon the mandatory adoption of a new accounting standard. The following example is given in the explanatory notes:

A lessee uses IFRS or FRS 101 and has a long funding operating lease which has three years left to run as at the 31 December 2019. In its accounts for the year to 31 December 2019 it is required to adopt IFRS 16 and moves from accounting for the long funding operating lease as an operating lease to accounting for the lease under IFRS 16, recognising a right-of-use asset and a lease liability. Section 70YA does not apply and the lease will continue to be taxed using the rules for a long funding operating lease without any deemed disposal or reacquisition.

A lessee of plant and machinery using IFRS 16 will have a long funding finance lease if the lease is not short and it meets either the lease payments test or the useful economic life test. There is no need to distinguish between long funding operating leases and long funding finance leases for a lessee using IFRS 16 because all leases will be accounted for in the same way. Furthermore, this measure will ensure that a lessee using IFRS 16 with a long funding finance lease will be able to adjust the deduction claimed in certain circumstances where the rentals increase or decrease.

The schedule makes several simplifications to the tests to identify a long funding lease which are not connected to the accounting standard changes. A short lease is a lease with a term of less than 7 years (before it was a lease with a term of less than 5 years with some leases of terms between 5 and 7 years being caught too). The lease payments test is met if the present value of the minimum lease payments is equal to 80% or more of the fair value of the leased plant or machinery with the present value of the minimum lease payments being calculated by using the interest rate implicit in the lease (being the interest rate that would apply accordance with normal commercial criteria). A new amendment states that if the interest rate cannot be determined then it is taken to be 1% above LIBOR. For completeness, a lease meets the useful economic life test if the term of the lease is more than 65% of the useful economic life of the leased plant and machinery.

Interaction with corporate interest restriction

The CIR rules operate to limit interest and other financing costs that are deductible for corporation tax purposes. For leases classified as finance leases for tax purposes, any finance charges in the accounts are tax-interest amounts for CIR. For leases classified as operating leases for tax purposes, any finance charges in the accounts are not tax-interest amounts for CIR.

In particular, where a lessee has a right-of-use asset under IFRS 16, the legislation will require the company to determine whether they would have accounted for the lease as a finance lease if they were required to determine whether the lease was a finance lease or not for accounting purposes.

Therefore, lessees will not suffer any interest restriction on amounts paid in respect of operating leases. This means effectively that this change in the legislation will not have any impact for the purposes of CIR. Any adjustments on change of accounting policy will also be excluded from the CIR provisions.

Transition from IAS 17 to IFRS 16

The transitional provisions on change of accounting treatment are amended for these provisions. The transitional provisions apply where a lessee treats a lease as a right-of-use asset under IFRS 16 and had not previously accounted for the lease as a finance lease. These will have effect for a period of account beginning on or after 1 January 2019.

There are three methods permitted to transition from IAS 17 to IFRS 16 where the lease is an operating lease under IAS 17:

1. Prospective application (simple method) – the lease liability is recognised on 1 January 2019 (for a calendar year-end company) as the present value of the lease payments to be made from that date. The lease asset will be set equal to the liability, but is then adjusted for any accrual or prepayment relating to the lease at 31 December 2018 (which would be perhaps where rent had been paid in advance, or there was a rent-free period which is being spread over the lease term).
2. Prospective application (complex method) – the lease liability is the same as in 1. above. The asset is calculated using a retrospective approach but using the interest rate on 1 January 2019.
3. Full retrospective application – each lease is recalculated from its start date on the presumption that IFRS 16 had always existed.

2. and 3. will result in a debit or credit to retained earnings and this debit or credit will be recognised for tax purposes using a spreading approach as described below.

The calculation steps result in a lessee spreading all adjustments recognised in consequence of adopting IFRS 16 across the average length of the leases which have given rise to those adjustments.

- Step 1 requires the lessee to calculate the net debits and credits brought into account for each lease. The legislation ensures that the net amount includes only amounts recognised in retained earnings which are in consequence of the transition to IFRS 16.
- Step 2 requires the lessee to calculate a percentage for each lease (“the relevant percentage”) by dividing the amount under Step 1 for that lease by the total amounts for the lessee for all leases found under Step 1.
- Step 3 requires the lessee to multiply the relevant percentage found under Step 2 by the remaining period outstanding in days of the lease as at the date of transition. The term of a lease is determined in accordance with generally accepted accounting practice.
- Step 4 requires the lessee to calculate the mean of all periods under Step 3. This will be done by adding together all of the amounts calculated under Step 3.
- Step 5 sets out that the spreading period is the number of days found under Step 4 beginning with the day on which the first period of account begins.

The following table illustrates these steps through an example, assume that the table below sets out details of four leases held by a lessee who adopts IFRS 16 on 1 January 2019. This is taken from the explanatory notes to the FB2019 provisions:

	Step 1	Step 2	Step 3	Step 4
Lease	Transitional debit/(credit) to retained earnings	Weighting percentage A/SUM (A1-An)	Remaining lease term on IFRS 16 adoption	Mean lease period
Lease 1	£(10,000,000)	26.32% (10m ÷ 38m)	1,826 days	481 (=1826 × 26.32%)
Lease 2	£ 8,000,000	21.05% (8m ÷ 38m)	730 days	154 (=730 × 21.05%)
Lease 3	Nil	Excluded	1,826 days	Excluded
Lease portfolio	£ 20,000,000	52.63% (20m ÷ 38m)	1,461 days	769 (=1461 × 52.63%)
Overall	£18,000,000 debit	1,404 days		

Step 1 – Calculate the net debits and credits

Calculation included in the table gives the figure of £18,000,000.

Step 2 – Calculate the relevant percentage – each amount is calculated by dividing the net amount by the total (treating the debits and credits as if they were added together not netted off)

Step 3 – Calculate the remaining lease term

Step 4 – Calculate the mean of all periods

Step 5 – Calculate the spreading period.

The spreading period is 1,404 days. If the lessee had a period of account which ran from 1 January 2019 to 31 December 2019 they would claim as a deduction £4,679,487 (=365 ÷ 1,404 × £18,000,000).

Note that if the lessee ceases activities, it can bring in any amounts not already relieved on cessation.

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