MOORE STEPHENS

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Technical Newsletter

The new leases standard

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HKFRS 16 Leases (the “New Standard”)

It’s been a long, long wait but we finally have the Hong Kong Standard dealing with leases, HKFRS 16.

It will still be a few years yet before the first financial statements are published which have to comply with the New Standard, since it is effective for periods beginning on or after 1 January 2019, although early adoption is allowed.

Even given this timing, companies affected will need to consider the effect on their financial statements quite soon. Some companies will see major changes to their statements of financial position, and some change to their reported financial performance. Where they have loans with covenants, companies will need to consider the effect that the changes will have on compliance with those covenants. Where breaches of covenant are likely, or reasonably possible, talking to lenders before the change hits accounts will be crucial.

Who will be affected?

There are some changes to the guidance dealing with the definition of a lease, and in particular more detail is provided on determining whether a contract conveys the right to use a particular asset. But nonetheless in most cases companies will find that their arrangements under the old and new guidance will be the same. What will change is how some of those leases are treated.

The New Standard covers all leases, whether the company acts as lessor or lessee.

The changes for lessors, however, are fairly minor. Whether lessors currently have finance leases or operating leases, or both, the New Standard largely carries over the current accounting model so will not lead to major change.

Lessees with existing finance leases will also find the changes do not make that much difference. Finance lease lessees already account for an underlying asset and the financing of that asset through that lease. They will continue to do so.

It is those who have operating leases as lessees who will be most affected by the changes.

Changes for lessees

The Hong Kong Accounting Standard, HKAS 17 Leases draws a distinction between finance and operating leases, depending on the terms of the lease such as its duration, the amounts payable and any options that may be included in the contract. Finance leases then give rise to the recognition of an asset and a financing liability, whilst operating leases are not recognised in the statement of financial position but treated as giving rise to an expense spread over the term of the lease. It is this distinction which disappears under the New Standard.

In future, all leases will be treated in the same manner. The new treatment is broadly similar to that of a current finance lease - companies will recognise an asset, being their right to use the underlying asset, and a liability representing the present value of their obligation to pay for that asset.

Effect of the changes

Where a lease is recorded under the New Standard, having previously been treated as an operating lease, this will not always have a major effect on reported net assets. But it may make a substantial difference to gross assets and gross liabilities, changing ratios that are based on these figures.

Where a company is a party to substantial leases, the recording of major new assets and the associated liabilities will change gearing ratios, showing total debt as higher than before. Where a company has loan covenants based on total debt levels this may lead to breaches simply due to the accounting change.

There will also be some effect on reported financial performance, although that will vary between companies. Current operating leases are nearly always spread evenly over their life, so the charge is constant. Under the new rules, the total charges will consist of two elements - the depreciation of the asset and the interest charge arising due to the financing. The depreciation will normally continue to be on a straight line basis, but the interest charges will be weighted towards the earlier part of the lease period. So whilst ultimately the total lease charges over the lease life will be the same as they were before they will be more front-loaded, with higher charges in the earlier years and lower charges in the later years. Obviously, the effect of this will be greatest on companies with just a few substantial leases, or even just one - those with a large portfolio of leases at various stages may find that even though the charges on each lease change, the overall charges remain broadly the same.

The standard setter has been at pains to stress that not all of the changes will lead to the accounts appearing to give a more negative view of a company. Operating cash flows, for example, will often increase, since some of the cash flows currently shown as operating outflows will be categorised as attributable to financing. However, whether or not that will change operating cash flows depends on how interest costs are currently categorised in the cash flow statement.

Distinguishing leases and service contracts

There is a difference between a contract that is simply a lease and one that includes a lease, but also contains other elements.

Many contracts contain a lease, that is they deal with the provision of an asset, but also cover services that will be provided, whether directly in connection with the asset or otherwise. It is only the asset element of the contract that falls within the scope of the lease Standard. The service element will continue to be dealt with separately, and no liability will be recorded until the services have been provided, as before.

Contracts that deal with both assets and services will often not attribute values to each element, and given that the commercial obligation is to pay for both there is no real reason why they should have to. Despite this, under the New Standard an allocation of total amounts payable will need to be made between the amounts attributable to the lease and amounts attributable to the service. Some judgements will often be required in making this allocation.

Determining values

The new model for all leases is broadly similar to the old model for finance leases. For current finance leases a lessee needs to determine the interest rate that should be applied to the lease to determine the amount at which both the asset and the initial liability is recorded. The liability is not the total nominal value of all the payments that will be made but the present value of those payments. Whilst this sometimes proves tricky, it is normally fairly straightforward given that the fair value of the liabilities is likely to be very similar to the fair value of the underlying asset.
The same basic idea will apply to all leases in the future.

This is likely to prove more complicated in practice than at the moment. Ideally, the interest rate inherent in the lease should be used, as it currently is with a finance lease. In practice, this amount will often not be known to the lessee. Where this is the case the amount will have to be estimated by reference to the lessee's incremental borrowing rate, not always clearly known and also likely to involve some judgement. There will not always be the 'sense check' of being able to compare the liability arising with the fair value of the asset. For example, if a company has a five year lease on a property it will not be able to compare the lease liability with the value of the property, since they will clearly be substantially different.

Exemptions

There are exemptions under the New Standard.

An asset and liability need not be recorded in respect of short leases, those of less than a year. To avoid this being used too widely, there are provisions covering leases with variable terms which may last for more than a year.

There is also an exemption for leases of small assets, which could basically be described as a materiality exemption.

Example

Background

- CC is a boutique retailer of children's clothes. They have entered into a 5 year lease of shop premises with Mall on 1 January 2016.
- The lease requires 5 yearly payments in advance of $25,000 (the first payment is 1 January 2016 and subsequent payments are 31 December).
- The interest rate implicit in the lease is 10%.

HKFRS 16 treatment

Years	0	1	2	3	4	5	Total
Payments	$25,000	$25,000	$25,000	$25,000	$25,000		$125,000
P.V.	$25,000	$22,727	$20,661	$18,783	$17,075	-	$104,247
Lease liability	$79,247	$62,171	$43,388	$22,727	-	-	
Right-to-use asset	$104,247	$83,397	$62,548	$41,699	$20,849	-	
Interest Exp		$7,925	$6,217	$4,339	$2,273	-	$20,753
Depreciation		$20,849	$20,849	$20,849	$20,849	$20,849	$104,247
P&L impact		$28,774	$27,066	$25,188	$23,122	$20,849	$125,000

Journals	Dr	Cr
1 January 2016		
Dr Right-to-use asset	$104,247	
Cr Lease liability		$104,247
Dr Lease liability	$25,000	
Cr Cash		$25,000
31 December 2016		
Dr Depreciation Exp	$20,849	
Cr Acc dep'n		$20,849
Dr Interest expenses	$7,925	
Dr Lease liability	$17,075	
Cr Cash		$25,000

How we can help

This summary does not cover all the changes required under the New Standard, but we are happy to help provide guidance on the changes that will affect your business.

Businesses come to Moore Stephens because of our specialist knowledge of reporting under HKFRSs and the wide-ranging advice and assistance we can give them.

Should you wish to discuss the implications of the New Standard to the preparation of financial statements, please contact your Moore Stephens director.

Moore Stephens CPA Limited
905 Silvercord, Tower 2, 30 Canton Road,
Tsimshatsui, Kowloon, Hong Kong
T +852 2375 3180
info@moorestephens.com.hk
www.moorestephens.com.hk