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IFRS 16 Leases – The impact on the hotel sector

It's been a long, long wait, but we finally have the international standard dealing with leases, IFRS 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, many hotel owners will need to consider the effect on their financial statements quite soon. Some hotel companies will see major changes to their balance sheets, and some change to their reported profits. Where they have loans with covenants, management 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?

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. The new standard largely carries over the current accounting model for both finance leases and operating leases so will not lead to major change. Lessor accounting has never been the main focus of the standard setter's interest, given that even under the existing model there has always been an asset recognised, and the IASB has decided not to make major changes to the nature of that asset. So property owners who lease their property to a hotel operator will see little change to their current accounting treatments.

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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 lessee, who will be most affected by the changes. Hence any hotelier who leases their hotel under an operating lease rather than owning it outright will be significantly affected.

Because lessee accounting is changing substantially whilst lessor accounting is not, there may be some oddities arising where hotels are owned by one company in the group and leased to another.

Changes to lessees

Current international standards draw 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 balance sheet 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. As a result, due to the long useful life of a building virtually all property leases, including those for hotels, currently only require disclosure in the notes to the accounts, but do not yet give rise to the recognition of any assets and liabilities.

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 asset and a liability, representing the present value of their obligation to pay for that asset.

So companies that currently lease their hotel, will find that in future they have to recognise their interest in the property as an asset in the balance sheet. At the same time, they will also be required to record a liability for their future payments under the lease agreement.

Effect of the changes

Where a lease is recorded under the new rules, having previously been treated as an operating lease, this will not always have a major effect on reported net assets. But given the size of many property leases, it may make a substantial difference to gross assets and gross liabilities, changing ratios that are based on these figures. In particular gearing ratios, as total debt will be higher than before. Where companies have loan covenants based on total debt levels this may lead to breaches simply due to the accounting change.
There may also be quite a dramatic effect on reportedly profit, although that will vary between companies. Currently 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 building 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 period 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. The effect of these changes could be quite substantial, particularly where the company operates just one hotel under a leased contract.

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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 the 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.

Determining values

The new model for all leases is broadly similar to the old model for finance leases. The liability and asset to be recorded is not the total nominal value of all the payments that will be made under the lease but the present value of those payments.

This is likely to prove more complicated 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.

Exemptions

There are exemptions under the standard.

An asset and liability need not be recorded in respect of short leases, those of less than a year. This is unlikely to be relevant for a hotel and to avoid this being misused, there are provisions covering leases with variable terms which may last for more than a year. So while very short term leases will be excluded, those with extension clauses will have to be considered in great detail and the lease terms closely considered.

There is also an exemption for leases of small assets, which could basically be described as a materiality exemption. Hence leases of catering equipment or audio equipment for example may potentially be ignored.

Other matters

Some other matters are dealt with in the standard, such as how to deal with variable payments and whether they are accounted for initially at best estimates or dealt with as and when they arise. Whilst such issues do not arise under most leases, hoteliers should look out for any unusual features of their leases since they may give rise to complex accounting issues.

What next?

- Consider whether current long term leases may be renegotiated with the landlord on shorter terms, to reduce the impact on the balance sheet.
- Begin preparation of transitional disclosures.
- Consider additional resources, eg time and staff, required to prepare the financial statements for the first year applying IFRS 16.

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 or provide assistance with the accounting adjustments required.

For more information or to discuss how we could help you with the transition, please contact us.

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