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HELPING SHARE GROWTH

**Accounting for leases and its significance for EMI and valuations**

The start of 2019 sees a new era begin for accounting for leases, with IFRS16 becoming effective for accounting periods beginning on or after that date.

The central objective of the new international accounting standard is to bring many more leased assets onto the balance sheet. In fact most leases that last more than one year, including property leases, will need to be brought onto the balance sheet under this standard.

As a result, the fair value of a leased asset will need to be calculated and recognised as an asset on the balance sheet and the matching liability will also need to be recognised. Therefore the immediate impact on the overall net assets of the company may be small.

However, this has been a controversial change and the focus of attention so far has been on its impact on the Income Statement. Instead of there being a rental expense for the use of the assets, in future this will be replaced by a depreciation or amortisation expense and a finance charge. Overall the effect on profit before tax may be quite small if the rental expense is similar to the total of the finance charge and the depreciation or amortisation. However, the impact on EBITDA – Earnings Before Interest, Tax, Depreciation and Amortisation could be substantial if there are substantial leased assets. As modern valuations are often calculated by reference to Enterprise Value, which is a multiple of EBITDA, this could have a material impact on market values and the theoretical valuations which share schemes over unquoted shares often require.

Furthermore, the increase in the gross assets of a company from recognising more leased assets on the balance sheet could mean that some companies in future will fail to qualify for EMI options because the £30 million gross assets test at grant will be breached. EIS schemes also have gross asset tests that could be effected.

Fortunately, most companies that award EMI options choose not to prepare their financial accounts under International Standards but prefer to use UK Accounting Standards, now consolidated into FRS102 or for micro-entities into FRS105. UK accounting standards are not yet taking the same approach. Instead, operating leases continue to be disclosed rather than included on the balance sheet. However, in general, UK accounting standards tend to follow changes in International Standards, so in November 2018 the ESOP Centre contacted the Financial Reporting Council (FRC), which is responsible for UK accounting standards, to try to establish their intentions regarding leased asset accounting. The FRC said there was no imminent intention to apply IFRS16 principles for leased assets in UK accounting standards, but that they have not ruled out following IFRS 16 at some point in the future and will be monitoring the implementation of IFRS16. Companies that have significant leased assets which want to grant EMI options will need to monitor developments in this area.

More information on EMI can be found here. If you would like to speak to us about EMI and understand more about the gross assets test, please contact William Franklin at william.franklin@pettfranklin.com or on 0121 348 7878.