Welcome to the March 2017 edition of Your Business - our regular round-up of news, views and advice specifically for growing companies, their owners, directors and shareholders. Get in touch with any of our team members if you have any questions.

What does the new IFRS 16 Leases standard mean for you and your clients?

If you're involved with leasing assets, IFRS 16 (the new leasing reporting standard) will affect your financial statements and the preparation you need to undertake in order to implement and maintain ongoing compliance.

The good news for lessors is that this new world of lease accounting doesn't hold too many changes, other than some additional disclosures. If you lease assets, however, then you should start preparing now for a transformation that has the potential to affect your business's KPIs, funding covenants and staff incentive schemes. So what should growing businesses start thinking about over the next few months?

A fundamental change

To date, it has been accepted that there are two types of leases: finance leases and operating leases. All this will change on 1 January 2019 (or 1 January 2018, if you early-adopt at the same time as the new IFRS 15 revenue recognition standard). From the implementation date, all leases - with the exception of short-term leases (those with less than twelve months duration) and low value assets (typically less than US$5,000 or £4,000) - will go on to the balance sheet as finance leases.

If this feels like tomorrow's problem, it's worth noting that there could be a significant impact on your comparative amounts, despite the transitional and grandfathering provisions. Even if you're not fazed by the task of working through the impact on the past, it's worth getting to grips with the future impact as early as possible so you can start managing stakeholder expectations and potentially renegotiating borrowing terms where there are gearing covenants.

Don't forget that entities that adopt IFRS are required to consider and disclose the impact of yet to be implemented new accounting standards on future financial statements, and that applies to financial statements to 31 December 2016.

So what should you start thinking about over the next few months?

Valuing leases – the challenges

The underlying business and its key cash flows remain the same before and after the implementation of the new financial reporting standard. So the adoption of the new standard should not alter the fundamentals of the business.

One of the drivers behind the new standard is increased transparency to allow greater comparability between businesses. With all leases going on to the balance sheet as finance leases, a valuation exercise will be needed to work out the value at which to recognise the asset and corresponding lease obligation. The process of accounting for the value of finance leases will not be new in most cases, so what is the big issue?

The challenges come in many forms:

- Bringing all leases on to the balance sheet and evaluating the carrying value of the lease obligation each year will give rise to greater balance sheet volatility than previously experienced. Depending on a business's KPIs, volatility in net asset value and key ratios, this could affect market perception
- A company's articles of association or funding terms may include a gearing related financial covenant. Bringing lease obligations on to the balance sheet may trigger a covenant breach.
- Although there shouldn't be a significant impact on profit before tax, there will be an increase in operating profit, finance costs and EBITDA because the rentals currently payable under operating leases are now being sliced up between a finance cost and depreciation. Again, this could have an impact for funding covenants that have an interest cover cap. Similarly, if you have an option or other staff incentive scheme linked to operating profit, the application of the new standard could trigger an earlier than expected achievement of targets.
- The allocation of cash flows within the statement of cash flows alters under the new standard, which may also have a bearing on financial covenants.

- Where you are providing a bundled service, part of the service agreement could be a lease. Such an agreement will need to be looked at closely to establish if it 'conveys the right to control the use of an asset in exchange for consideration'. After carrying out such an analysis, you may find yourself having to unbundle the contract for services into two or more components and account for the leasing and non-leasing components separately.
- Calculating the amount to bring on to the balance sheet requires an understanding of the minimum expected cash flows, how to deal with options to extend, residual value guarantees and identifying the interest rate implicit in the agreement, to name a few considerations. For new leases this may not be too difficult, but it may require more diligence for legacy leases.
- There are additional considerations where your lease payments are variable. Examples include indexed linked leases, leases with a usage linked element or a rent with a component linked to revenues.
- Having captured the legacy leases, you will need to quantify the impact relating to the prior years and identify the most appropriate transitional arrangements.

What are the tax implications?

Although changes in accounting practice will often affect the tax base of a company, the UK tax treatment of leases is subject to significant additional tax legislation based in part on the current leasing standards.

HMRC is at an early stage of policy development and is considering a range of new tax frameworks for both lessors and lessees under the new standard. It will announce its proposals prior to 1 January 2019 when IFRS 16 is due to take effect.

Managing the transition

The following suggestions may help ease the transition:

- Start as early as possible and don't underestimate the task.
- Start analysing your known operating leases. Look at the lease length and asset value if less than US$5,000 or £4,000, to strip out those short-term and low value leases. Focus your efforts on the long-term and high value leases.
- Review contracts for services agreements to identify if you have to unbundle – for example, a service agreement that includes fully-maintained equipment available for use or where the back office services have been outsourced, thereby creating a bundled lease and service agreement.
- Evaluate the likely financial impact on the current year and best estimate for the future. With the benefit of this knowledge you may well need to brief your broker and, where relevant, your Nomad if you are listed. Also consider including some explanatory paragraphs in your strategic report to avoid surprises down the line.
- Review your borrowing terms and your articles of association to identify any gearing caps. Where these exist and you anticipate a technical breach on adoption of the new standard, advanced discussions with your lenders might enable you to renegotiate caps or secure a waiver to recognise that the covenant calculation is 'frozen' under the old standard calculation.
- Review any staff incentive schemes and discuss the impact with employee representatives. The equitable and most transparent solution could be to agree on a 'frozen GAAP' solution.
- Make sure that your accounts team is trained on the operation of the new standard and that your accounting systems can capture the information needed for ease of on-going compliance.

VAT treatment of temporary workers – Tribunal decision expected soon

The highly anticipated decision from the Upper Tribunal in the Adecco case concerning the VAT treatment of temporary workers is expected soon, and it will be of major importance for businesses that use temporary workers.

During the appeal, Adecco argued that it only supplied introductory and payroll services to its clients and, as a result, was only liable to account for VAT on its commission charge. The temporary workers provided their services to the clients, and Adecco paid the temporary workers on behalf of the clients. Adecco was required to contract with the temporary workers in this manner, as a result of various changes to the Employment Conduct Regulations.

HMRC, however, contested that it was significant that there was no contractual relationship between the temporary workers and the clients, and argued that Adecco's contracts were incongruous with the economic reality. Consequently, HMRC stated that Adecco was making a taxable supply of staff to the clients, and Adecco was liable to account for VAT on the full consideration, which included the payments made to the temporary workers.

With the ultimate decision in this case pending, businesses with any concerns over the VAT treatment of temporary workers or tripartite arrangements in place, should consider contacting **Luigi Lungarella** on +44 (0)20 7516 2228 or llungarella@pkf-littlejohn.com.

Are you ready for the new tax year?

Tax planning is a year-round activity, but it takes on even more importance as the year end draws nearer. Taking appropriate action ahead of 5 April will help you and your business to remain up-to-date with changes to tax legislation and enable you to make the most of the available tax-saving opportunities.

There are a number of PAYE issues that growing businesses should have on their radar, including:

- Employer-arranged pensions advice, up to a value of £500, will be exempt for tax and NIC purposes under legislation to be included in the Finance Bill 2017 and will be effective from 6 April 2017.
- With effect from 6 April 2017, the benefit in kind taxable values of employer-owned assets made available for the private use of employees will be based solely on the period of time they are available to the employee. Previously, employees could be taxable on an annual value of the benefit even if it was not available for the whole of the tax year.
- The tax and NIC advantages of a large number of Salary Sacrifice Benefit in Kind arrangements will be removed with effect from 6 April 2017. Arrangements involving pensions, childcare, cycle to work and ultra-low emission vehicles (ULEVs) are exempted. Transitional arrangements will come into force for benefits provided under terms established before 6 April 2017, with a final cut-off date of April 2021 for ULEVs, accommodation and school fees, and April 2018 for all others.
- Guidance on the application of the new Trivial Benefits in Kind exemption is available on HMRC's website. The impact of this new legislation on annual PAYE Settlement Agreement (PSA) computations could result in significant savings for employers.
- Voluntary Payrolling of Benefits in Kind (PBIK) was introduced with effect from 6 April 2016, and has now been extended to include non-cash vouchers and credits tokens. Living accommodation and beneficial loans continue to be excluded from PBIK. Employers payrolling car and car fuel benefits from 6 April 2016 are not required to report information about these benefits on forms P46 (Car) and P11D. From April 2018, information on these benefits will need to be reported in the employer's Full Payment Submission (FPS), although employers can voluntarily start using FPS for this purpose from April 2017, providing their payroll software is compatible.
- The Finance Bill 2017 includes legislation setting the time limit for making good a non-payrolled benefit in kind at 6 July following the end of the tax year, and effective from the tax year beginning 6 April 2017.
- Budget 2017 included a consultation on the valuation of employer-provided living accommodation benefits in kind for tax purposes, and more generally on all other benefits in kind.

Our '**Year End Tax Strategies 2017**' guide provides a more detailed explanation of these and other changes and tax saving opportunities. For more information, please contact **Catherine Heyes** on +44 (0)20 7516 2237 or cheyes@pkf-littlejohn.com.

We hope you've found this issue useful. If people within your business would like to receive future issues, please send their details to Cathy Brown (cbrown@pkf-littlejohn.com).

Our specialist team is here to help. If you would like advice on any of the issues discussed in this newsletter, please contact one of our Growing Business specialists.

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