

## Newsalert

### Entry into effect of the IFRS 16 boosts EBITDA of IFRS-adopters

Effective from January 1, 2019, IFRS-adopters must account for leases pursuant to a new standard, IFRS 16, which eliminates the distinction between financial and operating leases by setting forth a common accounting framework.

Notably, under the new standard, an arrangement constitutes a “lease” when the lessee controls the use of an identified asset for a defined period of time in exchange for a given consideration.

Under the new rule, the lessee must account for within its balance sheet<sup>1</sup>:

- (a) the “right of use” of the asset (“RoU”) among its intangible assets<sup>2</sup>;
- (b) a “lease liability”, equal to the present value of the lease payments determined in accordance with the interest method<sup>3</sup>.

With reference to the P&L, the lessee is required to book the amortization of the RoU and interest separately. Furthermore, should the lease include additional services, the lessee may either account for the payments for services separately or consider all the payments as deriving from the lease.

Subject to a few exceptions, the above will have the potential effect of impacting valuations of businesses, such as:

- EBITDA will increase as rental expenses (previously included within costs) will be replaced with a depreciation charge in respect of the asset; and
- Net debt will increase due to a lease liability being reported on the balance sheet.

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<sup>1</sup> Unless in case of short-term leases (*i.e.*, less than 12 months) and low-value assets leases.

<sup>2</sup> The RoU is calculated as the sum of the lease liability plus any advance payment, initial direct costs and dismantling costs (if any), net of any incentive received by the lessee.

<sup>3</sup> Using a discount rate determined, in principle, at the beginning of the lease.

Consequently, IFRS 16 will have an impact on the financial ratios such as debt-to-EBITDA (expected to decrease) and net debt ratios (expected to increase).

While IFRS 16 has the advantage of a consistent treatment between owned and leased assets, care must be taken since, from a valuation perspective, net debt positions between different companies will not be easily comparable, since the net debt only represents the remaining lease period. So appropriate adjustments will have to be made.

The effects of the new accounting standard are even more disruptive if compared to the accounting treatment of leases under Italian GAAP, which – to present- have not been amended to mirror IFRS 16. Indeed, according to domestic standards, any lease arrangement gives rise to rental expenses to be accounted for in the P&L of the lessee, which is entitled to book and depreciate the underlying asset only after the exercise of its right to purchase such asset (if any).

From a tax perspective, the new accounting treatment is relevant for Italian corporate income tax purposes and, therefore, the lessee will tax income and deduct the expense<sup>4</sup> arising from the lease in accordance with the accounting qualifications provided by the IFRS.

Deep knowledge of these standards is key when pricing transactions.

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<sup>4</sup> In particular, deductibility of interest expenses should be ruled by Art. 96 of Presidential Decree no. 917/1986 and, therefore, the maximum amount of deductible interest expenses for the lessee would be equal to 30% of its EBITDA (computed based on the tax values of the entries composing the EBITDA).