Investment Property Forum

Investment Property Focus

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IFRS 16: Impact on the real estate industry

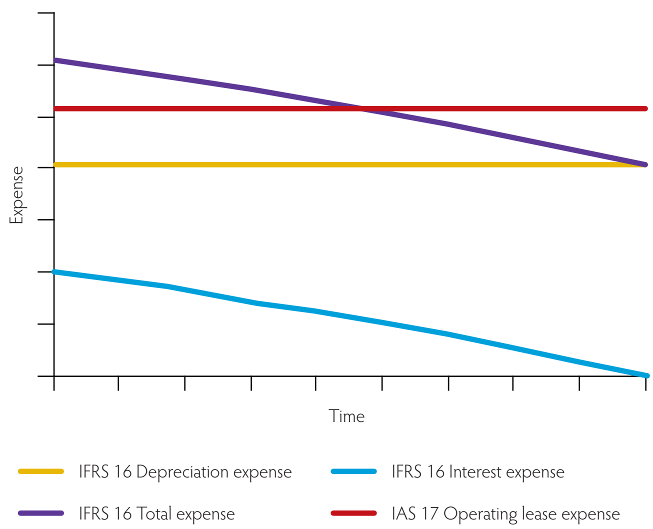
AVNI MASHRU & SANDRA DOWLING

PwC

In January 2016, the International Accounting Standards Board (IASB) issued a new standard, IFRS 16, 'Leases' that results in almost all leases being recognised on balance sheet; a significant change when compared with the accounting lessees apply today. This will transform many companies' balance sheets with the recognition of right of use assets and associated financial liabilities related to leased items. Outside of the balance sheet, depreciation of right of use assets and the accretion of interest on financial liabilities will result in recognising higher expenses in profit or loss during the earlier life of leases – see Figure 1.

Beyond the accounting impact, the new standard is likely to have significant business implications and will also impact key accounting metrics so clear communication will be required to explain the changes to stakeholders. But when it comes to leasing transactions, the vast majority of entities in the Real Estate industry will be the lessors. The new standard leaves lessor accounting unchanged, so is there any reason for concern?

Figure 1: **Pattern of expense recognition in profit or loss**



Why the new standard matters to the Real Estate industry

Although lessor accounting is unaffected, it's clear that's far from the case for the industry's customer base, its tenants (lessees). The retail industry is likely to be one of the most affected by the new standard, given the significant use of rented premises for their stores. The PwC Global Lease Capitalisation study published in February 2016 indicated that there would be a median debt increase of 98% for retailers (due to the recognition of lease liabilities), and 41% median increase in EBITDA (due to the exclusion of all lease costs).

In a wider context, both retail and commercial property leases can contain a number of common features such as renewal options and variable rental payments. Historically, tenants have accounted for such leases as operating leases recognising rental payments as an operating expense on a straight line basis and with no significant balance sheet impact.

The new leasing standard will not only have an impact on tenants' balance sheets, but also on operating costs, with a split of the expense between operating and finance costs. From a lessor perspective it is important to have an awareness of these impacts for tenants as they may influence market behaviour towards a preference for shorter term or more flexible leases with more types of contingent payment terms to minimise the amount recognised as lease liabilities. So what are the key requirements of the standard and what should the industry focus its attention on?

The new standard at a glance

When is the effective date?	The new leasing standard will become effective in 2019 and include pre-existing leases (however, there are some reliefs on transition).
Are there any exemptions?	A recognition and measurement exemption for short term leases and leases of low value assets is available as a policy choice. However, this is only available to the lessee.
What is the definition of a lease?	A lease is a contract (or part of a contract) that conveys the right to use an asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an identified asset and it conveys the right to control the use of that identified asset throughout the period of use. Each lease component should be identified and accounted for separately.
What is an identified asset?	An asset can be identified explicitly or implicitly. A contract does not depend on an identified asset if the supplier has a substantial right to substitute the asset.
What is the 'right to control the use' of an asset?	An entity has the right to control the use of an identified asset if it has the right to obtain substantially all of the economic benefits from the use of the asset and the right to direct the use of the asset, i.e. to decide how and for what purpose it is used.
When is an arrangement split into separate lease components?	A right to use an asset is a separate lease component if the lessee can benefit from the asset on its own (or together with readily available resources) and the asset is neither interdependent nor highly correlated with any other underlying asset in the contract.
What is recognised on the balance sheet?	Lessees will recognise almost all leases on the balance sheet (as a 'right-of-use asset' and 'lease liability'). Lessors will still distinguish between finance leases (recognise a lease receivable) and operating leases (continue to recognise the underlying asset).
How is a lease initially measured by lessees?	The lessee recognises: • a lease liability at the present value of future lease payments; and • a right-of-use asset to an equal amount plus initial direct costs and restoration costs.
What does a lessee recognise in profit or loss?	A lessee will recognise: • interest on the lease liability; and • depreciation of the right of use asset. Variable lease payments not included in the lease liability are recognised in the period the obligation is incurred.
Is lessor accounting affected?	IFRS 16 does not make any substantial changes to lessor accounting.

Key questions for the industry and its customers

Q: DO ALL ELEMENTS OF LESSOR ACCOUNTING REMAIN UNCHANGED?

A: The recognition and measurement guidance for lessors remains broadly unchanged. However, there are enhanced disclosure requirements for lessors such as the disclosures of an entity's risk management strategy in relation to rights retained in the underlying leased assets.

Q: WHAT TYPES OF ARRANGEMENTS MIGHT MEET THE NEW DEFINITION OF A LEASE?

A: Most property contracts for retail and commercial space are likely to qualify as leases. Such contracts will meet the key criteria for a lease being having the right to control the asset and obtaining the related economic benefits from that use.

There might be arrangements in the retail sector where the right of use of the asset is not so well defined and the tenant might not have the full economic benefit of the asset. This is especially the case in situations where the space allocated to the entity is not clearly defined, and/or the store owner has the right to substitute the available space having a significant impact on the customer's economic returns. Such arrangements might not meet the definition of a lease, and instead be considered as a service.

Q: WHAT MIGHT AFFECT TENANTS' IDENTIFICATION AND MEASUREMENT OF THE 'RIGHT TO CONTROL THE USE' OF AN ASSET?

A: In a property rental contract, the unrestricted use of a defined space, including control over the design by the tenant, control over physical access to the space, and control over use of the space will indicate a tenant's overall right to control the use of an asset. Dilapidation clauses whereby a tenant has the responsibility for returning the property to its condition at inception of the lease, and variable rental clauses are unlikely to affect the assessment as to whether the arrangement contains a lease, as they do not restrict the use of the asset.

Typically the real estate entity can only substitute the space of the tenant in very limited circumstances such as a need for major repairs. Assuming the real estate entity has an obligation to provide alternative space of similar standing and will cover relocation costs – this would not invalidate the assessment that the arrangement contains a lease. Most of the economic benefits relating to the use of the space would continue to accrue to the tenant.

The involvement of the real estate entity in maintenance, cleaning, security such as is often the case in a shopping centre would also typically not affect right to control the asset.

Q: WHAT AREAS MIGHT AFFECT THE LEASE LIABILITIES TENANTS RECOGNISE?

A: Lease liabilities need to be recognised at their present value, taking into account fixed payments and certain other payments that the tenant is reasonably certain to make, such as residual value guarantees, the exercise price of purchase or termination options and variable payments that depend on an index or rate.

Other types of variable payments are not included. This is likely to result in contingent rents based on sales being typically excluded from the lease liability, and accounted for in the period when sales are actually incurred.

A potentially critical element tenants will need to consider is renewal options that are market-priced but reasonably certain to be exercised, or where the tenant has a significant economic incentive to renew a lease (e.g. flagship stores in high street locations). In such cases, payments during the extended lease periods might need to be included in the calculation of the lease liability.

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH
www.ipf.org.uk