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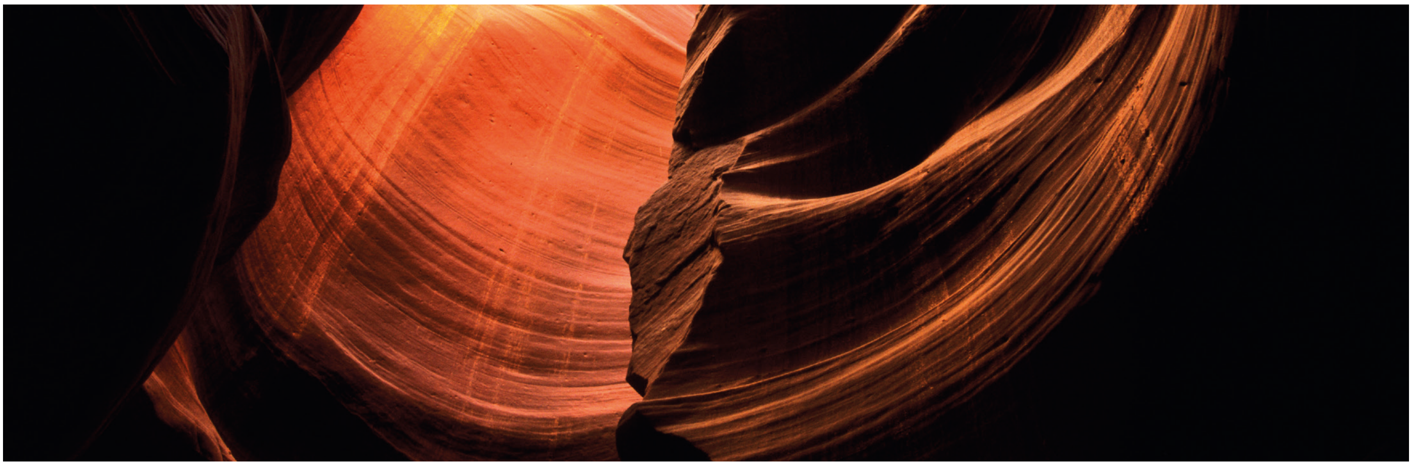


Point of view

Property occupiers: implications of the new leasing standard

In a nutshell

- IFRS 16 Leases has been published and is effective for periods beginning on or after 1 January 2019.
- Most property leases will come on-balance sheet for lessees, prompting recognition of a right-of-use asset and a liability for the lease component, but not the maintenance or other service component of payments.
- Straight line operating lease expenses will be replaced with depreciation and front-loaded interest.
- There is no requirement to estimate variable payments. Those varying with an index or rate are initially measured at the rate on the date of commencement, and are subsequently remeasured.
- For sale and leaseback transactions only the gain on the portion of asset not leased back is recognised immediately.
- Capturing all the necessary data for implementation could be a sizeable task. Two particular practical challenges will be determining appropriate discount rates and remeasuring the asset and liability when payments change.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 16 *Leases*. For lessees the new Standard brings most leases on-balance sheet under a single model similar to the existing finance lease model. However, lessor accounting, with the distinction between operating and finance leases, remains largely unchanged. The new Standard supersedes the previous standard and interpretations and brings in a new definition of a lease that will be used to identify whether a contract is, or contains, a lease. Subject to EU endorsement, IFRS 16 is effective for periods beginning on or after 1 January 2019, with earlier adoption permitted if IFRS 15 *Revenue from Contracts with Customers* has also been applied.

Implications for property occupiers

For property occupiers with large portfolios of leased properties such as retailers, hoteliers, and cinema operators, the additional assets and liabilities recognised on-balance sheet will be significant. There is approximately £305bn of retail property in the UK alone. In addition KPIs will be impacted including EBITDA, PBT, EPS and ROCE.

The Standard includes a practical expedient allowing the service components of lease payments not to be accounted for separately. However, if as seems likely property occupiers do not wish to follow that approach, an analysis of the payments into the lease and service components will be required. Where an entity has portfolios of leases with similar lease characteristics then the Standard permits the accounting to be on a portfolio basis using estimates and assumptions for the portfolio, if it is not expected to result in materially different accounting.

Occupiers should carry out an early assessment of the impact on their results, including the possible elections and transition provisions, and develop a plan for explaining this to their shareholders and stakeholders.

Operating leases coming on balance sheet

The main headline of IFRS 16 is that leases previously treated as operating leases will generally now be on-balance sheet. A lessee will recognise a right-of-use asset and a lease liability, and consequently a depreciation and interest expense in profit or loss. The limited recognition exemptions permitted are likely to be of relevance for a limited number of occupiers such as pop-up stores or those using serviced offices, given they relate to leases with a lease term of 12 months or less and leases of underlying assets which have a low value when new (for example, personal computers and small office furniture).

Variable rentals included if based on index or rate

Many property leases include variable rentals based on inflation or interest rates, or on turnover. Variable rentals are only included in the right-of-use asset and lease liability if they are based on an index or rate, such as the retail price index, with the liability initially measured by reference to the rate on lease commencement. Subsequently when the rental payments change, the liability and asset are adjusted which will mean additional complexity in terms of system requirements. Pure sales-based rentals are simply expensed as incurred rather than being estimated up-front.

Lease term and lease incentives

The new Standard has a similar definition of lease term to the existing standard, in particular it is still based on a reasonable certainty threshold, but with clarification that periods covered by a termination option are included if it is reasonably certain the termination option will not be exercised. Lease incentives will be included in the measurement of the right-of-use asset.

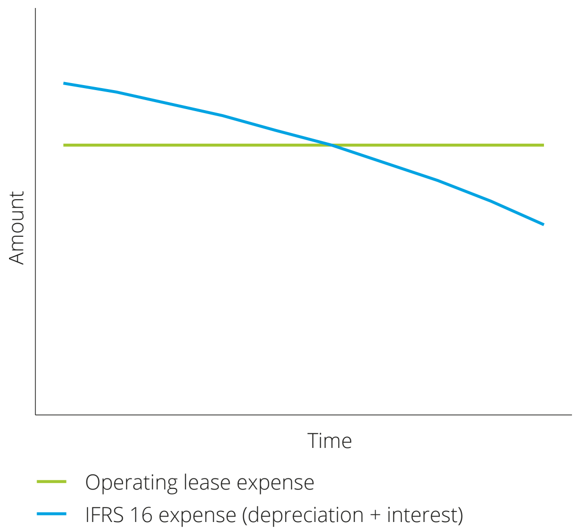
Profit recognition and KPIs

Where operating leases would typically have led to a fairly straight-line operating expense, under IFRS 16 this will be replaced by depreciation of the right-of-use asset and interest on the liability, boosting performance measures such as EBITDA.

Since depreciation of the asset will typically be straight-lined but interest on the liability will be front-loaded the overall expense profile on any particular lease will be front-loaded. Therefore at any point there could be a positive or negative impact on PBT, EPS or ROCE depending on the size and maturity of the lease portfolio, with less mature portfolios being negatively impacted due to the front-loaded interest charge.

On transition an entity will have the option to apply the Standard fully retrospectively, restating prior year figures, or taking some transitional relief, leaving the prior year figures unchanged, and measuring the liability and asset at the incremental borrowing rate at the date of initial application with an initial cumulative adjustment to the opening balance of retained earnings.

Change in overall expense profile upon adoption of IFRS 16 for an individual lease



Identification and capture of data

Capturing all the necessary data required to implement the new Standard and ensuring that it is a sufficiently robust basis for making material accounting entries is likely be a considerable challenge for many. In some cases careful consideration will also be required to assess whether a contract contains a lease. A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. If the supplier has the right to, and is likely to, substitute an asset and will benefit from doing so, an asset is not identified.

The Standard considers two examples of 'property contracts' to illustrate this point. The first is an analysis of a concession arrangement the terms of which give the customer a specified amount of floor space, for example within a department store where there is no identified asset, since it is likely to be beneficial for the supplier to move the concession around. The second example is the rental of a whole unit in a retail mall, the terms of which permit the supplier to move the tenant only in exceptional circumstances. Since those circumstances are considered unlikely at the start of the lease the unit is determined to be an identified asset and the contract a lease contract.

Unbundling the service component

IFRS 16 only requires lessees to bring the leasing component of a contract on-balance sheet. This is likely to be particularly relevant to multi-occupancy properties such as office blocks, industrial estates, and for retailers, shopping centres and malls. Any payments for services such as maintenance or security are not included in the lease liability and right-of-use asset, but expensed as incurred. The allocation of contract payments between the lease and service components is made on the basis of relative stand-alone prices, which may require considerable judgement to estimate.

As a practical expedient, lessees can elect to treat entire contracts that contain a lease as a single lease, removing the need for an unbundling exercise but increasing the liability and asset recorded.

Determining the discount rate – a practical challenge?

IFRS 16 requires the liability to be measured using the implicit rate of interest in the lease or, if that cannot be readily determined, using the incremental borrowing rate for a similar secured borrowing. Determining the rate implicit in the lease requires knowledge of the underlying asset's residual value and its fair value; information that is unlikely to be readily available to lessees. And, because property values are often expected to increase over time rather than decline, the pure mathematical approach to determining the implicit rate may produce unreasonable answers.

The Basis for Conclusions on IFRS 16 acknowledges that property yields (which may well be more readily available) can potentially be used as a starting point for determining an incremental borrowing rate. There will still be considerable judgement as to what particular adjustments will need to be made and it may require occupiers to understand more about the alternative use value of their estate.

How are subleases and sale and lease back transactions reflected?

A common scenario is for properties to be leased by an intermediate company and subleased to an occupier, or for properties to be leased and partially occupied with the remainder sublet. The intermediate lessor/ lessee will assess whether the sublease is a finance or operating lease by reference to the value and economic life of its right-of-use asset. When the sublease is classified as a finance lease the appropriate portion of the right-of-use asset will be derecognised and the net investment in the sublease recognised. Any difference will be recognised in profit or loss.

Many companies use sale and leaseback transactions of property as a means of raising finance. Under IFRS 16 the immediate gain recognised on such transactions will be lower than before. Whether there is a sale will be determined under IFRS 15, and if so an asset recognised for the right-of-use leased back. However, the gain on such transactions will only reflect the extent to which the right-of-use has transferred, in other words the right-of-use asset retained by the seller will be reflected as a portion of its previous carrying amount.

Where can I go for more information?

This publication highlights just some of the issues that will be of particular interest to property occupiers. More detailed information on the new Standard can be found in Deloitte's Need to Know publication, available at www.ukaccountingplus.co.uk.

If you would like to discuss any aspects raised in this report in more detail please contact one of the below at Deloitte:

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