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. KPIs will be impacted including EBITDA, PBT, EPS and ROCE.

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.

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. IFRS in Focus publication, available at www.iasplus.com.

Contact us:
If you would like to discuss any aspects raised in this summary in more detail please contact:

Ciarán O’Brien
Partner
cobrien@deloitte.ie

Sinéad McHugh
Partner
simchugh@deloitte.ie

Babar Khan
Senior Manager
babkhan@deloitte.ie

Brian Rajakovich
Manager
brajakovich@deloitte.ie
At Deloitte, we make an impact that matters for our clients, our people, our profession, and in the wider society by delivering the solutions and insights they need to address their most complex business challenges. As the largest global professional services and consulting network, with approximately 286,000 professionals in more than 150 countries, we bring world-class capabilities and high-quality services to our clients. In Ireland, Deloitte has nearly 3,000 people providing audit, tax, consulting, and corporate finance services to public and private clients spanning multiple industries. Our people have the leadership capabilities, experience and insight to collaborate with clients so they can move forward with confidence.

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte Ireland LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte Ireland LLP is a limited liability partnership registered in Northern Ireland with registered number NC1499 and its registered office at 19 Bedford Street, Belfast BT2 7EJ, Northern Ireland.

Deloitte Ireland LLP is the Ireland affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

© 2019 Deloitte Ireland LLP. All rights reserved.