Real estate leases

How will IFRS 16 impact real estate entities?

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Contents

Highlights

- The IASB has issued a new leases standard that requires tenants to recognise most rental contracts on their balance sheets.
- Tenants will apply a single accounting model for all rental contracts (with an exemption for short-term leases).
- Landlord accounting is substantially unchanged and the IAS 17 classification principle has been carried over to IFRS 16.
- Tenants that measure investment property at fair value will also measure leased investment property at fair value.
- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.

Overview

Real estate entities will need to change certain lease accounting practices when implementing the new leases standard, IFRS 16 *Leases*, issued by the International Accounting Standards Board (IASB). IFRS 16 significantly changes the accounting for lessees that are real estate tenants, requiring them to recognise most leases (i.e., rental contracts) on their balance sheets as lease liabilities with corresponding right-of-use-assets.

Landlord accounting is substantially unchanged from current accounting. As with IAS 17 *Leases*, IFRS 16 requires landlords to classify their rental contracts into two types, finance and operating leases. Lease classification determines how and when a landlord recognises lease revenue and what assets a landlord records. The profit or loss recognition pattern for landlords is not expected to change. This will be a relief for many real estate entities, because, based on the IASB's discussions during the project deliberations, landlords were concerned that there would be major changes in landlord accounting.

IFRS 16 requires tenants to recognise most rental contracts on their balance sheets as lease liabilities with corresponding right-of-use assets. Tenants apply a single model for most leases. Generally, the profit or loss recognition pattern will change as interest and depreciation expense is recognised separately in the statement of profit or loss (similar to today's finance lease accounting). However, tenants can make an accounting policy election, by class of underlying asset to which the right of use relates, to apply accounting similar to IAS 17's operating lease accounting to 'short-term' leases.

IFRS 16 could have far reaching consequences for real estate entities' businesses.

For tenants, recognising lease-related assets and liabilities could have significant financial reporting and business implications (e.g., decisions about whether to lease or buy property might change). Tenants may seek more flexible lease terms to manage the impact on their balance sheets and their financial statement ratios. This may potentially lead to a change in current business practices.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, has been or is applied at the same date as IFRS 16. Lessees must adopt IFRS 16 using either a full retrospective or a modified retrospective approach.

This publication summarises the new standard and describes some sector-specific issues real estate entities may want to consider. Like all other entities, they will also need to apply the new standard to leases of non-real estate assets, such as office equipment.

Our forthcoming *Applying IFRS, A closer look at the IASB's new leases standard*, will provide an in-depth discussion of IFRS 16. We refer to that publication as our *General Applying IFRS*. Refer to that publication for further information about the technical accounting topics and concepts discussed in this publication. In addition, our *IFRS Practical Matters, Leases make their way onto the balance sheet: Navigating the journey for a smooth landing* (EYG No. AU3725), is designed to help entities to understand the business impacts of the new standard. Refer to that publication for further information about the impacts of the standard and the steps entities should be taking to apply it. This publication summarises the key implications for real estate entities.

The views we express in this publication are preliminary as of May 2016. We may identify additional issues as we analyse IFRS 16 and entities begin to interpret it, and our views may evolve during that process.

1. Key considerations

1.1 Scope and scope exclusions

IFRS 16 applies to leases of all assets, except for the following:

- Leases to explore for or use non-regenerative resources
- Leases of biological assets held by a lessee
- Service concession arrangements
- Licences of intellectual property granted by a lessor
- Rights held by a lessee under certain licensing agreements (e.g., motion picture films, patents, copyrights)

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

1.2 Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of an identified asset.

The concept of an identified asset is generally consistent with the 'specified asset' concept in IFRIC *4 Determining whether an Arrangement contains a Lease*. Under IFRS 16, an identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a floor of a building). Even if an asset is specified, a customer does not have the right to use an identified asset if, at the inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising its right to substitute the asset.

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

(a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use

Or

(b) The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either:

   i. Has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use, without the supplier having the right to change the operating instructions

   Or

   ii. Designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus is on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also says that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

Real estate entities will generally reach similar conclusions on definition as they do today.

For most real estate contracts, the landlord does not have a substantive substitution right. Further, the tenant generally has exclusive use of the leased property and, therefore, has the right to substantially all of the economic benefits from its use. The tenant also generally has the right to direct the use of the underlying property because the tenant decides how and for what purpose the property will be used. For example, in a lease of a retail unit, the tenant generally decides the mix of products that will be sold and the sales price for those products, and has the sole discretion to change such decisions.

Property leases often contain clauses requiring the tenant to maintain the property and/or allow the landlord to inspect the condition of the property. Such clauses are designed to protect the landlord's interest in the property and are examples of protective rights, which do not, by themselves, prevent the tenant from having the right to direct the use of the property.

Is there a change?

While IFRS 16 provides new criteria for determining whether an arrangement meets the definition of a lease, we expect real estate entities to generally reach conclusions that are similar to those they reach today about whether arrangements are, or include, leases of real estate properties.

1.3 Identifying and separating lease and non-lease components and allocating contract consideration

1.3.1 Identifying and separating lease components

For contracts that contain the right to use multiple assets (e.g., a building and equipment, multiple buildings), the right to use each asset is considered a separate lease component if both of the following conditions are met: (1) the tenant can benefit from the use of the underlying asset either on its own or together with other resources that are readily available to the tenant; and (2) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

For example, the rental contract for an office building and an adjacent land parcel to be used for future development by the tenant will generally be considered to contain two lease components because the tenant could benefit from the commercial building without development of the adjacent land parcel.

1.3.2 Identifying and separating non-lease components of a contract

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For example, rental contracts for an office building typically include maintenance and security, which are non-lease components. For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other standards. For example, the non-lease components may be accounted for as executory arrangements by tenants (customers) or as contracts subject to IFRS 15 by landlords (suppliers).

IFRS 16 provides a practical expedient that permits tenants to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component.

Tenants that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Tenants are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, tenants estimate stand-alone prices, maximising the use of observable information.

Landlords are required to apply IFRS 15 to allocate the consideration in a contract between the lease and non-lease components generally on a relative stand-alone selling price basis. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the landlord must estimate the stand-alone selling price. IFRS 15 also provides suitable methods for estimating the stand-alone selling price.

Under IFRS 15,[1] a landlord allocates any variable payment amounts specifically related to its efforts to transfer goods or services that are not a lease component entirely to the non-lease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in IFRS 15.73.[2]

Although IFRS 16 does not specify the landlord's accounting for variable lease payments that do not depend on an index or rate, given that the IASB decided to substantially carry forward the lessor accounting model in IAS 17, a landlord recognises such variable lease payments as income in the period in which they are earned, consistent with current accounting. See section **5.3 Variable lease payments** below for further discussion of the accounting for variable lease payments.

1.3.3 Considerations for landlords – tenant reimbursements

Under IFRS 16, payments for maintenance activities, including common area maintenance (CAM) (e.g., cleaning the lobby of a building, removing snow from a

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1 IFRS 15, paragraph 85.

2 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

parking lot for employees and customers) and other goods or services transferred to the tenant (e.g., providing utilities or trash removal), are considered non-lease components because they provide the tenant with a service. As a result, landlords are required to apply IFRS 15 to allocate and recognise consideration related to reimbursements for CAM, maintenance activities and other goods or services provided to the tenant.

Landlords evaluate the criteria in IFRS 15[3] to determine whether the distinct services provided to the tenant are a single (or multiple) performance obligation(s). If the services meet the criteria to be considered a series of services that are "substantially the same and have the same pattern of transfer" to the tenant, they are accounted for as a single performance obligation. Any variable consideration received for performing these services may be eligible for the variable consideration 'allocation exception' in IFRS 15. That is, variable consideration (e.g., pro-rata reimbursement) is allocated to a specific part of the contract (e.g., a distinct month of services) and recognised, if both:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct service
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct service is consistent with the overall allocation objective of IFRS 15

This allocation exception is only used to allocate variable consideration.

Fixed reimbursements for services provided are allocated using the standard model in IFRS 15. That is, a landlord allocates the consideration in the contract between the lease and non-lease components using the general principles in IFRS 15 and recognises the consideration allocated to the non-lease components (i.e., the transaction price under IFRS 15) when (or as) it transfers control[4] of the services (i.e., when or as it provides the services) to the tenant over the term of the contract.

The landlord also considers whether it is acting as a principal or an agent with respect to the additional services provided when recognising the tenant reimbursement.

Is there a change?

IFRS 16 requires that landlords account for consideration related solely to services provided using the requirements of IFRS 15. If the variable consideration allocation exception criteria in IFRS 15 are met, the resulting pattern of revenue recognition for many arrangements may be consistent with how entities recognise such operating lease and lease-related revenue today.

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[3] Per IFRS 15, paragraph 23, a series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met: (a) each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 35 to be a performance obligation satisfied over time; and (b) in accordance with paragraphs 39-40, the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

[4] IFRS 15, paragraph 35, includes three criteria for evaluating whether control of a good or service is transferred over time. Contracts to provide services (e.g., maintenance) may meet the first criteria (i.e., "the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs"), but evaluation of each arrangement is required to reach this conclusion. Consideration from arrangements that do not meet the criteria for over time recognition is recognised at a point in time. Refer to our *Applying IFRS in Real Estate, The new revenue recognition standard – real estate*, March 2015 (EYG No. AU2978) for more information on IFRS 15.

In some leases, a tenant also may reimburse (or make certain payments on behalf of) the landlord that relate to the leased asset for activities and costs that do not transfer a good or service to the tenant (e.g., payments made for real estate taxes that would be owed by the landlord regardless of whether it leased the building and regardless of who the tenant is, payments made for the insurance that protects the landlord's investment in the building and the landlord will receive the proceeds from any claim). Under IFRS 16, such costs are not separate components of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components).

For such payments that are allocated to the lease component, landlords will need to evaluate whether they are fixed (or in-substance fixed) lease payments or variable lease payments. See section **5.3 Variable lease payments** below for further discussion of the accounting for variable lease payments.

Is there a change?

IFRS 16 does not specify whether tenant payments for insurance or real estate taxes on leased property are considered to be a separate good or service. Consistent with current practice, we believe that tenant reimbursements for real estate taxes imposed on an owner of a property are not a separate good or service and, therefore, would not be considered a non-lease component of the contract. The treatment of tenant reimbursements for insurance on leased property depends on the circumstances. For example, if the insurance protects the landlord's investment in the property and the landlord receives the proceeds of any claim, the landlord does not provide the tenant with an additional good or service and reimbursement for the insurance premium would not be a separate component of the contract.

1.3.4 Considerations for landlords – lease structures

As described above, real estate lease arrangements most often require that the tenant: (1) provides consideration (e.g., monthly payment) to the landlord for use of the leased space; and (2) separately reimburses the landlord for its share of operating costs (e.g., CAM, real estate taxes, insurance associated with the landlord's asset). However, other types of real estate structures also exist.

Certain real estate lease arrangements require the tenant to remit a single monthly payment that compensates the landlord for use of the property, including the related ownership costs of the building (e.g., taxes, insurance) and other services. Today, many landlords recognise the single payment received from these 'gross lease' arrangements as lease revenue on a straight-line basis. In contrast, IFRS 16 requires that entities determine whether such an arrangement contains non-lease components (e.g., maintenance or other CAM services) and allocate consideration to those components, based on their stand-alone selling prices.

Is there a change?

Identifying non-lease components of contracts (e.g., CAM) may change practice for some tenants and landlords. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for variable payments from an operating lease and executory contract) is often the same.

2. Lease classification

Under IFRS 16, landlords classify all leases in the same manner as under IAS 17, distinguishing between two types of leases: finance and operating. Landlords are required to reassess lease classification upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease) that does not result in a separate lease. See section **5.4 Lease modifications** below for further discussion of lease modifications.

Tenants, however, apply a single accounting model for all leases, with an option not to recognise short-term leases on the balance sheet. See section **4.3 Short-term leases recognition exemption** below for further discussion of short-term leases.

3. Landlord accounting

IFRS 16 requires landlords to account for operating leases using an approach that is substantially unchanged from IAS 17. That is, landlords continue to recognise the underlying asset and lease payments are recognised as income over the lease term, either on a straight-line basis or another systematic basis that is more representative of the pattern in which the benefits from the use of the underlying asset is diminished.

Under IFRS 16, landlords are required to account for finance leases also using an approach that is substantially unchanged from IAS 17. That is, landlords derecognise the carrying amount of the underlying asset, recognise a lease receivable[5] and recognise, in profit or loss, any selling profit or loss.

3.1 Subleases – intermediate landlord accounting

Under IFRS 16, an intermediate landlord accounts for the head lease as described in section **4. Tenant accounting** below and the sub-lease as described above. However, an intermediate landlord considers the lease classification criteria with reference to the remaining right-of-use asset rather than the underlying asset (e.g., building subject to a lease) arising from the head lease when classifying a sublease as finance or operating.

If a leased property meets the definition of investment property, the sublease is classified as an operating lease and the intermediate landlord elects the fair value model in IAS 40 *Investment Property* as an accounting policy, IFRS 16 requires the intermediate landlord to measure right-of-use assets arising from leased property in accordance with IAS 40. This represents a change from the current scope of IAS 40. Under existing requirements, this is an election that is available on a property-by-property basis.

An intermediate landlord generally accounts for a head lease (as a tenant) and a sublease (as a landlord) as two separate rental contracts. However, when contracts are entered into at or near the same time with the same counterparty or related parties of the counterparty, an intermediate landlord is required to consider the criteria for combining contracts (i.e., whether the contracts are negotiated as a package with a single commercial objective, the consideration to be paid in one contract depends on the price or performance of the other contract or the rights to use the underlying assets conveyed in the contract form a single lease component). If any criterion is met, the intermediate landlord accounts for the head lease and sublease as a single combined transaction.

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5 At the commencement date, the sum of lease payments receivable and any unguaranteed residual value, discounted at the interest rate implicit in the lease.

4. Tenant accounting

4.1 Initial recognition

At the commencement date of a lease, a tenant recognises a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset (e.g., a real estate property) during the lease term (i.e., the right-of-use asset).

Tenants measure the lease liability using the interest rate implicit in the lease, if that rate is readily determinable. If that rate cannot be readily determined, the tenant is required to use its incremental borrowing rate. In determining the incremental borrowing rate, the lessee may use observable rates such as a property yield when assessing a property lease, but must adjust the rate to determine its incremental borrowing rate.[6]

Tenants measure the right-of-use asset at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the tenant's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

4.2 Subsequent measurement

Assets and liabilities recognised by tenants for long-term leases of property could be significant.

Under IFRS 16, tenants are required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. When the right-of-use asset is depreciated on a straight-line basis, this will generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.

If right-of-use assets relate to a class of property, plant and equipment to which the tenant applies the revaluation model in IAS 16 *Property, Plant and Equipment*, the tenant may elect to apply that model to all of the right-of-use assets that relate to that class of property, plant and equipment.

Tenants will need to consider the effect of IFRS 16 on their financial statements. In many circumstances, assets and liabilities recognised for long-term property leases will be significant.

4.3 Short-term leases recognition exemption

Tenants can make an accounting policy election, by class of underlying asset to which the right of use relates, to apply accounting similar to IAS 17's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset (short-term leases). If a tenant applies this exemption, short-term leases are not recognised on the balance sheet and the related expense is recognised on a straight-line basis over the term of the lease or another systematic basis, if that basis is more representative of the pattern of the tenant's benefit. For leases of real estate, straight-line recognition is generally appropriate.

[6] IFRS 16, Basis for Conclusions BC162.

5. Other considerations

5.1 Initial direct costs

Under IFRS 16, initial direct costs are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant to incentivise that tenant to terminate its lease). Tenants and landlords apply the same definition of initial direct costs.

IFRS 16's requirements on initial direct costs are consistent with the concept of incremental costs of obtaining a contract in IFRS 15. Landlords' initial direct costs exclude allocated costs (e.g., salaries) and costs incurred regardless of whether the lease is obtained (e.g., fees for certain legal advice, estate agent fees not contingent upon success).

IFRS 16 requires landlords to recognise initial direct costs for operating leases as expenses over the lease term on the same basis as lease income. Landlords include initial direct costs in the initial measurement of their net investments in finance leases. However, initial direct costs related to finance leases of a manufacturer/construction entity (i.e., finance leases with selling profit or loss) are expensed at lease commencement.

Is there a change?

The revised definition of initial direct costs could result in some changes in practice for landlords. In addition to excluding allocated costs (e.g., salaries), which also are excluded under IAS 17, landlords' initial direct costs exclude costs that are incurred regardless of whether the lease is obtained (e.g., certain legal advice).

Sale and leaseback transactions will no longer provide seller-tenants with a source of off-balance sheet financing.

5.2 Sale and leaseback transactions

Because tenants are required to recognise most leases on the balance sheet (i.e., all leases except for short-term leases if the tenant makes an accounting policy election to apply this exemption), sale and leaseback transactions no longer provide seller-tenants with a source of off-balance sheet financing.

IFRS 16 requires seller-tenants and buyer-landlords to apply the requirements in IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. If control of an underlying asset passes to the buyer-landlord, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

Is there a change?

The new requirements are a significant change from current practice for seller-tenants. Under IFRS 16, seller-tenants must apply the requirements in IFRS 15 to determine whether a sale has occurred, which imposes new restrictions. Also, even if the criteria for a sale have been met, sale-leaseback transactions generally would no longer lead to an off-balance sheet financing.

5.3 Variable lease payments

Variable lease payments that depend on an index or a rate are included in lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). Variable payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset, are not included as lease payments.

Variable payments that are not based on an index or rate and are not in-substance fixed lease payments are recognised in a manner similar to today's accounting. Tenants recognise an expense in the period in which the event that triggers those payments occurs. Consistent with IAS 17, we believe, landlords recognise income in the period in which it is earned.

Under IFRS 16, tenants are required to remeasure the lease liability under certain circumstances, including when there is a change in future lease payments resulting from a change in an index or rate used to determine those payments. The tenant is required to remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect). For example, if the contractual rent payments change every two years and the change is linked to a change in the consumer price index (CPI) during the two-year period, a tenant would reassess the lease liability every two years when the contractual payments change, not each time the CPI changes.

Absent a lease modification, landlords are not required to remeasure the lease receivable for variable lease payments that depend on an index or rate.

5.4 Lease modifications

IFRS 16 requires lease modifications that meet certain criteria to be accounted for as a separate lease.

IFRS 16 defines a lease modification as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

IAS 17 does not address the accounting for lease modifications. Under IFRS 16, tenants and landlords of finance leases are required to account for a lease modification as a separate, new lease when both of the following conditions are met:

- The modification increases the scope of the lease by adding the right to use one or more underlying assets (e.g., the use of additional square footage of leased space) not included in the original lease
- The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original lease and the new lease.

For a lease modification that does not result in a separate lease (e.g., a change in the lease term) tenants generally remeasure the existing lease liability and right-of-use asset without affecting profit or loss. However, for a modification that decreases the scope of a lease (e.g., reducing the square footage of leased space), tenants remeasure the lease liability and recognise a proportionate reduction (e.g., the proportion of the change in the lease liability to the pre-modification lease liability) to the right-of-use asset. Any difference between those adjustments is recognised in profit or loss.

For landlords, a modification to a finance lease that is not a separate lease is accounted for as follows:

- If the lease would have been an operating lease had the modification been in effect at inception, the modification is treated as a new lease from the effective date of the modification. The landlord measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification.
- If the lease classification does not change as a result of the modification, the modification is accounted for in accordance with IFRS 9 *Financial Instruments*.

Landlords account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

Refer to our forthcoming *General Applying IFRS* for more details on lease modifications, including the accounting for a lease when the modification does not result in a separate new contract.

6. Business considerations and implications

Under IFRS 16, tenants recognise a lease liability and a corresponding right-of use asset on the balance sheet. Similar to current accounting, the definition of 'lease payment' excludes certain variable payments, and the 'lease term' includes only those renewal options that are reasonably certain of being exercised. As such, tenants may reassess their needs when negotiating their rental contract terms and payments. A higher proportion of variable payments compared to fixed payments or shorter initial rental terms may result in smaller lease liabilities.

Landlords should consider the potential impact that shorter lease terms and an increased amount of variable rent would have on their business, including their financing costs, the value of the properties and, perhaps, increased operating costs as more frequent lease negotiations are held.

Tenants that, today, enter into net leases of single-tenant properties may make different decisions about whether to lease or purchase the property. Many factors will influence a tenant's decisions, including the nature of its business, its real estate requirements, debt and equity covenant restrictions, and access to capital.

Tenants may request that landlords separately price non-lease components to help them support the allocation of consideration between the lease and non-lease components to minimise the financial statement impact of IFRS 16. However, landlords may be reluctant to disclose this information for proprietary reasons. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes.

For tenants, recognising lease-related assets and liabilities could have additional financial reporting implications, such as:

- Increase in total assets and liabilities
- Increase in net debt and earnings before interest, tax, depreciation and amortisation (EBITDA)
- Increase in finance expense; decrease in operating expense
- Shifts in cash flow statements (from operating to financing)

- Front loading of lease expense on individual rental contracts
- Deterioration of debt-related ratios
- Change in deferred tax assets and/or liabilities

IFRS 16 may have additional business implications for tenants, such as:

- Off-balance sheet accounting (an important advantage today of leasing compared to buying an asset) will diminish under IFRS 16, so leasing may become less attractive
- Debt covenants may need to be modified
- Changes in the administration of rental contracts, management reporting, employee remuneration policies and key performance indicators
- The volume of balance sheet driven sale and leaseback transactions is likely to decrease

Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. Two critical first steps include: (1) identifying the sources and locations of an entity's lease data; and (2) accumulating that data in a way that will facilitate the application of IFRS 16. For entities with decentralised operations (e.g., an entity that is geographically dispersed), this could be a complex process given the possibility of differences in operational, economic and legal environments. Entities will also need to make sure that they have the processes, including internal controls, and systems in place to collect the necessary information to implement IFRS 16 (including making the necessary financial statement disclosures).
- Real estate entities should begin to educate leasing and tenant coordination departments about IFRS 16. An entity may want these departments to evaluate its current portfolio of leases and/or prospective targets to identify tenants that may seek to alter their leasing strategies as a result of IFRS 16.
- Real estate entities also should start the dialogue with existing tenants to better understand whether they will request modification of terms of existing rental contracts (e.g., the length of the non-cancellable lease term, options to renew, variable lease payments). If the changes lead to tenants demanding different lease terms, alternative ways of financing some real estate projects may be required.
- Entities should identify a cross-functional team and develop a project plan with effective project management to tackle its implementation. There is unlikely to be a 'one size fits all' approach as the nature of leasing activities (i.e., the underlying assets, value and volume of leases), existing policies and processes, financial reporting requirements, and strategic business decisions vary across entities.

Appendix: Effect of application of IFRS 16 on tenant financial statements

The following example illustrates the effect of IFRS 16 on the financial statements of a tenant of retail space (Retailer), comparing the balance sheet and income statement under IAS 17 to that under IFRS 16 for one year. It is important for landlords to understand how IFRS 16 could affect their tenant customers' financial statements as this could affect tenant behaviour.

Assume at the beginning of 2019, Retailer has several rental agreements under operating leases with remaining lease terms of 13 years. Total annual rent for these leases is CU1,200. Retailer's incremental borrowing rate for these rental agreements as of the beginning of 2019 is 4.72%. The present value of the lease payments at the beginning of 2019 is CU11,463. When applying IFRS 16 for the first time in 2019, as of the beginning of 2019, Retailer records a right-of-use asset and a lease liability in the amount of CU11,463. During 2019, Retailer recognises depreciation on the right-of-use asset of CU882 (Retailer depreciates the right-of-use asset on a straight-line basis over the remaining lease term) and interest expense of CU541. In contrast, under IAS 17, the rental agreements would have been classified as operating leases and would have been accounted for off-balance-sheet.

The extracts of the condensed balance sheet and condensed income statement below show a comparison between the lease accounting under IAS 17 and IFRS 16 (for purposes of simplification, financial statement captions have been condensed and deferred taxes have been ignored).

Extract of condensed balance sheet as of 31 December 2019	Under IAS 17		Under IFRS 16	
Owned property	21,803		21,803	
Right-of-use assets	-		10,581	
Cash	4,243		4,243	
Other assets	5,765		5,765	
Total assets	31,811		42,392	
Equity	10,899		10,676	
Gearing ratio (net debt*/total equity)		27%		129%
Borrowings	7,192		7,192	
Lease liabilities	0		10,804	
Other liabilities	13,720		13,720	
Total of equity and liabilities	31,811		42,392	
Net debt	2,949		13,753	

* Net debt is a non-GAAP measure defined as borrowings plus lease liabilities minus cash

Under IFRS 16, there is a significant increase in total assets and total liabilities at year end from the right-of-use asset and lease liability of CU10,581 and CU10,804, respectively, and a decrease in equity of CU223. The gearing ratio deteriorates significantly and increases by a factor of approximately 5.

The effect on the income statement is, as follows:

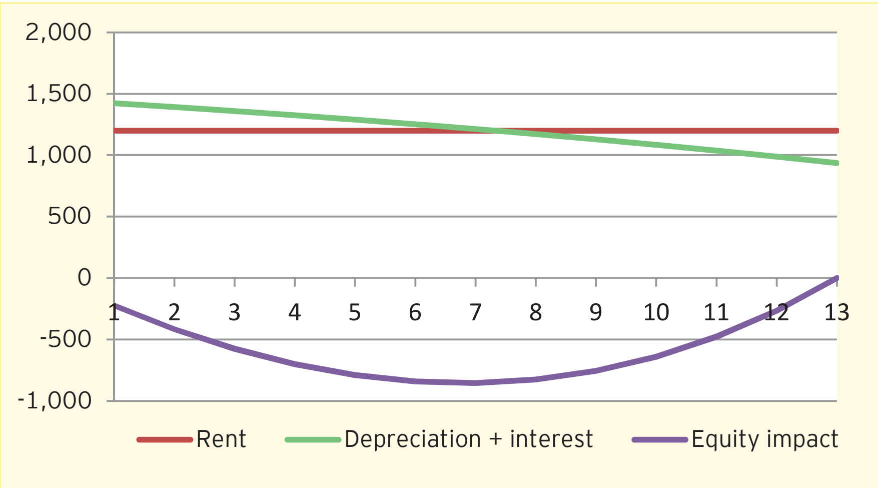
Extract of condensed income statement	Under IAS 17	Impact of IFRS 16	Under IFRS 16
Gross margin	21,521	0	21,521
Operating expense excluding depreciation	(16,731)	1,200	(15,531)
Depreciation and amortisation	(1,978)	(882)	(2,860)
Finance cost	(529)	(541)	(1,070)
Profit before tax	2,283	(223)	2,060
Taxes	(558)	0	(558)
Other	(389)	0	(389)
Net profit	1,336	(223)	1,113
EBITDA	4,790	1,200	5,990
Net debt to EBITDA	0.62		2.30

Under IFRS 16, there is a significant change in EBITDA because lease-related expenses are presented as depreciation and interest, rather than in a single line as operating expense. In the first year, there is a marginal decrease in Retailer's profits because of the application of the amortised cost model, which results in higher interest expense in earlier years. There is also a significant increase in the net debt to EBITDA ratio. For a larger portfolio of rental contracts with different start and end dates of the individual contracts, the impact of the changed expense recognition impact on net income may not be significant.

Comparison of cost under IFRS 16 and IAS 17

Total lease-related expense over the term of the lease is the same under IAS 17 and IFRS 16. However, when the right-of-use asset is depreciated on a straight-line basis, the accelerated interest expense in the earlier years of a liability results in higher total lease-related expenses in the earlier years of an individual lease contract.

Below we present a graphical representation of the total cost over the life of Retailer's rental contracts.



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