

In depth

IFRS 16 implications for lessors in the real estate industry

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IFRS 16 implications for lessors in the Real Estate industry

IFRS 16, 'Leases', will be effective for annual reporting periods beginning on or after 1 January 2019. Guidance for lessors remains substantially unchanged from IAS 17. Lessors are still required to classify leases as either finance or operating, and the indicators used to make that distinction are again unchanged from IAS 17.

For a finance lease, the lessor recognises a receivable at an amount equal to the net investment in the lease; this is the present value of the aggregate of lease payments receivable by the lessor and any unguaranteed residual value.

For an operating lease, the lessor continues to recognise the underlying asset on its balance sheet.

Changes for lessors?

Although the broad mechanics of lessor accounting remain unchanged, a number of topics do affect both lessees and lessors. For example, IFRS 16 contains revised guidance on the definition of a lease. Further, 'lease term' is defined for both lessees and lessors in the same way (for example, whether or not extension or termination options are taken into account when determining the lease term).

In this guide, we focus on specific areas where IFRS 16 will have a particular impact on lessors:

- Lease payments;
- Separating or combining components of a contract;
- Subleases;
- Sale and leaseback transactions; and
- Lease modifications.

Lease payments

Lease payments are defined in the same way for both lessees and lessors, comprising the following components:

- Fixed payments (including in-substance fixed payments), less any lease incentives receivable by the tenant;
- Variable lease payments that depend on an index or a rate;
- Amounts expected to be payable by the lessee under residual value guarantees;
- The exercise price of a purchase option (if the lessee is reasonably certain to exercise that option); and
- Payments of penalties for terminating the lease (if the lease term reflects the lessee exercising the option to terminate the lease).

IFRS 16 distinguishes between three kinds of contingent payments, depending on the underlying variable and the probability that they actually result in payments:

- Variable lease payments based on an index or a rate. Variable lease payments based on an index or a rate (for example, linked to a consumer price index, a benchmark interest rate or a market rental rate) are part of the lessor's lease payments. These payments are initially measured using the index or the rate at the commencement date (instead of forward rates/indices).
- Variable lease payments based on any other variable. Variable lease payments not based on an index or a rate are not part of the lessor's lease payments, such as payments of a specified percentage of sales made from a retail store. Such payments are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.
- In-substance fixed payments. Lease payments that, in form, contain variability but, in substance, are fixed are included in the lessor's lease payments. The standard states that a lease payment is in-substance fixed if there is no genuine variability.

Example of variable lease payment based on an index or a rate

A lessor agrees an operating lease of office space with a lessee on the following terms:

1. Lease term: 10-year non-cancellable term.
2. Annual payment: CU100,000 in the first year, with a CPI increase in every following year.
3. Market rent review: beginning of year 6, with a CPI increase in every following year.

The lessor initially measures lease income as CU100,000 in every year. In year 2, CPI increases by 2%.

The lessee is required to remeasure its lease liability when the cash flows change in respect of CPI in year 2 for the lease payments from year 2 to year 5. [IFRS 16 para 42(b)]. The lease payments from years 6 to 10 would not be remeasured, because those cash flows have not yet changed. These cash flows will only change when the market rent review occurs and rent is reset to the market rate at that time.

From year 2, the following lease income is forecast for the purposes of the lessor determining recognition of lease income on a straight-line basis:

Year	2	3	4	5	6–10 (annual)
Lease income (CU)	102,000	102,000	102,000	102,000	100,000

The lessor initially measures lease income as CU100,000 in every year. In year 2, CPI increases by 2%.

The lessee is required to remeasure its lease liability when the cash flows change in respect of CPI in year 2 for the lease payments from year 2 to year 5. [IFRS 16 para 42(b)]. The lease payments from years 6 to 10 would not be remeasured, because those cash flows have not yet changed. These cash flows will only change when the market rent review occurs and rent is reset to the market rate at that time.

Should the lessor remeasure the lease income to be recognised in year 2?

PwC observation

Given the guidance for lessees, it would be logical for the lessor to remeasure lease income to be recognised in the same way. Therefore, the rental income recognised in year 2 would be CU100,888, reflecting recognition of the revised income above on a straight-line basis. However, there is no explicit requirement in IFRS 16 for a lessor to remeasure its lease income in the same way as a lessee. An alternative approach would be to recognise the increases in rental income related to CPI changes in the periods in which those changes occur in accordance with IFRS 16 paragraph 38. Under that approach, the rental income in year 2 would be CU102,000. The method applied is an accounting policy choice, and it should be applied consistently to all leases in accordance with IAS 8.

For lessees, in relation to payments initially excluded from the lease liability, if the variability is resolved at a later point in time (for example, insurance premiums or taxes become known and unavoidable for the upcoming year) they become in-substance fixed payments at that point in time in accordance with IFRS 16 paragraph B42. However, there is no similar explicit requirement in IFRS 16 for a lessor under an operating lease. Lessors could apply the guidance as for lessees or, alternatively, they could recognise the variable lease payments in the periods in which they occur. The method applied is an accounting policy choice, and it should be applied consistently in accordance with IAS 8.



Separating or combining components of a contract

Contracts often combine different types of obligations, and they might contain a combination of lease components, or of lease and non-lease components. For example, real estate arrangements often require the lessee to reimburse the lessor for certain costs related to the leased asset, such as insurance, property taxes or common area maintenance provided by the lessor.

IFRS 16 requires each separate lease component to be identified and accounted for separately.

1. Interaction with IFRS 15

The right to use an asset is a separate lease component from other lease components if two criteria are met:

- a. The lessee can **benefit from the use of the asset** either on its own or together with other readily available resources.
- b. The underlying asset **must not be highly dependent on** or **highly interrelated with** other underlying assets in the contract.

PwC observation

IFRS 15 contains guidance on how to evaluate whether a good or service promised to a customer is distinct for lessors. The question arises as to how IFRS 16 interacts with IFRS 15.

For a multi-element arrangement that contains (or might contain) a lease, the lessor has to perform the following assessment:

- Apply the guidance in IFRS 16 to assess whether the contract contains one or more lease components.
- Apply the guidance in IFRS 16 to assess whether different lease components have to be accounted for separately.
- After identifying the lease components under IFRS 16, the non-lease components should be assessed under IFRS 15 for separate performance obligations.

The criteria in IFRS 16 for the separation of lease components are similar to the criteria in IFRS 15 for analysing whether a good or service promised to a customer is distinct.

When identifying non-lease components, an entity must consider whether a good or service is transferred to the lessee. [IFRS 16 para B33]. As mentioned above, real estate arrangements often require the lessee to reimburse the lessor for items such as insurance, property taxes or common area maintenance provided by the lessor. There will usually be (at least) one lease component (the right to use the real estate) and one non-lease component (such as common area maintenance). However, payments for insurance and property taxes typically do not involve a transfer of a separate service, and they generally do not represent a separate lease or non-lease component. Instead, these payments form part of the consideration for the lease and non-lease components.

2. Determine overall consideration

The overall consideration in the contract needs to be determined. This will include payments for the lease component(s), and it might also include payments for non-lease components and/or payments that do not represent separate components. Overall consideration includes both fixed and any variable payments. For example, in some real estate arrangements, the payments received from the tenant for property taxes and insurance might be variable payments.

3. Allocation of consideration

When the lease and non-lease components have been identified, the consideration within the contract must then be allocated.

Lessors allocate consideration in accordance with IFRS 15, on the basis of stand-alone selling prices of the identified components. Where insurance and property taxes do not represent a separate component, no consideration is allocated to them; consideration is only allocated to the identified lease and non-lease components.

The example below explains how the variable payments of property tax and insurance would be measured when determining the overall consideration.

Example – How are variable payments of property tax and insurance measured?

A lessor requires a lessee to reimburse the lessor for property taxes and insurance under an operating lease. Applying IFRS 16 paragraph B33, the lessor has determined that, in this specific situation, the payments for property taxes and insurance do not transfer a separate good or service, so they are not accounted for as a separate non-lease component. The lease contract has no other service or non-lease components, and so these tax and insurance payments are allocated as lease payments to be received and recognised as rental income over the lease term.

Often, payments for reimbursing the lessor for property taxes and insurance are variable. Depending on the specific facts and circumstances in each lease and in each jurisdiction, there might be different causes of variability. Potential types of variable payment and how they could be measured are considered further below, although there is significant judgement involved.

Property tax

Property tax might be calculated as the tax value of the property multiplied by a fixed percentage. The tax value of the property might be determined based on specific requirements in tax law, and so it might not be representative of market value.

Even if valuation of the property takes into account market indices or rates, it is not, in itself, an index or a rate. Hence, these types of property taxes should be accounted for as variable lease payments that do not depend on an index or a rate. Only the amounts that are already in-substance fixed are included in the initial measurement of lease income. For example, if the property taxes are known for the first year and will then be reassessed from the second year, only the property taxes for the first year would be included initially, and the income for property taxes in future periods would be recognised when they occur or become in-substance fixed.

Insurance

The initial amount of the insurance premium might be known by both parties but not explicitly stated in the contract. Furthermore, the amount might change over time for reasons other than the market value of the property – for example, if the insurance company's assessment of risk changes or the lessor moves to another insurance company.

The amount of premiums might vary in subsequent periods. Amounts received in relation to insurance meet the definition of variable lease payments, but they are not dependent on an index or a rate. Only the amounts that are already in-substance fixed are included in the initial measurement of lease income. For example, if the insurance premium is known for the first year and will then vary from the second year, only the insurance premium for the first year would be included initially, and the income for insurance in future periods would be recognised when it occurs or becomes in-substance fixed.



Application in the example

Lessees will include payments for property taxes and insurance as part of the lease liability if they are linked to a rate or an index or are in-substance fixed payments and they are not separate goods or services under the lease.

Similarly, lessors will include payments for property taxes and insurance as part of rental income. As a result, the lessor will record rental income for amounts received in respect of property taxes and insurance. The lessor also records an expense for the costs incurred for these items.

PwC observation

Application of this principle could be challenging in some jurisdictions where the lessor has the primary obligation to pay the property tax while the lessee pays the tax or the insurance directly to the tax authority or insurance company respectively. Lessors might find it difficult to collect information from lessees in respect of these expenditures, or it might be difficult to keep track of a wide range of different insurance arrangements. In such cases, it will be important for lessors to communicate with lessees, to determine methods of collecting this information.

Subleases

Intermediate lessors must now classify subleases based on the right-of-use asset from the head lease, rather than the underlying lease asset (as under IAS 17).

For example, the term of a property sublease would be compared to the term of the head lease when assessing whether the lease is for the major part of the economic life.

Similarly, the present value of lease payments is compared to the fair value of the right-of-use asset, instead of the underlying asset, when assessing whether it is for substantially all of the fair value.

Since the head lease term for a property lease or the fair value of a right-of-use asset is often smaller than the life or fair value of the underlying property, there is now an increased likelihood that a sublease may be classified as a finance lease. The change to sublease guidance must be considered both on transition to IFRS 16 for existing subleases and for all new subleases entered into once IFRS 16 applies.

Practical impact

Real estate companies can often hold investment properties that are located on leased land. In turn, these ground leases are often for long periods of time, for example 99 years. Therefore, real estate companies are lessees in respect of the ground lease and are required to apply IFRS 16.

As a result, real estate companies will recognise a right of use asset and lease liability in relation to ground leases. In turn, the right of use asset is classified as an investment property given the leased land is held solely for the purposes of holding the related investment property building. Further, where the real estate entity applies the fair value model for its investment property, it will equally be required to apply this model to right of use assets that meet the definition of investment property. [IFRS 16 para 34].

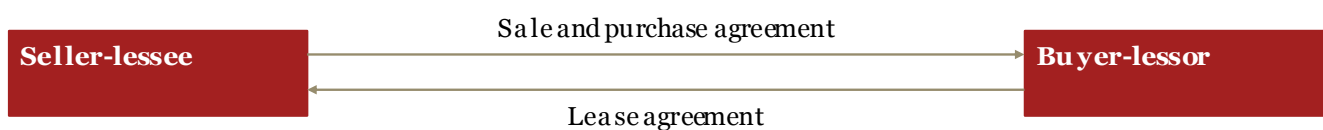
The right of use asset is measured on initial recognition in accordance with IFRS 16. [IAS 40 para 29A]. Where a ground lease is negotiated at market rates, on initial recognition, re-measurement of a right of use asset from cost to fair value should not give rise to any gain or loss on day one. [IAS 40 para 41]. As such, on initial recognition of ground leases negotiated at market rates, the amounts reflected in the balance sheet will be an investment property right of use asset and a lease liability of an equal amount. This effectively shows the gross position of the ground lease investment property fair value since valuation models for investment property will include ground lease payments as cash out flows. These cash out flows are now reflected on the balance sheet as a lease liability and IAS 40 does not permit this liability to be presented net against the investment property. [IAS 40 para 50(d)].

Sale and leaseback transactions

Determining whether the transfer is a sale

Aside from lessee accounting, the accounting for sale and leaseback transactions is one of the main areas in which the new lease standard changes the current guidance. The accounting for sale and leaseback transactions under IAS 17 mainly depended on whether the leaseback was classified as a finance or an operating lease. Under IFRS 16 the determining factor is whether the transfer of the asset qualifies as a sale in accordance with IFRS 15. An entity should apply the requirements for determining when a performance obligation is satisfied in IFRS 15, to make this assessment.

Structure of a sale and leaseback



Transfer of the asset is a sale

If the buyer-lessor has obtained control of the underlying asset and the transfer is classified as a sale in accordance with IFRS 15, the seller-lessee measures a right-of-use asset arising from the leaseback as the proportion of the previous carrying amount of the asset that relates to the right of use retained. The gain (or loss) that the seller-lessee recognises is limited to the proportion of the total gain (or loss) that relates to the rights transferred to the buyer-lessor.

If the consideration for the sale is not equal to the fair value of the asset, any resulting difference represents either a prepayment of lease payments (if the selling price is below market terms) or an additional financing (if the selling price is above market terms). The same logic applies if the lease payments are not at market rates. The buyer-lessor accounts for the purchase in accordance with applicable standards (such as IAS 40 if the underlying asset is investment property), and for the leaseback in accordance with IFRS 16.

Example – Sale and leaseback transaction

Entity A owns a property with a carrying value of CU3 million, and it enters into a sale and leaseback transaction. The market value of the property is CU10 million. The present value of minimum lease payments under the term of the leaseback is CU5 million. The initial sales price and the ongoing rental are all at market value.

Under IFRS 16, the right-of-use asset retained by entity A as a proportion of the underlying asset is 50%, being:

Present value of minimum lease payments (CU5 million)

Market value of the property (CU10 million)

The right-of-use asset retained is CU1.5 million, being:

$$\text{Carrying amount of the property (CU3 million)} \times \text{Proportion of the underlying asset (50\%)}$$

The gain on sale is CU3.5 million, being the proportion of the total gain that relates to the rights transferred to the buyer-lessor:

$$\text{Total gain (CU7 million)} \times \frac{\text{Market value of the property less the present value of the lease payment (CU10 million – CU5 million)}}{\text{Market value of the property (CU10 million)}}$$

Under IAS 17, assuming the transaction qualifies as an operating leaseback, the gain on sale would be CU7 million, being the difference between the fair value of the property (CU10 million) and its carrying value (CU3 million). Further, no asset or liability would be recognised on the balance sheet subsequent to the transaction. However, under IFRS 16, the gain recognised relates only to the proportion of the right to use the underlying asset that is transferred to the buyer-lessor.

Transfer of the asset is not a sale

If the transfer is not a sale (that is, the buyer-lessor does not obtain control of the asset in accordance with IFRS 15), the seller-lessee does not derecognise the transferred asset, and it accounts for the cash received as a financial liability. The buyer-lessor does not recognise the transferred asset, and instead it accounts for the cash paid as a financial asset (receivable).

PwC observation

The accounting treatment for sale and leaseback transactions for seller-lessees under IFRS 16 can be significantly different from IAS 17. However, we do not expect this difference to result in a complete elimination of sale and leaseback activity. There are still valid commercial reasons for seller-lessees to enter into such transactions, such as managing cash flows, facilitating operational decisions, and tax considerations.

Lease modifications

There is no explicit guidance in IAS 17 on accounting for modifications of operating leases by lessors. Where the modification of an operating lease does not result in the lease being reclassified as a finance lease, any changes to future lease payments are accounted for prospectively on a straight-line basis over the remaining revised lease term.

IFRS 16 provides guidance on modifications of operating leases by lessors. The accounting requirements under IFRS 16 are generally consistent with previously developed practice for accounting for modifications of operating leases by lessors. Modifications to an operating lease should be accounted for 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. [IFRS 16 para 87]. IFRS 16 provides greater clarity as to the effective date of a modification and defines this as the date on which the parties agree to the modification.

Final thoughts

IFRS 16 does contain changes that have an accounting impact on lessors. In particular, lessors should be aware of the new guidance on the definition of a lease, lease term and lease payment, separation of components, subleases and the accounting for sale and leaseback transactions. From a commercial point of view, changes in lessee accounting could also impact lease negotiations, given that property leases will often result in the recognition of significant assets and liabilities for many lessees. The focus in negotiations might no longer be on whether the contract would qualify as an operating or a finance lease, but instead on whether the definition of a lease is met at all.

Other negotiation points might include variable lease payments which could be excluded from the lease liability, or inclusion of termination options which might minimise the lease term. As such, the standard might have an impact that extends beyond the accounting treatment.

For more guidance, see our *In-depth, IFRS 16 – A new era of lease accounting*.

Questions

PwC clients who have questions about this in depth should get in touch with their regular PwC contact.

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