# An industry focus on the impact of IFRS 16 - Retail and consumer

## IFRS 16, 'Leases'

*April 2016*

The new lease accounting standard will fundamentally change the accounting for lease transactions and is likely to have significant business implications. Almost all leases will be recognised on the balance sheet, with a right-of-use asset and financial liability that recognise more expenses in profit or loss during the earlier life of a lease. This will have an associated impact on key accounting metrics, and clear communication will be required to explain to the impact of changes to stakeholders.

*Why the new standard matters to the Retail and consumer industry*

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 indicated that there would be a median debt increase of 98% for retailers, and 41% median increase in EBITDA.

Most of such leases are in the form of medium term leases (generally 3-5/9 years), whether in premium locations (flasgship stores), shopping centres or ordinary outlets. Such leases typically offer renewal options, and often involve variable rentals. This variability is commonly due to inflation adjustments and contingent rentals in some locations where the property owner has a vested interest in the performance of the business (e.g. airports, and shop-in-shop arrangements). Historically such leases have been considered as operating leases, and have not therefore had any impact on the balance sheet. The amount recorded in the income statement was typically on a straight line basis and entirely included in operating expenses. The new lease standard will not only have an impact on the balance sheet, but also on the operating costs, with a split of the expense between operating and finance costs.

The exemption for short-term leases and small assets is unlikely to provide any significant relief to retailers.

## An In depth guide to the new standard and its effects

In depth INT 2016-01 provides a comprehensive analysis of the new standard.

This publication summarises the main aspects of the standard, highlighting some key challenges and questions management should ask as they prepare for transition.

Although the new standard will not be effective until 2019, the extent of data gathering and requirement to embed new processes for many entities means that, for many, preparations should begin now.

*The new standard on a page*

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| 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). |
| What is the scope of the standard? | The standard covers every lease except for rights to explore non-regenerative resources, rights held under licensing agreements, leases of biological assets and service concession arrangements.<br>For lessors, licences of intellectual property granted are excluded from IFRS 16; lessees are not required to apply IFRS 16 to certain rights held under licensing agreements. |
| 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.<br>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 they have 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:<br>• a lease liability at the present value of future lease payments; and<br>• 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:<br>• interest on the lease liability<br>• depreciation of the right of use asset<br>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*

**Q: What types of arrangements might meet the new definition of a lease?**

**A:** Most rental contracts for retail outlets whether for individual outlets, high-street locations or shop-in-shops in department stores 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 where the right of use of the asset is not so well defined and the entity might not have the full economic benefit of the asset. Careful analysis of the terms of these arrangements should be made, especially 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 the identification and measurement of the "right to control the use" of an asset?**

**A:** In a rental contract for a retail outlet, the unrestricted use of defined retail space, including control over the shop design by the tenant, control over physical access to the space, and control over the goods sold will indicate a 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.

In a shopping centre, typically the property owner can only substitute the retail space of the tenant in very limited circumstances such as a need for major repairs, or the need to combine retail space to accommodate a new major tenant. Assuming the property owner has an obligation to provide another retail space of similar standing in terms of location and customer traffic, 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 property owner in maintenance, cleaning, security such as is often the case in a shopping centre would also typically not affect right to control the asset.

Careful consideration should be given to the treatment of initial direct costs, being those unavoidable incremental costs relating to the lease such as commissions or some payments made to existing tenants to obtain the lease. Such costs might need to be included as part of the right-of-use asset and amortised over the anticipated lease term (see IFRS 16 - example 13).

**Q: What economic benefits other than physical output should be considered?**

A: The main economic benefit from the rental of retail space will result from the ability to sell products with a view to earning a profit. For retailers, other more indirect benefits, include:

- Brand reinforcement by renting outlets in premium locations (i.e. flagship stores);
- Physical presence to allow advertising or testing of new and/or existing products which can be ordered/purchased by other means (e.g. online);
- Other strategic rentals whereby outlets may be located either close to shops selling similar or complementary products (typical for the luxury industry), or occupying retail space in a defensive move to prevent the competition occupying nearby premises.

**Q: What areas might affect the lease liabilities recognised?**

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

Variable payments that depend on something other than an index or rate 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 which will need to be considered are 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.

Services provided under lease agreements not meeting the definition of a lease, such as insurance and maintenance, need to be identified. These are excluded from the lease liability if they can be reliably estimated and allocated. Alternatively, an accounting policy choice (available for each class of underlying asset) not to separate such components is available to the lessee.

Restoration/dilapidation clauses need to be accounted for as provisions under IAS 37, and will affect the right-of-use asset recognized. This is consistent with the current requirements of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar liabilities*. The restoration/dilapidation costs will not typically be part of the lease liability

**Q: What will be the impact of implementation on key accounting metrics?**

**A:** For lessees, the new accounting treatment will immediately affect a range of key metrics monitored by stakeholders, including:

- Net debt and gearing (increases as lease liability included in net debt)
- Net assets (decreases as the right of use asset amortises on a straight line basis while lease liability is unwound more slowly in early years)
- EBITDA (increases as rental expense replaced by interest and depreciation)
- ROCE (Return on Capital Employed) where capital is defined as equity plus borrowings including lease liabilities – reduces as the increase in operating profit is not proportionate to the increase in capital employed.

**Q: What are the wider potential business impacts?**

A: The new accounting treatment could affect a number of areas:

- Debt covenants – covenants might need to be renegotiated.
- Share-based payments– performance metrics might need renegotiation.
- Dividend policy – the revised profile of the profit or loss expense might affect the ability to pay dividends.
- Lease negotiations – although accounting should not be the key driver in commercial negotiations, market behaviour might change towards shorter lease tenures to minimize lease liabilities.

**Q: Will we need to develop an entirely new system to track and administer leases?**

A: Many lessees currently manage operating leases on spreadsheets or through the accounts payable system. Information needed to reassess lease terms and index-based payments at each reporting date will now need extensive data capture. Lessees might need to modify information systems, processes and internal controls to comply with the standard.

**Q: How and when should I start a program to manage change and meet compliance?**

**A:** Entities should take advantage of the long implementation period available. An initial assessment of people, processes, systems, data, governance and policy would be a good starting point.

**Q: What other departments other than accounting might be affected?**

**A:** The tax department will need to assess how deferred tax liabilities might be affected. The human resources department should consider whether there are any effects on compensation metrics and policies.

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