GROSVENOR

International Accounting Standards Board
30 Cannon Street
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13 September 2002

Dear Sirs

Exposure Draft of Proposed Improvements to International Accounting Standards

We are writing to comment on the Exposure Draft of Proposed Improvements to International Accounting Standards.

Grosvenor is an international property group with interests in the UK, the USA, Europe, Asia and Australia. Although Grosvenor is a private group, it publishes its results in accordance with listed company requirements and so will be affected by the move to International Accounting Standards in 2005.

Of the proposed improvements, the changes to IAS 17 Leases and IAS 40 Investment Property are of most relevance to Grosvenor as a property company, so our comments are limited to those two standards.

IAS 17 Leases

Problems with the exposure draft

We do not agree that, when classifying a lease of land and buildings, the lease should be split into two elements – a lease of land and a lease of buildings. Our rationale for this conclusion is set out below.

- Split of land and buildings is not relevant to commercial substance

  A property lease represents the right to use a building for a certain period of time. That right includes the right to occupy the building itself as well as use of the underlying land on which the building stands. The lease payments are established according to a number of factors including the nature of the building and its location. However it would be a theoretical exercise to allocate lease payments according to the various rights which the lease confers on the lessee.

  From both a lessor's and a lessee's point of view, any notional split of lease rentals between a land element and a buildings element would have no commercial relevance, since the whole of the rental represents a payment for the package of land and buildings provided to the lessee.

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- Loss of accounting focus

  Readers of property company accounts expect to see financial statements which reflect the economic substance of the leasing transactions.

  For a typical property lease, in the majority of cases and under current accounting conventions, this will result in a property held at valuation in fixed assets (under the valuation model), and lease rentals recognised in the profit and loss account. Alternatively, if a property is "sold" on a very long lease, the property will be de-recognised from the balance sheet and, to the extent that the consideration is financed by the lessor/vendor, then that consideration will be shown in debtors and the lease payments will be allocated to principal and interest according to the usual rules.

  It would be confusing to users of accounts if the proposals led to a mixture of these two scenarios, such that for a particular lease one would have to look at both the investment in fixed assets and in debtors to understand the total investment in a lease. Since a property lease represents a single transaction, it would logically follow that it should result in a single treatment in the financial statements. To split it notionally into two separate transactions would only serve to confuse.

- Presumption that leases are finance leases

  We do not agree with the presumption in paragraph 11B that, where lease payments cannot be allocated between the land element and the buildings element, that the entire lease is classified as a finance lease unless it is clear that both elements are operating leases. The accounting treatment for the two elements together should be in accordance with the definitions of a finance lease and an operating lease respectively.

- Costly to maintain valuations of the different elements

  Should the proposals be implemented, there is likely to be a substantial cost to both lessors and lessees in examining property leases. Lease payments will need to be allocated (quite likely on a notional basis) between the land and buildings elements. If this is not possible, the relative market values of the land and the building excluding the land would need to be estimated. It is hard to justify such a cost in order to satisfy a rather theoretical accounting solution, which fails to recognise the economic reality of property leases.

Our counter proposals

We therefore propose that the accounting treatment for leases of land and buildings should be based upon the entire lease, rather than separate land and buildings elements.

We suggest that the lease as a whole should be considered as either a finance lease or an operating lease, according to the relevant definitions.

IAS 40 Investment property

Agreement of definition

We agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease.

Problems with the exposure draft

However, we do not agree with amendment paragraph 26A, which requires a lessee that classifies such a property as investment property to account for the lease as if it were a finance lease. Our rationale for this conclusion is set out below.

- Double counting

  Valuations of investment properties held under operating leases take account of the lease payments to the head-lessor, so that in effect the valuation represents the value of the lease payments receivable as lessor, net of the value of head-lease payments payable as lessee. If the head-lease payments were capitalised as part of the finance lease accounting, this would result in a double counting of the liability, since it would be included as a liability for finance lease payments and also deducted in arriving at the valuation of the property. To overcome this would require the valuation of the leasehold interest to be "grossed up" as if it were a freehold interest. This would not reflect the economic reality of the transaction.

- Variable terms

  The terms of lease payments under head-leases can lead to highly variable payments, for example where the lease payment is based on a turnover rent, or a proportion of the lessee's sub-lease income or other methods. This would cause considerable problems in identifying the capital amount of the initial lease, as well as the treatment of payments in subsequent periods.

Our counter proposals

We therefore propose that amendment 26A is deleted.

We also propose that clarification is given that, under the fair value model, the fair value of an investment property which is held under an operating lease should be arrived at taking into account any obligations to make payments to a head-lessor.

We trust you find our comments helpful and would be delighted to discuss these further with you, or to provide any assistance.

Yours faithfully

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Group Finance Director
Grosvenor