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BPF — The Voice of Property — British Property Federation

British Property Federation

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

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. The British Property Federation represents the Property Industry in the UK. We have restricted our comments to the proposed changes to IAS 17 Leases and IAS 40 - Investment Property as those standards are of specific interest to the Property Industry both in the UK and elsewhere.

IAS 17

We do not believe that leases of property should be notionally split as between leases of land and leases of buildings and accounted for separately under IAS 17.

There are a number of reasons for this, which we elaborate on later in this letter:

- Leases are indivisible. Lessees lease property which is the combination of the building, its location and the uses and permissions that have been granted to the property.

- Financial statements which for lessors include property partly as fixed assets (the land) and partly as debtors (the buildings) and for lessees partly off the balance sheet (the land) and partly as borrowings (the buildings) will have severely reduced transparency and understandability.

- Significant work will be required of lessors and lessees in determining the artificial split of property lease cash flows and considering the finance/operating lease decision. Where finance leases arise on the buildings, changes to accounting systems will arise. This work will be carried out in order to reinforce the distinction between operating and finance leases just at a time when there is a project being undertaken by the UK ASB, the Lease Accounting Project, aimed at eliminating this distinction. This is a current IASB Active Research Topic. Further systems changes may arise should the Lease Accounting Project come to fruition.

- The proposal to split account for land and buildings seems to emanate from the view that very long leases of land must always be operating leases and that they are fundamentally different from freeholds as land has an infinite life. This view is theoretical and ignores the economics of very long leases.

Is properly divisible?

We can understand the theoretical justification for applying different accounting treatments to two components of a composite transaction if there are many transactions in the marketplace of each component separately and a materially different answer would arise from not adopting component accounting. A clear example is with convertible bonds where bonds and warrants can, and are, issued separately.

However property is not divisible in this way. Whilst land can be leased without a building, its worth is usually justified by the building that is, or can be, constructed on the site. Buildings cannot be leased without the land. Consequently the use of split accounting is adopting a theoretical approach by creating and accounting for a series of transactions that simply never appear in practice. Lessees lease property as a package and it is of no relevance to a company to consider what it might have cost to lease an empty site where its factory is currently situated.

On separate matters of detail it should be noted that:

- Valuations of land and buildings within an overall property valuation (the suggested allocation basis) are a less precise science than the valuation process itself as the valuation of the site is more difficult to ascertain due to there being fewer comparable transactions available to consider. The valuation process takes account of market evidence of real comparable transactions. This will not generally be possible for the allocation of the valuation as between the land and buildings elements with the result that the split may be completely speculative.

- If it were possible to determine accurately the split between the valuation of land and buildings at the inception of a lease, the suggested allocation basis of rentals will not be a reasonable allocation basis as it assumes that the residual values at the end of the lease of the land and buildings elements of the property are also in the same proportion. This is rarely going to be the case. Predicting this future split would be an even more imprecise science and in practical terms unrealistic to determine.

Transparency and understandability

The proposals, if they lead to large numbers of property leases being treated as partly operating leases and partly finance leases, will lead to a somewhat hotchpotch balance sheet which will be difficult for users of financial statements to understand. If the proposals do not lead to many buildings being treated as finance leases, then there would seem little point in the proposals in any event.

In times of increasing investor concern as to the capacity of listed company financial reporting, these proposals will serve only to confuse investors. It is difficult to understand why two companies paying the same rent on identical terms on two different properties might account for those transactions completely differently if one property was in a high land value area and the other in a low land value area. It is also difficult to understand why the figures being accounted for do not bear any transparent and understandable relationship to the rent being paid.

Cost benefit analysis

In order to implement the proposed changes to IAS 17, lessors and lessees will have to examine each and every property lease, obtain a valuation of the property at lease inception date and a notional split of that valuation as between the land and buildings elements. In most cases, outside professional help will be required to ascertain this information. Having obtained that split, an analysis of the notional buildings lease cash flows and terms will need to be carried out in order for the operating/finance lease decision to be made. Should a finance lease arise, accounting systems will need to be changed to determine the income/expense recognition and the accounting entries.

The work involved to implement the proposed changes to IAS 17 is potentially very substantial and is not justified on cost benefit grounds.

The fact that these changes are being sought at a time when the IASB has an Active Research Topic underway, the Lease Accounting Project, which is aimed at doing away with the distinction between operating and finance leases (be they real or notional) makes the cost even less justified.

Are very long leases of land different from freeholds?

The proposals to change lAS 17 appear to emanate from a view that very long leases of land are fundamentally different from freeholds. We do not necessarily share that view.

Very long leaseholds of land, in cases where there is little ground rent to pay, are virtually identical to freeholds and so any distinction between the accounting for freeholds and very long leasehold interests of land in such circumstances is unjustified. However very long leaseholds of land where the lessee is paying market rent set at regular intervals are very different from a freehold interest from the lessee's perspective. Capturing these distinctions is something to be considered in the Lease Accounting Project.

We believe that the presumption that leases of land are operating leases simply because land has an infinite useful life (IAS 17 - paragraph 11) is an assumption which has no commercial logic. This presumption should be eliminated and leases of land and buildings could then be considered as finance leases or operating leases according to their economic characteristics. In such circumstances there would be no need to introduce an artificial split of a property lease as between a lease of land and a lease of buildings. Special considerations apply to leases where the lessee's interest is an investment property, as noted under lAS 40 below.

IAS 40

We note that it is proposed to accept that a lessee's long leasehold interest in a property can be treated as an investment property and we welcome this change. However we do not agree that it should be a prerequisite under the fair value model that a lessee's property interest be accounted for as a finance lease.

The purpose of investment property accounting is to account for a company's investment property in the balance sheet at valuation and to record the income from that property in the income statement. For leasehold property, the property interest that is held is a lease. If this interest is sold [certainly in the UK marketplace] the purchaser normally takes on the obligation to meet the lease payments. The lease to the tenant cannot generally be sold without also passing on the obligation to make payments under the head lease.

In the UK, leasehold investment property is recorded at valuation and the valuation reflects the lease terms including an obligation to make payments under any existing lease.

If head leases were capitalised as finance leases the following anomalies would arise:

- The valuation would be arrived at after a deduction for head lease payments and in addition the head lease 'liability' would be deducted as a borrowing. This would double count the 'liability' and understate net assets. The alternative to this of attempting to value a notional freehold would seem artificial.

- Treating property leases as finance leases is problematic and needs careful consideration before wholesale accounting change is considered. Different terms of leases including turnover rents, upward only rent reviews, rents of head leases determined as a proportion of tenant lease income cause particular difficulty in the UK marketplace. Applying simple finance lease accounting to these circumstances is likely to lead to misleading results in the context of investment property accounting as the lease terms will be valued differently on the asset side of the balance sheet from the treatment on the liability side creating a distortion in reported net assets. On the liability side, only minimum lease payments are accounted for whereas on the asset side valuers apply a value to potential future rent increases.

We do not understand the Board's concern expressed in paragraph A6 of the Appendix to the draft revision to lAS 40 that the asset recognised at inception and subsequent changes in fair value would depend on the balance of rentals prepaid at lease inception. If any lease premium is capitalised as part of the cost of investment property and the investment property valuation is determined having regard for future head lease payments, as it is in the UK, there is no problem to overcome and net assets will be fairly stated.

Accordingly we believe that lAS 40 should be amended to require all lessee interests in investment property to be treated as operating leases where the company has adopted the fair value model of accounting for investment property. Clarification might also be given that the fair value of investment property should reflect the lease terms and any obligation to make lease payments on any leasehold interest.

The changes to the current proposals to effect our recommendations might be:

IAS 17

1. However, this Standard shall not be applied to the measurement by:

(a) lessees of investment properly (see IAS 40, Investment Property);

Delete paragraphs 11A, 11B and 11C and the reference in paragraph 59A to paragraphs 11 -11C.

IAS 40

2. Among other things, this Standard deals with the measurement in a lessee's financial statements of investment property interests held under a lease and with the measurement in a lessor's financial statements of investment properly leased out under an operating lease. This Standard does not deal with matters covered in IAS 17, Leases, including:

(a) classification of leases as finance leases or operating leases,'
(b) recognition of lease income earned on investment properly (see also lAS 18, Revenue);

(c) measurement in a lessor's financial statements of property leased out under a finance lease;
(d) accounting/or sale and leaseback transactions; and
(e) disclosure about finance leases and operating leases.

26A. A lessee that classifies a properly interest held under an operating lease as investment properly shall account for that property interest as if it were an operating lease by applying paragraphs 25—27 of lAS 17, Leases but should include any premium paid to acquire that properly interest as part of the cost of the investment property.

We are aware of the wider Leases Accounting Project currently being undertaken as part of an IASB Active Research Topic. This project will need to take full account of the enormous difficulty in simply treating occupational property leases as finance leases. Until further

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guidance is issued and fully debated, we believe that the proposals set out in this comment letter represent a sensible and workable solution to the problems of property accounting.

Yours faithfully

A W BRITTAIN
DIRECTOR (TAX AND ACCOUNTING)
AND COMPANY SECRETARY