Project **Leases**

Topic **Lessor accounting–investment properties**

Purpose

1. This paper was prepared for the December 2009 meeting; however, since it was not discussed in December, the staff have revised the paper for the January 2010 meeting.
2. Investment properties, as defined in IAS 40, *Investment Property*, are properties that are held to earn rentals, or for capital appreciation or both. That is, holders of investment property realise its value from either selling or leasing the property. When the holder of the investment property realises its value through leasing, the holder acts as a lessor. US GAAP does not currently define investment properties.
3. The purpose of this paper is to discuss how a lessor should account for leases of investment properties.
4. This paper is structured as follows:
   (a) Summary of staff recommendations
   (b) Comment letter feedback
   (c) Approach A

   Underlying Asset:

   (i) Lessor accounts for investment property following existing guidance

   Lease:

   (ii) Lessor records a lease receivable

(iii) Lessor records a performance obligation

(iv) Revenue is recognised over the lease term as interest income and amortisation of the performance obligation.

(d) Approach B

Underlying Asset:

(i) Lessor accounts for all of its investment property using either a cost model or a fair value model. The choice between the models would be an accounting policy choice (ie lessors would be required to apply the chosen model to all of its investment properties)

(ii) If the fair value model is used, fair value gains and losses on the investment property are recognised in profit or loss; the investment property is not depreciated

(iii) If the cost model is used, information about the fair value of investment properties would be disclosed in the footnotes to the financial statements; the investment property is depreciated

Lease:

(iv) Lessor does not record a lease receivable or a performance obligation

(v) Lease income is recognised over the lease term (normally on a straight-line basis).

Approach B is the same as the approach currently required by IAS 40 (for the underlying asset) and IAS 17 (for the lease, following the IAS 17 accounting for operating leases). The IAS 40 approach to investment property accounting is described in Appendix A.

(e) Approach C

(i) Same as approach B; however, the lessor is required to measure its investment property at fair value. If the lessor is unable to determine fair value reliably, then the lessor must follow approach A.

(f) Staff recommendations

5. Investment properties can either be owned by a reporting entity or held under a lease. That is, an investment property can be a leasehold interest in a property. This means that a right-of-use asset under the proposed new leases requirements could also potentially meet the definition of an investment property. If the investment property is held under a lease, the reporting entity acts as both a lessee and a lessor of the property (ie there is a head lease and a sub-lease).

6. If the boards adopt either approach B or approach C in this paper, some modifications to the lessee accounting requirements may be required for when an investment property is held under a lease. This is discussed in Appendix B.

Summary of staff recommendations

7. The staff thinks that the proposed approach to lessor accounting does not provide users of financial statements (users) with useful information when applied to investment properties. Consequently, we do not recommend approach A.

8. Some staff support approach B, while other staff support approach C.

Comment letter feedback

9. The leases discussion paper asked respondents whether investment properties should be accounted for in the same way as other leased assets held by lessors. Respondents' views on this issue were mixed.

10. Some respondents stated that investment properties should be accounted for in the same way as other leased assets held by the lessor, because this would ensure consistent accounting between leases of investment property and other leases.

11. Others, including a large number of investment property companies, stated that investment properties should not be accounted for in the same way as other

leased assets (CL 65 summarises the views of most of these respondents). Their reasons were as follows:

(a) Rental income is an important measure for investment property analysts. Under the approach proposed by the boards for lessors, rental income would be replaced by amortisation of the performance obligation and interest income.

(b) Measuring investment property at fair value with fair value gains and losses recognised in profit or loss (as permitted by IAS 40) provides more relevant information to users than a cost-based approach.

(c) Real estate is fundamentally different from other leased assets. It is actively managed to produce an investment return.

(d) A property lessor views the in-place lease as only part of an indivisible property asset. Recognising the in-place lease (the receivable) separately from the property asset does not reflect how a property lessor manages its business.

(e) The current IFRS approach to investment properties (and leases of investment property) is supported by the investment property industry (both preparers and users of financial statements).

12. There is also support for a different accounting approach for investment properties within the US investment property industry:

> [We] are especially concerned that the boards' preliminary views on lessor accounting would not provide financial reporting that faithfully reflects the economic characteristics of owning and operating investment property.
>
> [Accounting] for investment property should be incorporated within the scope of IAS 40 [CL 197].

13. The staff and some Board members have held meetings with users of investment property company financial statements. The comments of those users support the views expressed by the investment property industry. When analysing investment property companies, those users are interested in the rental income generated by the properties and the fair value of the properties held. Both of

these measures are presented in the financial statements under the existing IFRS rules (if the cost model in IAS 40 is used the fair values of the investment properties are disclosed). However, rental income is not presented in the financial statements under the lessor accounting model proposed by the boards (it is replaced with interest income and amortisation of the performance obligation). The investment property could still be measured at fair value under IFRS (assuming IAS 40 accounting for the underlying asset is retained). However, under US GAAP, the fair value of the investment property would not be presented.

Approach A

14. Approach A treats leases of investment properties in the same way as other leases. Consequently, approach A would account for leases of investment properties in accordance with the proposed new lessor requirements as follows:

Underlying asset:

(a) The lessor would account for its investment property following existing guidance. That is, under US GAAP the investment property would be accounted for at depreciated cost whereas under IFRS preparers would have the option to measure the investment property at fair value.

Lease:

(b) The lessor would initially recognise a receivable and a performance obligation equal to the present value of the lease payments. The receivable and the performance obligation would be measured subsequently on an amortised cost basis.

(c) Interest income and amortisation of the performance obligation would be recognised in income over the lease term.

15. The following table describes the advantages and disadvantages of approach A:

Advantages	**Disadvantages**
There would be consistent accounting between leases of investment property and other leases.	This approach would not reflect rental income in the income statement. Rental income is an important measure for investment property analysts.
This is consistent with the boards' tentative conclusion to have one model for all leases.	The fair value of an investment property is an important measure for investment property analysts. Fair value information would only be presented under this approach if IFRS preparers used the FV option; US GAAP preparers do not currently have a fair value option).
	Real estate is fundamentally different from other leased assets because it is actively managed to produce an investment return. This approach does not reflect that difference
	A property lessor views the in-place lease as only part of an indivisible property asset. Recognising the in-place lease (the receivable) separately from the property asset does not reflect how a property lessor manages its business

Approach B

16. Approach B is the same as that currently required by IAS 40 (for the underlying asset) and IAS 17 (for the lease of the underlying; that is, following the current operating lease accounting guidance). Approach B would account for leases of investment properties as follows:

    Underlying asset:

    (i) Lessor accounts for its investment property using either a cost model or a fair value model. The choice between the models would be an accounting policy choice (ie lessors would be required to apply the chosen model to all of their investment properties).

    (ii) If the fair value model is used, fair value gains and losses on the investment property are recognised in profit or loss; the investment property is not depreciated.

    (iii) If the cost model is used information about the fair value of investment properties would be disclosed; the investment property is depreciated.

    Lease:

    (iv) Lessor does not record a lease receivable or a performance obligation.

    (v) Lease income is recognised over the lease term (normally on a straight-line basis).

17. If the boards adopt approach B, they will then need to decide how best to incorporate this approach into any new proposed lease requirements. For example, the boards will need to decide whether the accounting for investment properties will be specified in the leases exposure draft, or in a separate comprehensive investment property standard (for example, IAS 40).

18. The following table describes the advantages and disadvantages of approach B:

Advantages	**Disadvantages**
Would reflect rental income in the income statement. Rental income is an important measure for investment property analysts	Subjectivity (and lack of comparability) with a choice between cost and fair value.
The fair value of an investment property is an important measure for investment property analysts. Fair value information would be provided under this approach either in the carrying amount of the investment property (if the FV model is applied) or through disclosure (if the cost model is applied).	Lack of comparability between leases of investment property and other leases.
Real estate is fundamentally different from other leased assets because it is actively managed to produce an investment return. This approach reflects that difference.	Under US GAAP, entities that realise the value of their investment properties by leasing them out will have the option to measure the underlying investment property at fair value. However, this option would not be available for investment properties that are not leased out (unless there is a general reconsideration of investment property accounting under US GAAP). This will result in different accounting for investment properties depending on whether or not they are leased.
It is the same as the approach currently	A fair value option for investment

required for investment properties under IFRS (IAS 40). It will therefore be easy for IFRS reporters to implement.	properties is inconsistent with the US GAAP accounting for other non-financial assets.
	This would be inconsistent with the boards' tentative conclusion to have one leases model for all leases; it also could call into question whether there are other leases (besides investment properties) that should receive different lease accounting treatment.

Approach C

19. Under approach C, the lessor is required to measure its investment property (the underlying asset) at fair value. If the lessor is able to determine fair value reliably and accounts for its investment property at fair value, then the lessor will be allowed to account for its leases of its investment property consistent with current operating lease accounting.

20. However, under this approach if the lessor is unable to determine fair value reliably, then the lessor must follow approach A. That is, it will use current guidance to measure the underlying asset (cost under US GAAP and either fair value or cost under IFRS) and it will be required to follow the proposed new leases requirements for its leases of its investment property.

21. If the boards adopt approach C, they will then need to decide how best to incorporate the accounting for investment properties into any new proposed lease requirements.

Advantages	**Disadvantages**
Would reflect rental income in the income statement if the underlying investment property were accounted for at fair value. Rental income is an important measure for investment property analysts	Inconsistent with US GAAP accounting for non-financial assets
Requiring fair value provides more relevant information to users than cost	Lack of comparability between leases of investment property and other leases.
Reflects the fundamental differences between investment properties and other leased assets	Different accounting for investment properties if fair value cannot be reliably determined
The accounting for investment properties would have more consistency and more comparability by requiring more companies to measure at fair value.	It could represent a significant change to the existing investment property accounting requirements for IFRS reporters which may be difficult and time-consuming to implement.
May limit structuring opportunities	This will result in different accounting for investment properties depending on whether or not they are leased (see explanation under approach B).
	This would be inconsistent with the boards' tentative conclusion to have one leases model for all leases; it also could call into question whether there are other leases (besides investment properties) that should receive different lease accounting treatment.

Staff recommendations

22. The staff agree with the comments made by both the investment property industry and the users of investment property company financial statements. The accounting model proposed by the boards for lessors does not provide relevant information to investment property analysts. In particular, it does not:

    (a) reflect the same amount of rental income in profit or loss as does the current lease accounting guidance

    (b) provide information about the fair value of investment properties to US GAAP reporters

    (c) reflect the fundamental differences between investment properties and other leases.

23. Consequently, the staff do not support approach A.

24. Some staff prefer approach B, which would require entities to apply either a cost model or a fair value model to their investment properties. These staff acknowledge that providing a choice between cost and fair value may reduce comparability. However:

    (a) even under the cost model, rental income is presented in profit or loss, and the fair value of investment properties is disclosed

    (b) not all countries have the professional expertise to value properties. Consequently, requiring the use of fair value would be difficult for these countries to implement

    (c) requiring the use of fair value would be burdensome for entities that have only one or two investment properties (eg an entity that chooses to sublet a property that it no longer requires for its own use)

    (d) the choice between the cost model and the fair value model would be an accounting policy choice. Entities would apply the chosen model to all their investment properties (they could not cherry-pick the properties to be held at cost or fair value).

25. In addition, these staff members note that approach C would represent a fundamental change to investment property accounting under IFRS. Although most listed investment property companies within Europe apply the fair value model, many other entities apply the cost model – particularly non-investment property companies who only hold one or two investment properties. The focus of the leases project is not investment property accounting. If the IASB decides to change IAS 40 through the leases project, then this could:

    (a) divert attention away from lease accounting to investment property accounting; and

    (b) have implications for the timing and other aspects of the project.

26. Other staff prefer approach C, which would limit the number of investment property companies measuring their investment properties at cost, and would consequently increase comparability. The staff think many investment property companies will prefer, and will be able to, measure their investment properties at fair value. In fact, most listed investment property companies within Europe already apply the fair value model under IAS 40. Those entities that currently apply the cost model under IAS 40 must disclose the fair value of the investment property. Therefore, all entities currently applying IAS 40 have fair value information for their investment properties. Current guidance indicates that it would only be in limited circumstances that an entity would not be able to determine fair value reliably.

27. Approach C allows those lessors who fair value their underlying asset to get current operating lease accounting for its leases of those underlying assets.

Question 1
The staff recommend that leases of investment properties should have different accounting to the proposed lessor accounting requirements. Which of the three approaches (A, B or C) do the boards prefer?

Appendix A – Requirements of IAS 40 *Investment Property*

A1. This appendix summarises the accounting requirements of IAS 40 *Investment Property*.

A2. Investment property is defined in IAS 40 as:

> …property (land or building – or part of a building – or both) held … to earn rentals or for capital appreciation or both, rather than for: (a) use in production or supply of goods or services or for administration purposes; or (b) sale in the ordinary course of business.

A3. IAS 40 applies to individual properties. Consequently, it is possible for a reporting entity that is not an investment property company to hold investment property.

A4. The classification and disclosure requirements of IAS 17 apply to investment properties. However, leases of investment properties provided by lessors under operating leases are excluded from the measurement requirements of IAS 17. Instead, they are accounted for under IAS 40.

(a) Note: the proposed new leases guidance will no longer distinguish between operating and finance leases; therefore IAS 40 will need to be revised to reflect this change.

A5. Leases of investment properties provided by lessors under finance leases are deemed to be in-substance sales of the property. Consequently, they cannot be treated as investment properties. Instead, they are accounted for under IAS 17.

(a) Note: Transactions that are considered sales of the property will be excluded from the scope of the proposed new leases guidance.

A6. It is also possible to use investment property accounting for properties that are held by the lessor under a lease rather than owned outright. The implications of this are discussed in Appendix B.

A7. IAS 40 provides entities with a choice for subsequent measurement of the investment property. The holder of the investment property must choose either the cost model or the fair value model and apply it to all its investment properties (subject to some limited exceptions). The choice between the two models is an accounting policy choice. Changing between the two models is only permitted if the change would result in more relevant or reliable information. Paragraph 31 of IAS 40 states that it is highly unlikely that a change from the fair value model to the cost model would result in more relevant information.

A8. If an entity elects to use the fair value model, its investment properties are subsequently measured at fair value. Gains and losses arising from changes in fair value are recognised in profit or loss in the period that they arise.

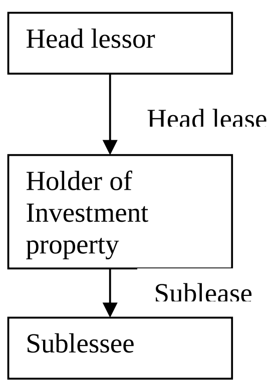
A9. If an entity elects to use the cost model, the investment property is subsequently measured at depreciated cost (using the cost models in IAS 16 *Property, Plant and Equipment*). The fair value of investment properties held is disclosed.

A10. IAS 40 does not specify the required accounting for the rental income arising from investment property. However, it is normally recognised on a straight-line basis over the term of the lease.

(a) Note: If approach B or approach C is adopted, the accounting for rental income arising from investment property will need to be specified somewhere (either in the proposed new lease accounting requirements or in an amendment to IAS 40).

Appendix B – Implications of applying approach B or approach C to investment properties that are held under a lease rather than owned

B1. Investment properties (as currently defined in IAS 40) can be either owned by a reporting entity or held under a lease. That is, an investment property can be a leasehold interest in a property. This means that a right-of-use asset under the proposed new leases guidance could also potentially meet the definition of an investment property. If the investment property is held under a lease, the reporting entity acts as both a lessee and a lessor of the property (ie there is a head lease and a sub-lease).



B2. The head lease will, under the new approach to lease accounting, give rise to a right-of-use asset and to an obligation to pay rentals.

B3. If the boards adopt approach B, subsequent measurement of the right-of-use asset would be at cost or fair value. If approach C is adopted, the subsequent measurement of the right-of-use asset will generally be at fair value unless fair value cannot be determined reliably.

B4. The obligation to pay rentals would continue to be accounted for under the proposed new leases requirements.

B5. Additional guidance will be required for head leases that include options to extend or terminate the lease or contingent rentals. For example, if the right-of-use asset is measured at fair value, the staff may recommend that adjustments to the obligation to pay rentals arising from changes in the lease term, or to estimated contingent rentals, be recognised in profit or loss. If, however, the right-of-use asset is measured at cost, changes to the obligation to pay rentals should be accounted for under the proposed new leases requirements – that is:

(a) Changes in the obligation to pay rentals arising from a change in lease term would be added to the carrying amount of the right-of-use asset.

(b) Changes in the obligation to pay rentals arising from changes in expected contingent rental payments would either be expensed, or added to the carrying amount of the right-of-use asset (the boards have not yet reached a tentative decision).

B6. The staff will ask the boards to reach decisions on these issues at a future board meeting.