STAFF PAPER

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Project	**Leases**		
Paper topic	Rental income recognition for investment properties		
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Purpose

1. The purpose of this paper is to discuss how a lessor should account for rental income arising from investment property that is outside the scope of the lessor receivable and residual approach.

2. This paper does not address the definition of investment property, which will be addressed in a future board paper. This paper assumes that the definition of investment property for the purposes of lessor accounting will be an asset-based, not an entity-based, definition. Consequently, under US GAAP, there will be investment properties held by lessors that are not investment property entities or investment companies. This paper also assumes that these investment properties are typically measured at cost. However, there are some investment properties that are held by lessors who are not investment property entities or investment companies and that are measured at fair value; for example, investment properties held by health and welfare benefit plans.

Background

3. At the October 2011 joint board meeting, the boards decided that a lessor's leases of investment property would be outside the scope of the receivable and residual approach. Instead, for such leases, the lessor would continue to recognise the underlying asset and the lease income over the lease term. However, the boards did not decide on the *pattern* of rental income recognition that a lessor should apply to such leases.

IFRSs

4. IAS 40 *Investment Property* requires lessors of investment property to look to IAS 17 *Leases* to determine how to recognise rental income. Consequently, a lessor would recognise rental income arising from investment property on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the benefit received from the leased asset (assuming that the lease is an operating lease).

5. The *Leases* August 2010 exposure draft ('the ED') proposed that IAS 40 require that 'a lessor [of investment property] that uses the fair value model recognises lease income arising on the investment property (other than fair value gains or losses) on a straight-line basis over the lease term'. The ED also proposed that a lessor that uses the cost model for investment property recognises rental income in accordance with the lessor model proposed in the ED.

US GAAP

6. US GAAP does not currently have specific guidance for investment property. Therefore, lessors of investment property currently recognise rental income in accordance with Topic 840 *Leases*, which includes guidance similar to that in IAS 17 (referred to in paragraph 4 above).

7. However, in its Investment Property Entities and Investment Company projects, the FASB has proposed that rental income arising from investment properties held by investment companies or investment property entities should be recognised on a contractual basis (that is, when the lease payments are received

or become receivable in accordance with the lease contract). The project proposes that those investment properties should be measured at fair value.

Feedback received

8. Feedback received on the ED's proposals about rental income recognition for investment property measured at fair value was limited. Some real estate industry respondents noted that the straight-line basis of rental income recognition is widely understood, and that separating rental income from other fair value changes in profit or loss provides useful information. Some respondents requested more guidance on rental income recognition, particularly regarding the definition of rental income.

9. Following the FASB's decision about recognising rental income on a contractual basis for investment property held by investment companies and investment property entities, a European real estate association performed an informal survey of its members to assess whether they would prefer rental income from investment properties measured at fair value to be recognised using a contractual or straight-line basis. The majority of respondents indicated that they would prefer rental income to be recognised on a straight-line basis.

10. The staff also heard feedback from the real estate industry indicating that they would prefer the same method of rental income recognition to be used for all investment properties, regardless of whether the property is measured at cost or fair value.

11. In the course of outreach performed for the FASB's Investment Property Entities and Investment Companies projects, the FASB has heard support for using the contractual method for investment properties measured at fair value. These constituents believe that the contractual method is more consistent with the fair value measurement of the underlying investment property.

Staff analysis

12. Given the boards' decisions regarding investment property and lessor accounting, the staff think it is appropriate that the proposed leases standard provides specific guidance about the recognition of rental income from investment properties that are not within the scope of the receivable and residual approach to lessor accounting. The staff think such guidance is necessary for:

    (a) *all* investment properties (both investment properties measured at fair value and investment properties measured at cost) under IFRSs; and

    (b) investment properties that are not held by investment property entities or investment companies (that is, investment properties measured at cost) under US GAAP. Again, the FASB's *Investment Property Entities* and *Investment Companies* exposure drafts provide rental income recognition guidance for investment properties held by investment property entities and investment companies. These investment properties are measured at fair value.

13. Although the staff acknowledge that it would be attractive to refer to the revenue recognition standard to determine the pattern of rental income recognition, the staff would not recommend such an approach. Under the proposed revenue recognition guidance, one could argue that a lessor has satisfied its performance obligation relating to the lease at lease commencement and should therefore recognise the entire expected rental income on that date. To avoid this conclusion, the staff would recommend explicitly stating the pattern of rental income recognition in the leases standard.

14. There are two broad approaches to rental income recognition that the staff considered for investment properties:

    (a) Approach A—to recognise rental income on a contractual basis; or

    (b) Approach B—to recognise rental income on a straight-line basis, or another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property.

Investment property measured at cost (FASB and IASB issue)

15. The staff do not think that recognising rental income on a contractual basis (Approach A) would be appropriate for investment property measured at cost. This is because, under such an approach, the amount of rental income recognised is entirely dependent on the contractual timing of lease payments. If a lessor wanted to manage earnings, it could easily do so by changing the timing of lease payments. In addition, the staff think Approach B—the straight-line approach—would better reflect that a lessor is earning rental income over the lease term as it makes the leased asset available for use by the lessee.

16. The staff would therefore recommend that the straight-line method described in Approach B be used for investment property measured at cost (refer to paragraphs 25–30 of this paper for further details about the application of this approach). Under US GAAP, this would mean that this method would be used for leases of investment property not held by investment property entities or investment companies.

Investment property measured at fair value (IASB-only issue)

17. The IASB also needs to decide which method of rental income recognition should be used for investment property measured at fair value. The FASB has already made this decision as part of its Investment Property Entities and Investment Companies projects.

18. The staff do not think that the choice between Approach A and Approach B is quite as straightforward for investment properties measured at fair value. The advantages and disadvantages of each approach are listed in the paragraphs below. However, it is important to note that, when investment property is measured at fair value, the choice of rental income recognition method is really a question of presentation. This is because the net income recognised (taking into account both rental income and fair value gains or losses) and the net amount of assets recognised (taking into account both the carrying amount of the investment property and any accrued or prepaid rental income) should be the same under Approaches A and B. For example, when a lessor applying the fair value model in IAS 40 currently recognises rental income in a pattern different

from the contractual rents, the lessor makes adjustments to the fair value changes recognised to avoid double-counting.

Approach A: recognise rental income on a contractual basis

19. Approach A would require that a lessor of investment property measured at fair value recognises rental income arising from that property on a contractual basis (when the lease payments are received or become receivable in accordance with the lease contract). If the IASB chooses Approach A for investment property measured at fair value, the result would be different methods of rental income recognition for investment properties, depending on whether they are measured at cost or fair value.

20. As discussed previously, the FASB, in its Investment Property Entities and Investment Company projects, has recently decided to propose that rental income arising from investment properties be recognised on such a contractual basis. The Basis for Conclusions of the *Investment Property Entities* exposure draft explains the reasons for the FASB's decision:

> The Board decided that rental revenue from investment properties subject to a lease should be recognized when lease payments are received or as lease payments become receivable in accordance with the contractual terms of the related lease to be consistent with fair value measurement of investment properties. Therefore, increases in rent due to concessions such as free rent or decreased rent would not be recognized until the rent income is earned and billable. The Board noted that the fair value of an investment property would include the effects of future rent increases. Requiring an entity to recognize rental revenue on a straight-line basis over the lease term would require an adjustment to the fair value of the investment property to avoid double-counting. The Board believes that including the effects of future rent increases is more relevant as part of the fair value of the property than recognizing rental revenue on a straight-line basis.

21. The staff acknowledge that the above argument represents the greatest advantage of recognising rental income on a contractual basis. This approach

would be consistent with the fair value measurement of the investment property that is being leased, and would not require any adjustments to the fair value of the investment property. This approach would also result in convergence with US GAAP, assuming the proposals in the FASB's *Investment Property Entities* and *Investment Companies* exposure drafts are finalised. The staff note that these proposals are still subject to change.

22. Nonetheless, this approach would result in inconsistency in accounting for rental income arising from investment properties measured either at cost or fair value. The staff have talked to some constituents from the real estate industry who prefer the contractual method of rental income recognition for investment properties measured at fair value. Despite those views, constituents think it is more important that the same method of rental income recognition be used for all investment properties under IFRSs. They would, therefore, support rental income recognition on a straight-line basis if that resulted in consistency in accounting for rental income arising from *all* investment property.

23. Additionally, this approach would be somewhat different from the current rental income recognition model applied in IAS 17, which generally results in recognising rental income on a straight-line basis. One could argue that such a change to the current guidance in IAS 17 and IAS 40 would be outside the scope of the Leases project. Unlike the FASB, the IASB does not have an active investment property project on its agenda and it could be misleading to present such a change to the guidance in IAS 40 as a simple consequential amendment of changes proposed to leases.

24. Finally, one could argue that the contractual basis would not always best present how rental income is earned by an investment property lessor. For example, if rent payments are severely front-loaded or back-loaded in the contract, the presentation of rental income would also be very front-loaded or back-loaded. One could argue that this is inappropriate because a lessor is earning rental income throughout the lease contract, regardless of how the payment profile is structured.

Approach B: recognise rental income on a straight-line basis, or another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property

25. Under Approach B, the leases standard would contain guidance that specify that a lessor of investment property measured at fair value would recognise rental income on a straight-line basis, or another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property. The staff's suggested guidance is as follows:

> A lessor of investment property measured at fair value shall recognise rental income arising from leases of investment property (other than fair value gains or losses) in profit or loss on a straight-line basis, or another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property.

26. If the IASB elects this approach for investment property measured at fair value, IFRSs would require the same rental income recognition method for all investment property.

27. This approach is generally consistent with the guidance for rental income arising from investment property measured at fair value that was proposed in the ED (which proposed that a lessor would recognise rental income on a straight-line basis). However, the staff do not think that a straight-line basis of rental income recognition is always the most appropriate. In the case of variable lease payments, the staff think it would be simpler and more consistent with the boards' tentative decisions to recognise the rental income arising from variable lease payments as it occurs, instead of estimating the total variable income under the lease and recognising that estimated amount on a straight-line basis over the lease term. In the case of stepped rent increases (when those stepped rents are expected to compensate the lessor for increases in market rentals), the staff think that recognising the rental income arising from rents as they are received would

better reflect the time pattern in which rentals are earned from the investment property.[1]

28. To address this issue, the proposed guidance under this approach is broadly consistent with the operating lease rental income recognition guidance in IAS 17. There is, however, one difference: the staff recommendation (Approach B) would require the recognition of rental income on a straight-line basis *or* another systematic basis, whereas IAS 17 requires the recognition of rental income on a straight-line basis *unless* another systematic basis better represents the way in which rental income is earned from the investment property.

29. Following this approach, a lessor would not follow straight-line income recognition if there were variable lease payments or stepped rent increases to account for market rentals. Those uneven payments would be recognised in the period in which they arise. This approach would be consistent with the treatment of variable lease payments under the receivable and residual approach. Under the receivable and residual approach, all variable lease payments would effectively be recognised in the period in which those payments are made, even variable lease payments measured on the basis of an index or a rate. Although these payments are included in the receivable, because they are included using the spot rates or an index (which is reassessed and updated to the new spot rate or an index), this would (in effect) mean that these payments are also not recognised on a straight-line basis.

30. Under this approach, a lessor would estimate uneven lease payments and recognise those lease payments on a straight-line basis only when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front-loading or back-

[1] [1] Recognising increases in rentals that are expected to compensate for increases in market rentals or market conditions as they occur would represent a change from current practice. According to Technical Bulletin 85-3 *Accounting for Operating Leases with Scheduled Rent Increases*, scheduled rent increases are required to be projected and straight-lined instead of recognised as they occur; only contingent rents are recognised as they occur. We understand that IAS 17 is applied in a similar way. Nonetheless, the staff think that the proposal set out in paragraph 26 above would be more appropriate because variable lease payments measured on the basis of an inflation index and scheduled rent increases designed to compensate the lessor for inflation are economically very similar. The staff think that both of these increases in rental payments should be recognised as revenue as they occur because that best represents how a lessor is earning rentals from an investment property.

loading of payments or when rent-free periods exist in a lease contract). Application guidance would be added to the standard to illustrate this application.

31. This approach would result in consistent accounting for all investment properties under IFRSs in terms of rental income recognition. Additionally, this approach would be generally consistent with both current practice and what was proposed in the *Leases* ED. It would also present a solution to the criticism of the contractual basis discussed in paragraph 24 of this paper. One could argue that when a lessor continues to recognise an underlying asset, a straight-line basis would better reflect that the lessor is earning rental income over the lease term as it makes its asset available for use by the lessee.

32. However, such a straight-line basis for profit recognition would not necessarily be consistent with the fair value measurement of the underlying asset. Moreover, as discussed earlier in this paper, this basis would at times require adjustments to the carrying amount (ie the fair value measurement) of investment property to avoid double-counting in the case of uneven payments. Finally, this decision would not result in convergence with the proposals made in the FASB's *Investment Property Entities* and *Investment Companies* exposure drafts.

Staff recommendation

33. The staff can see merits in both rental income recognition approaches proposed for investment properties measured at fair value under IFRSs. The most significant advantages of Approach A are that the approach:

    (a) is consistent with the fair value measurement of the investment property, and would not require adjustments to that fair value measurement; and

    (b) is consistent with the proposals in the FASB's *Investment Property Entities* and *Investment Companies* exposure drafts.

34. The most significant advantages of Approach B are that the approach:

(a) would result in consistent rental income recognition for all investment property, regardless of whether that investment property is measured at cost or fair value;

(b) is generally consistent with the current guidance in IAS 40, and

(c) presents rental income as being earned throughout the life of a lease.

35. The staff think it is desirable to have one rental income recognition method for all investment property under IFRSs. Given that the straight-line method of rental income recognition has worked well in current practice for investment property, the staff would recommend that this method be retained (subject to the modifications and clarifications discussed in paragraphs 25-30 above). Therefore, the staff would recommend applying Approach B to all investment properties under IFRSs.

36. The staff also recommend applying Approach B to investment properties not held by investment property entities or investment companies under US GAAP.

Question 1

Does the IASB agree that all lessors of investment property should recognise rental income on a straight-line basis, or another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property?

Does the FASB agree that lessors of investment property that are not investment property entities or investment companies should recognise rental income on a straight-line basis, or another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property?

Recognition of lease assets and lease liabilities for lessors of investment property

37. Some have questioned the implications of the boards' decision to remove leases of investment property from the scope of the receivable and residual approach in terms of which assets and liabilities a lessor would recognise. Some would argue that, in order to be consistent with the lessee right-of-use model, a lessor of investment property should not only continue to recognise the underlying asset but also recognise a lease receivable and a corresponding lease liability.

Under such an approach, the lease receivable and lease liability would be presented net on the balance sheet. The gross presentation of those amounts was rejected by the vast majority of respondents to the ED.

38. The staff do not recommend this approach and would instead recommend that a lessor of investment property recognise only the underlying investment property on its balance sheet (as well as any accrued or prepaid rental income). The approach described in paragraph 37 was discussed and rejected by the boards at the May 2011 joint board meeting and the staff continue to have the same concerns with this approach that they had in May. This approach (ie recognising a lease receivable and lease liability, but presenting them net) would be the same as recognising only the underlying investment property in virtually all circumstances. Given the cost and effort that would be involved in obtaining the carrying amounts of the lease receivable and lease liability, the staff do not think that the benefits of this approach would outweigh the costs. The staff also note that the proposed disclosures in agenda paper 2C/FASB Memo 223 would provide users with information about the future contractual cash flows under leases of investment property.

Question 2
Do the boards agree that a lessor of investment property would recognise only the underlying investment property (as well as any accrued or prepaid rental income)?