Contact(s) | **Sarah Geisman** | sgeisman@ifrs.org | +44 020 7246 6464
Patrina Buchanan | pbuchanan@ifrs.org | +44 020 7246 6468

Project **Leases**

Topic **Consequential amendments to IAS 40**

Purpose

1. The purpose of this paper is to ask the Board about the consequential amendments to be made to IAS 40 *Investment Property* as a result of the draft IFRS *Leases* standard.

2. The staff think that the board needs to answer two questions in relation to the consequential amendments to IAS 40:

   (a) How should a lessor account for rental income from investment property measured at fair value? (paragraphs 5-25 of this paper)

   (b) What disclosures should a lessor of investment property measured at fair value make? (paragraphs 26-34 of this paper)

3. The boards' decision in July 2011 to exclude leases of investment property measured at fair value from the scope of the leases standard requires a number of consequential amendments to IAS 40. The staff do not think that these amendments need to be deliberated by the Board because they are simply consequences of the decision to exclude investment properties measured at fair value from the leases standard and other previous tentative decisions. The most significant consequences are listed in Appendix A to this paper.

4. Appendices B and C to the paper set out information about the proposed disclosure requirements to be included in IAS 40.

Treatment of rental income from investment property measured at fair value

5. IAS 40 does not provide guidance on the treatment of rental income from investment property because guidance is included in IAS 17 *Leases*. As a result of the boards' decisions regarding lessor accounting, the accounting requirements for leases of investment property measured at *cost* will be contained in the leases standard. However, the staff think that IAS 40 should provide guidance regarding the recognition of rental income from investment property measured at *fair value*.

6. The *Leases* ED proposed that IAS 40 require that 'a lessor that uses the fair value model recognises income arising on the investment property (other than fair value gains or losses) on a straight-line basis over the lease term'.

7. Under current guidance, IAS 40 requires lessors to look to IAS 17 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. Some real estate industry respondents to the ED noted that the straight-line basis is widely understood and has been applied for many years, and that separating rental income from other fair value changes in profit or loss provides useful information.

8. As noted above, the staff think it is appropriate that IAS 40 provides guidance about the recognition of rental income from investment properties measured at fair value. Although the staff acknowledge that referring to the revenue recognition standard for this purpose would be attractive, the staff would not recommend referring to such guidance. Under the proposed new 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 IAS 40.

9. The staff think that there are two approaches that the Board could take to rental income recognition relating to investment property measured at fair value:

   (a) Approach A: Recognise rental income on a contractual basis.

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

10. Before discussing the two alternatives, the staff thinks it is important to note that when the 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 either method noted in paragraph 9 above. 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

11. Approach A would require that a lessor of investment property measured at fair value would recognise 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).

12. The FASB, in its investment company and investment property projects, has recently decided to propose that rental income arising from investment properties be recognised on such a contractual basis. The FASB reached this decision because the fair value of an investment property takes into account the timing of contractual cash flows expected to be received as rent. Recognising rental income on a straight-line basis rather than a contractual basis would require adjustments to the fair value of an investment property to avoid double

counting. The FASB believes that including the effects of future rent increases is more relevant as part of the fair value of the property than recognising rental revenue on a straight-line basis.

13. The staff acknowledges 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 investment properties.

14. However, 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 due to the leases standard.

15. Additionally, the staff do not think the contractual basis would 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, no matter how the contract is structured. On the other hand, one could argue that if rent payments are received in advance, a market participant would not include those payments in the amount they would pay for the investment property in an orderly transaction. Again, the staff would like to note that this is only a matter of presentation as the net income will be the same under both methods of rental income recognition after taking into account fair value gains and losses.

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

16. Under Approach B, IAS 40 would contain guidance specifying that a lessor of investment property measured at fair value would recognise rental income on a straight-line basis or on 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 on another systematic basis if that basis is more representative of the time pattern in which rentals are earned from the investment property.

17. This is generally consistent with the guidance for rental income 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 rather than 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.

18. To address this issue, the proposed guidance under this approach is broadly consistent with the operating lease rental income recognition guidance in IAS 17, with one difference—the staff recommendation under Approach B would require the recognition of rental income on a straight-line basis <u>or</u> 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.

19. Following the proposed wording in 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. These uneven payments would be recognised in the period in which they were earned. Regarding variable lease payments based on an index or a rate, even though these payments are included in the receivable, because these are included at spot, which is simply reassessed and updated to spot, then this would (in effect) mean that these payments are also not recognised on a straight-line basis.

20. Under this approach, a lessor would project and straight-line uneven lease payments only when there were uneven payments for reasons other than to reflect or compensate for market rentals or market conditions (eg when there is significant front-loading or back-loading of payments or when rent-free periods exist in a lease contract).

21. This approach would present a solution to the criticism of the contractual basis discussed in paragraph 15. One could argue that a straight-line basis would better present that a lessor is earning rental income over the lease contract as it continues to provide the lessee with access to the lease asset. Additionally, this approach would be generally consistent with both current practice and what was proposed in the leases ED.

22. 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.

Staff recommendation

23. The staff can see merits in both approaches. Approach A's most significant advantages are that the approach:

(a) is consistent with the fair value measurement of the investment property; and

(b) would not require adjustments to that fair value measurement.

24. Approach B's most significant advantages are that the approach:

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

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

25. The staff think the right answer in this case depends on how much the board would like to change the existing accounting for leases of investment property measured at fair value. One could argue that changing such accounting is outside the scope of the leases project. If the board would prefer to remain consistent with current accounting and present rental income as being earned throughout the life of a lease, the staff would recommend Approach B. If, however, the board would prefer to use a method of revenue recognition that is consistent with the fair value measurement of the underlying investment property, the staff would recommend Approach A. The staff think that Approach A is a viable option for the board given that a consequence of removing the operating lease accounting guidance in IAS 17 is that this rental income guidance in IAS 40 will now apply only to investment property measured at fair value, whereas the current operating lease income guidance in IAS 17 applies to asset measured at both cost and fair value.

Question 1
Which approach does the board prefer?

Disclosures

26. IAS 40 requires lessors of investment property to provide all the lessor disclosures required by IAS 17. Because, from a lessor's perspective, only investment properties subject to operating leases are included in the scope of

IAS 40, this means that only the lessor operating lease disclosure requirements are applicable.

27. IAS 17 requires that lessors disclose the following information for operating leases:

    (a) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
        (i) not later than one year;
        (ii) later than one year and not later than five years;
        (iii)later than five years.

    (ii) total contingent rents recognised as income in the period.

    (iii) a general description of the lessor's leasing arrangements.

28. Given the boards' tentative decision regarding a single lessor accounting model and the changes that are being proposed to required lessor disclosures (discussed in Agenda paper 2D/FASB Memo 208, also due to be discussed at this board meeting), the staff do not think it is appropriate that IAS 40 continues to require a lessor of investment property to make all other disclosures required of lessors in the lease standard. Many of the required disclosures for lessors proposed in Agenda paper 2D relate to the right to receive lease payments and the residual asset; these disclosures will not be relevant for lessors of investment property measured at fair value because they will not be recognising a right to receive lease payments or a residual asset.

29. Therefore, the staff think that the disclosure requirements for lessors of investment property measured at fair value should be included in IAS 40 itself.

30. Agenda paper 2D and the *Leases* exposure draft contain some disclosure recommendations that the staff think would be useful for a lessor of investment property measured at fair value and can be carried forward directly from the leases standard. These disclosures are:

    (a) Disclosures regarding the nature of an entity's lease arrangements and information about the principal terms of any lease not yet commenced if the lease creates significant rights and obligations for the entity.

(b) Disclosures about the nature of significant service obligations related to leases.

31. Also, Agenda paper 2D discusses maturity analysis and tabular lease income disclosures. The staff think that both of these would be relevant for a lessor of investment property measured at fair value but that the wording would need to be slightly changed. A lessor of investment property measured at fair value would need to disclose a maturity analysis of the future fixed lease payments expected to be earned from leases (not a maturity analysis of the right to receive lease payments). A tabular note disclosure of lease income items for a lessor of investment property would contain fixed rental income, variable rental income and fair value gains and losses.

32. Regarding roll forward disclosures (also discussed in Agenda paper 2D), the staff do not recommend that IAS 40 contain lease roll forward requirements for investment property measured at fair value. IAS 40 already contains a roll forward requirement for all investment property measured at fair value and the staff think this is an adequate disclosure.

33. The staff would recommend retaining all other IAS 40 disclosure requirements (subject to minor changes to reflect the new leases requirements). In addition, all lessors of investment property measured at cost would be required to make the disclosure requirements contained in the leases standard.

34. Appendix B contains the staff's proposed drafting regarding the new disclosure requirements in IAS 40. Appendix C contains a list of the proposed lessor disclosure requirements in Agenda paper 2D and the staff's reasons for rejecting, retaining or modifying those disclosure requirements for lessors of investment property measured at fair value.

Question 2
Does the Board agree with the staff's proposed disclosure requirements for lessors of investment property measured at fair value? See Appendix B for a list of the recommended disclosure requirements.

Appendix A: Significant consequences of the boards' tentative decisions as they relate to IAS 40

A1. The staff is proposing a number of consequential amendments to be made to IAS 40. However, with the exception of the two questions presented in the main body of the paper, the staff think that the rest of the consequential amendments simply represent consequences of the board's previous tentative decisions. Of these consequential amendments, the staff think the following are the most significant:

(a) Lessors of investment properties that measure investment properties at cost should apply the leases standard to account for these properties; such properties will be excluded from the scope of IAS 40 for purposes of recognition, measurement and presentation (while still being in the scope of IAS 40 for purposes of the cost/fair value accounting policy choice and disclosures).

(b) A lessee's right-of-use asset could be accounted for as an investment property, either measured at fair value in accordance with IAS 40, measured at cost in accordance with IAS 40 or measured in accordance with the leases standard (if the right-of-use asset is measured at cost and then subleased). This will increase the scope of IAS 40; currently it includes interests in investment property held by lessees under finance leases and interests held by lessees under operating leases if that interest is measured at fair value. As a result some operating lessees of investment property would have to follow IAS 40 and provide its required disclosures.

(c) All of a lessor's investment properties held in a lease and measured at fair value will be in the scope of IAS 40. IAS 40 previously specified that only a lessor's investment properties held under operating leases were within its scope. The staff acknowledges that this will be widening the scope of IAS 40 and will result in some leases previously accounted for as finance leases, with the corresponding accounting treatment, now being required to be treated as investment properties measured at fair value. Effectively, the new line determining IAS 40’s scope will be the line between a sale and a lease (investment properties that are leased will be in the scope of IAS 40, while those that are sold will not). However, the staff think that drawing a dividing line between retaining the risks and rewards of the underlying asset in order to retain IAS 40’s original scope would not be consistent with the boards’ tentative decisions regarding a single model for lessee and lessor accounting. Moreover, the staff thinks that fair value information will always be relevant for investment properties.

Appendix B: Proposed drafting for IAS 40 disclosure requirements for lessors of investment property measured at fair value

A2. A lessor of investment property measured at fair value would disclose the following:

(a) the nature of its lease arrangements, including:

- (i) a general description of those lease arrangements.
- (ii) the basis and terms on which variable lease payments are determined.
- (iii) the existence and terms of options, including for renewal and termination.
- (iv) the existence and principal terms of any options for the lessee to purchase the underlying asset.

(b) information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations for the entity.

(c) information about the nature of significant service obligations related to its leases.

(d) a maturity analysis of the fixed lease payments showing the undiscounted cash flows on an annual basis for, at a minimum, the first five years and a total of the amounts for the remaining years.

(e) a tabular schedule of income related to leases of investment property, including:

- (i) Fixed rental income;
- (ii) Variable rental income; and
- (iii) Fair value gains and losses.

Appendix C: Proposed lessor disclosure requirements with staff recommendations for lessors of investment property at fair value

General lessor disclosure	Recommendation for investment property measured at fair value
An entity shall disclose: a) the nature of its lease arrangements, including: i) general description of those lease arrangements. ii) the basis and terms on which contingent rentals are determined. iii) the existence and terms of options, including for renewal and termination. iv) a discussion of how the lessor manages its exposure to the underlying asset, including: A) its risk management strategy in this respect. B) The carrying amount of the residual asset that is covered by residual value guarantees and the unguaranteed portion of the carrying amount of the residual asset, including the terms of those residual value guarantees. C) whether the lessor has any other means of reducing its exposure to residual asset risk (eg buyback agreements with the manufacturer from whom the lessor purchased the underlying asset, options to put the underlying asst back to the manufacturer, etc). b) information about the principal terms of any lease that has not yet commenced if the lease creates significant rights and obligations for the entity.	Retain with the exception of (iv), which is not applicable to investment properties measured at fair value.

An entity shall disclose a tabular schedule of income related to leases including: a) profit recognised at lease commencement (split into revenue and cost of sales, if that is how the lessor presented this information in the statement of comprehensive income) b) interest income on lease receivable c) income from accretion of receivable d) variable lease payment income e) short term lease income.	Retain tabular schedule, but this will include fixed rental income, variable rental income, and fair value gains and losses.
An entity that accounts for short-term leases in accordance with paragraphs 64 and 65 shall disclose that fact.	Reject; not applicable
A lessor shall disclose a reconciliation of the opening and closing balances for each of the following: a) rights to receive lease payments. The reconciliation shall show each of the following if applicable: i) Increase due to the accretion of the receivable; ii) Cash received; iii) Foreign currency translation adjustments; iv) Effect of business combinations; v) Impairments; and vi) Any other line items that would be useful in understanding the change in the balance. b) residual assets. The reconciliation shall show each of the following if applicable: i) Residual asset added from new lease contracts; ii) Accretion of the residual asset; iii) Residual asset reclassified at conclusion of lease; iv) Residual asset sold; v) Foreign currency translation adjustments; vi) Effect of business combinations; vii) Impairments; and	Reject; not applicable. IAS 40 already has a roll forward requirement for all investment property at fair value.

viii) Any other line items that would be useful in understanding the change in the balance.	
A lessor shall disclose information about the nature and amount of each class of residual asset as well as the risks associated with the residual assets.	Reject; not applicable
A lessor shall disclose information about the nature of significant service obligations related to its leases.	Retain
An entity shall disclose information about significant assumptions and judgements and any changes in assumptions and judgements relating to renewal options, variable lease payments, term option penalties, residual value guarantees and the discount rate used when determining the present value of lease payments.	Reject; not applicable
(IASB) Except as described in paragraph 86, an entity shall disclose information relating to the risks arising from a lease required by paragraphs 31-42 if IFRS 7 Financial Instruments: Disclosures.	Reject; not applicable
A lessor shall disclose a maturity analysis of the right to receive lease payments showing the undiscounted cash flows on an annual basis for, at a minimum, the first five years and a total of the amounts for the remaining years. The maturity analysis shall reconcile to amounts recognized in the statement of financial position.	Amend to ‘right to receive lease payments’ to ‘fixed lease payments’