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Project	**Leases**		
Paper topic	Leases excluded from the scope of the receivable and residual approach		
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Introduction

1. At the October 2011 joint board meeting, the boards decided that the lessor ‘receivable and residual’ approach should not be applied to leases of investment property, regardless of whether the lessor measures the investment property at fair value or on a cost basis. This paper considers whether the definition of investment property in IAS 40 *Investment Property* should be used to determine the population of leases to which the receivable and residual approach would not apply.
2. The definition of investment property discussed in this paper is to be applied only in the context of the leases proposals. Consequently, we are not proposing any change to the definition of investment property as it is used in IAS 40 and the definition of investment property proposed in the FASB’s proposed Accounting Standards Update, *Real Estate-Investment Property Entities (Topic 973)* (IPE ED).

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3. Therefore, just to clarify, the tentative decision to define investment property in the context of the leases proposals has the following consequences:

   (a) because the FASB definition of investment property is applied at an entity level, there will be assets that meet the definition of investment property for the purpose of determining which lessor accounting approach to apply; however, these assets may not meet the investment property definition in the IPE ED. Accordingly, these assets would be accounted for under Topic 360 *Property, Plant, and Equipment*; and

   (b) if the boards retain the IAS 40 definition of investment property for the leases project, then IFRSs would contain one definition of investment property. However, if the boards decide to alter the IAS 40 definition of investment property for the purposes of lessor accounting as is recommended in this paper, there would be a population of leases of investment property assets that would be excluded from the scope of the receivable and residual approach, but may not meet the IAS 40 definition of investment property. Therefore, these assets would be accounted for under IAS 16 *Property, Plant and Equipment.*

4. Note that the consequences for subleases are discussed in Appendix A.

Summary of staff recommendations

5. The staff recommend distinguishing between leases that are included or excluded from the scope of the lessor's receivable and residual model, by:

   (a) using the IAS 40 definition of investment property as the starting point for the definition of property within the leases standard;

   (b) including leases of integral equipment (defined according to IAS 40) in the exemption, regardless of whether the underlying asset is measured at cost or fair value;

(c) applying the exemption to leases of a physically distinct portion of property, as long as that portion can be sold or leased separately; and

(d) applying the exemption to leases of property even if the lessor also provides significant services to the lessee.

Background

6. The decision to exclude leases of investment property from the receivable and residual approach was made in response to:

    (a) concerns raised about the difficulty of applying the receivable and residual approach to many real estate contracts; and

    (b) concerns that the receivable and residual approach might not reflect the economics of leases of real estate.

7. The staff had recommended that multi-tenanted leased assets (ie assets leased out to multiple parties concurrently) should be excluded from the scope of the lessor's receivable and residual approach. The boards' discussion during the October 2011 joint board meeting highlighted the difficulty in defining 'multi-tenanted'. Board members pointed out that most assets could be argued to have the potential to be leased out to multiple parties concurrently. Therefore, basing the exception on the ability to be a multi-tenanted leased asset could allow many assets to be excluded from the scope of the receivable and residual approach that the Boards do not wish to exclude. However, if the exception were to be based on whether a leased asset was currently a multi-tenanted leased asset, this could result in leased assets moving in and out of different accounting approaches as the lessees change.

8. Because of these difficulties, the boards decided that lessors with leases of investment property would apply operating lease accounting to those leases instead of applying the receivable and residual approach. The boards further decided that investment property would be defined, for the purpose of setting the scope of leases to which the receivable and residual approach would apply, using an asset-based approach.

9. By excluding leases of investment property from the scope of the receivable and residual approach, the boards' intentions were to capture the vast majority of multi-tenanted leased assets, while at the same time using a definition that could be applied in practice. However, this decision means that lessors with leases of multi-tenanted assets that do not meet the definition of investment property would be required to follow the receivable and residual approach. Consequently, lessors of assets such as satellites and cell towers would possibly be required to follow the receivable and residual approach for those leases, even if portions of the asset were concurrently leased to different lessees.
10. Because the boards decided to use an asset-based definition of investment property, they asked the staff to investigate whether the IAS 40 definition of investment property would provide an appropriate basis for excluding particular leases from the scope of the receivable and residual approach.

Current application of IAS 40

11. The definition of investment property in IAS 40 is as follows:

> Property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:
>
> (a) use in the production or supply of goods or services or for administrative purposes; or
>
> (b) sale in the ordinary course of business.

12. Although the boards specifically asked staff to consider the IAS 40 definition of investment property, the staff have compared aspects of the IAS 40 definition to the definition of investment property in the FASB's IPE ED. That definition is as follows:

> Real estate property, including any property improvements or integral equipment, held by an investment property entity

(within the scope of Topic 973) for investing purposes rather than for either of the following purposes:

a. The entity's own use in the production or supply of goods or services or for administrative purposes

b. Development for sale in the ordinary course of business upon completion.

Inclusion of 'integral equipment'

13. IAS 40 requires that an entity must not double-count assets or liabilities that are already recognised when applying the fair value model. As a part of this requirement, it notes that some equipment "such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property." This guidance is interpreted in practice so that equipment, infrastructure or machinery may be included in the unit of account of the investment property if it is found to be an integral part of the investment property. Note that IAS 40 does not have a formal definition of integral equipment.
14. As a consequence, this guidance could mean that, for example, equipment such as winery equipment leased with a vineyard, or container cranes leased with a port could be included in the unit of account of investment property in IAS 40 and would not, therefore, be accounted for using the receivable and residual approach.
15. Current U.S. GAAP defines property improvements or integral equipment as follows:

> Any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.

16. Paragraph 360-20-55-59 of the FASB Codification (Example 5: Determining Whether Equipment Is Integral Equipment) indicates that the cost is significant if it is greater than 10% of the fair value of the equipment.

17. Using the FASB's IPE ED definition means that assets such as cell towers could meet the definition of investment property, whereas such assets would not meet the definition of investment property in IAS 40.

When the underlying asset is measured at fair value

18. When the underlying asset is measured at fair value, and the lessor has included integral equipment in that measurement, the staff recommend that the lessor should not be required to account for that integral equipment separately using the receivable and residual approach. This is because the staff think that measuring underlying assets (that are currently within the scope of IAS 40 or the FASB's IPE ED) at fair value provides users with more useful information than the information provided by the receivable and residual approach. It would also be more complex to apply, because a lessor would be required to separate lease payments into a component that relates to the investment property, and a component that relates to the integral equipment, when those lease payments have been priced as a package.

When the underlying asset is measured at cost

19. In circumstances when the underlying asset is measured at cost there are two alternative approaches.
20. **Alternative one** would require the lessor to split the cost of the integral equipment from the cost of the property and account for the integral equipment using the receivable and residual approach.
21. This approach would result in all leased equipment being accounted for consistently. This approach views the contract as a bundle of different physical assets, and requires that those different assets should be accounted for separately. It is therefore consistent with the boards' decision to 'un-bundle' non-leased items in the contract from the leased items.

22. **Alternative two** would not require the lessor to split the cost of the integral equipment from the cost of the property and, therefore, operating lease accounting is applied to both the property and the integral equipment.
23. Alternative two:

(a) assumes that the lessee is obtaining a single 'right'. For example, renting a furnished apartment compared to an unfurnished apartment, just changes the nature of the right the lessee obtains. In the case of a furnished apartment the lessee has obtained the right to use a furnished apartment, not the right to use an apartment, a right to use the sofa, a right to use the lamp, etc.

(b) separating one overall lease package into different components and accounting for those components differently might not be the best reflection of the transaction and, consequently, it might be difficult for a lessor to explain the accounting to users of its financial statements. Unbundling different underlying assets is not the same as separating out service components of a contract, because all of the underlying assets would typically be made available to the lessee at the same time. Services are generally not provided to the lessee at the same time as the underlying assets are made available to the lessee.

(c) would be less costly to apply, which is one of the reasons why the boards decided to exempt investment property from the receivable and residual approach.

(d) may lead to structuring opportunities, because a lessor could lease equipment together with property to obtain operating lease accounting. However, the staff are not sure that it would always be practical to lease a piece of equipment with a piece of land or building to obtain the exemption. The equipment must also meet the definition of being 'integral' to that property, and, therefore, the staff are not sure of the extent of the structuring that could occur.

(e) would mean that the IAS 40 definition would not need to be modified (if the IAS 40 definition of investment property was used). However, integral equipment would need to be defined.

24. The staff can see merits to both alternatives one and two, however, on balance the staff recommend alternative two for the reasons listed in paragraph 23.

Defining integral equipment

25. Whether alternative one or two as explained in paragraphs 20 and 22 (respectively) above is selected, the boards will need to include a definition of integral equipment in the proposed leases guidance. The definition could either be the IAS 40 notion of integral equipment, the current U.S. GAAP definition of integral equipment (set out in paragraph 15 of this paper), or IFRS and U.S. GAAP could retain their current definitions, which would result in a different definition for IFRS and U.S. GAAP.
26. The staff recommend that the boards should aim for a converged solution and, therefore, the staff have not discussed the option to have different definitions for IFRS and U.S. GAAP. Consequently, this paper compares the IAS 40 notion of integral equipment to the current definition in U.S. GAAP.
27. If the boards were to select the U.S. GAAP definition of integral equipment:

(a) some would argue that this definition is more robust than the notion of integral equipment in IAS 40. This is because IAS 40 does not have a formal definition of integral equipment, and instead just provides examples as to what integral equipment could be.

(b) this definition would include some assets that are leased to multiple tenants, such as cell towers, which might not be captured by the IAS 40 definition of integral equipment. Therefore, this definition is likely to capture a wider population of the types of leases that the boards were trying to exempt from the receivable and residual approach.

28. As noted above, IAS 40 does not define integral equipment and, therefore, it requires judgement to determine whether equipment is integral to the investment

property. However, the staff recommend using the IAS 40 notion of integral equipment for the following reasons:

(a) Using the current U.S. GAAP definition is likely to result in the need to include detailed implementation guidance similar to what is included in U.S. GAAP today. We understand that the 10% rule mentioned in paragraph 16 of this paper is applied in practice in a very mathematical way. The staff note, however, that if the boards select the U.S. GAAP definition of integral equipment, the 10% rule need not be included in the lease proposals, such that the definition could be applied using judgment rather than a rule.

(b) Some think the current U.S. GAAP definition could give rise to more leases being structured to obtain operating lease accounting. This is because the equipment does not need to be integral to the investment property, merely attached to it, and the 10% cost rule provides a bright line.

(c) Although the U.S. GAAP definition captures more assets that are leased to multiple tenants at the same time, such as cell towers, it would not capture other similar assets that are leased to multiple tenants. For example, it would not capture leases of satellites or leases of a portion of a cargo ship.

Physically distinct portions of land or buildings

29. Another implication of using the definition of investment property in IAS 40 is that physically distinct portions of buildings or land may not qualify as investment property in some circumstances. Paragraph 10 of IAS 40 states that:

> Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an

> entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

30. Applying this guidance in IAS 40 would lead to the conclusion that portions of buildings would not meet the definition of investment property if they could not be sold or leased under a finance lease separately, and if more than an insignificant portion of the underlying building was held for the owner's own use. This would mean that, for example, a lessor who owns a 10-floor building and uses nine of those floors for its own use, would be required to use the receivable and residual approach to account for the one floor that is leased, if that floor could not be sold or leased under a finance lease separately. Leasing one floor of a building, particularly when the lessor might not be in the business of leasing but is simply leasing out some excess space, is one example of when it is costly and complex to apply the receivable and residual approach. We think that the boards intended to exclude such leases from the receivable and residual approach when they tentatively decided to exclude leases of investment property from the scope of the receivable and residual approach. For this reason, the staff recommend, that the definition of investment property used in the leases standard, should include physically distinct portions of property that could be sold or leased separately. Consequently, a lessor would not apply the receivable and residual approach to a physically distinct portion of land or of a building that could be leased out separately.
31. Allowing a physically distinct portion of land or of a building to be in included in the definition of investment property for the purposes of lessor accounting is also consistent with the boards' decision to allow an underlying asset to be a physically distinct portion of an asset. The staff note that the FASB decided that the proposals in the IPE ED should not be applied to a portion of investment property because of the difficulties in measuring the fair value of a portion of property. However, the entities that will apply this exemption will often measure the underlying asset at cost. If the exemption is not permitted to be applied to a

portion of property, then the lessor would have to obtain the fair value of that portion to be able to apply the receivable and residual approach. Therefore, the staff recommendation is consistent with the FASB's rationale for its decision with regards to portions in the IPE ED.

Leases of investment property with significant service components

32. IAS 40 also contains guidance regarding the provision of services supplied in conjunction with leased property. Paragraphs 11 and 12 state:

> In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.
>
> In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

33. Applying this guidance could result in leases of land or buildings with a significant service component failing to meet the definition of investment property. For example, assume a lessor owns and operates a retirement home. If residents lease their apartment or room from the lessor, and the lessor also provides services that are deemed to be significant, that property would not meet the IAS 40 definition of investment property. Consequently, the lessor would apply the receivable and residual approach to those leases of apartments or rooms.
34. The staff note that the FASB's IPE ED also includes a reference to services as follows:

> 973-10-55-3 If an entity provides … services that relate only to the investment property entity's own investment

> activities (for example, property management services), even if those activities are significant, the entity can still meet the nature-of-the-business-activities criterion. . .to be an investment property entity.
>
> BC15. The Board believes that business activities related to investing in a real estate property or properties generally include buying, selling, and managing those properties. Judgment would be required to determine whether other business activities such as those that may enhance the value of real estate properties would qualify as relating to investing in a real estate property or properties. An entity performing significant business activities other than investing in a real estate property or properties would call into question whether that entity is an investment property entity. For example, an entity that operates a hotel that is located on its investment property may be investing in a real estate property, but the activities related to operating the hotel are not considered investing in a real estate property.

35. The staff think that the level of services provided by the lessor to the lessee should not be a barrier from requiring the lessor to apply operating lease accounting, if the lease would be considered a lease of investment property in all other respects. Indeed, some might argue that the more significant the level of services provided by the lessor, the more appropriate it is that the lessor should apply operating lease accounting to the lease component of the contract. On the basis of current tentative decisions, lessors will be required to split out payments for services separately from payments for the use of the underlying asset. The staff think, therefore, that the level of services provided to the lessee is irrelevant when considering the accounting model to be applied to the lease component of a contract. Consequently, the staff recommend that the IAS 40 definition of investment property should be changed to allow lessors who lease property and who also provide significant services to the lessee to be exempt from applying the

receivable and residual approach. The staff note that by removing the reference to services, the definition being used to distinguish between leases in and out of scope of the lessor's receivable and residual approach, no longer contains a notion of investment property, but simply property.

Summary of staff recommendations

36. The staff recommend that the following types of leases be excluded from the scope of the receivable and residual approach:

    Leases of property (land or a building—or part of a building that could be sold or leased separately—or both) including any equipment integral to the building.

37. This definition is the result of the following staff recommendations:

    (a) using the IAS 40 definition of investment property as the starting point for the definition of property within the leases standard;

    (b) including leases of integral equipment (defined according to IAS 40) in the exemption, regardless of whether the underlying asset is measured at cost or fair value;

    (c) applying the exemption to leases of a physically distinct portion of land or of a building, as long as that portion could be sold or leased separately; and

    (d) applying the exemption to leases of property even if the lessor also provides significant services to the lessee.

Question
Do the boards agree with the staff recommendations set out in paragraphs 36 and 37 above?

APPENDIX A: Subleases

Nature of the underlying asset

A1. When a lessee subleases an asset, the underlying asset in respect of that sublease is the right-of-use asset. Therefore, this could mean that lessees that sublease investment property would be required to apply the receivable and residual approach because the nature of the underlying asset is a right-of-use and not the investment property itself. Consequently, the lessee/sublessor would need to determine the fair value of the right-of-use asset, or a portion of it, when applying the receivable and residual approach, which could be difficult. In the staff's view these were the types of leases that the boards were intending to capture when tentatively deciding to provide an exemption from the receivable and residual approach.

A2. In the context of that tentative decision, the staff recommend that the lessee/sublessor should be able to apply the exemption (from applying the receivable and residual approach), if the asset being leased meets the definition of property in paragraph 36, even if the underlying asset is a right-of-use asset.

Mismatch of expense/income recognition

A3. Concerns have been raised that requiring leases of investment property to be excluded from the scope of the receivable and residual approach will result in the 'mismatch' of expense/income recognition for a sublessor, which will not provide useful information to users. Those raising these concerns think that the economics of the lease and the sub-lease are similar, yet different expense and income recognition patterns occur for the lease and the sublease.

A4. The boards' tentative decisions (and also the two other approaches discussed in Agenda Paper 2C/227) treat leases as financing transactions. Consequently, these approaches will result in a lessee, who leases investment property, recognising a higher interest expense in the early years of a lease. If that lessee subleases the investment property, the lessee/sublessor will recognise a 'straight-line' rental

income profile (and will not recognise a corresponding higher interest income profile in the early years of a lease, that it would have recognised had it applied the ‘receivable and residual’ approach).

A5. For example, assume a lessee enters into a 10 year lease of investment property. Applying any of the three lessee accounting approaches set out in Agenda Paper 2C/227 would result in the lessee recognising a right-of-use asset and a lease liability at lease commencement, and amortisation and interest on that asset and liability during the period of the lease. The interest expense of all three approaches is higher in the earlier years of the lease compared to the later years (although Approaches B and C would mitigate the front-loading effect of the total lease expense, at least to some extent, by amortising the right-of-use asset using a different method).

A6. If the lessee was to sublease only 5 years of the 10 year lease, the lessee would apply current operating lease accounting (as it is a lease of investment property) and recognise a straight-line rental expense in the income statement, which would not be consistent with the profile of the interest expense.

A7. At the June 2011 joint meeting:

> The boards discussed the accounting for subleases under the proposed leases requirements for lessees and lessors and tentatively decided the following:
>
> 1. A head lease and a sublease should be accounted for as separate transactions.
> 2. An intermediate lessor, as a lessee in a head lease arrangement, should account for its assets and liabilities arising from the head lease in accordance with the decisions to date for all lessees.
> 3. An intermediate lessor, as a lessor in a sublease arrangement, should account for its assets and liabilities

arising from the sublease in accordance with the decisions to date for all lessors.

A8. Therefore, the boards have already tentatively decided that no adjustments should be made to the lessee and lessor model for subleases. The staff think that there is no need for the boards to reconsider these decisions. This issue of a mismatch also occurs in situations other than subleases. For example, a mismatch in expense/income recognition would also occur if a lessor bought property, financed by a loan, which the lessor subsequently leases. This would result in the loan transaction producing a higher interest expense in the lessor's financial statements in the earlier years of the financing period and the lease producing a 'straight-line' income profile.

A9. The staff also note that a mismatch may not always occur. For example, a lease that is subleased for exactly the same period as the head lease is likely to meet the definition of a sale and, therefore, lessor accounting would not apply. In that case, the sublease would be considered to be a sale of the right-of-use asset and, accordingly, a mismatch of income/expense may not arise.

A10. For example, using the example in paragraph A5 of this paper, if the lessee/sublessor was to sublease the right-of-use asset for the whole 10 year lease period, the lessor would, in fact, have sold the right-of-use asset. Accordingly, the lessee/sublessor would recognise a receivable and derecognise the right-of-use asset. The receivable would generate interest income over the 10-year period, reflecting the fact that the sale occurred with deferred payments. Therefore, the lessee/sublessor would also recognise lease income with an 'interest' type profile in the income statement, consistent with the profile of interest expense recognised in respect of the lease liability.