STAFF PAPER

24 January, 2012

Working Group Meeting

Project	**Leases**
Paper topic	Lessor accounting – the definition of investment property

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 asks working group members for their views on whether the current definition of investment property in IAS 40 *Investment Property* should be used to distinguish between leases from a lessor’s perspective in the context of this tentative decision.
2. This paper does not consider whether a different population of leases should be excluded from the scope of the receivable and residual approach as a consequence of any possible changes being made to lessee accounting. Whether an alternative line should be drawn, and whether that line should be the same for both lessees and lessors, is considered in Working Group Paper 2B.

Questions for working group members

3. This paper explains the Boards’ current tentative decisions, and discusses a number of aspects of the current definition of investment property in IAS 40. The Boards would like your views to help them determine whether the current definition of investment property in IAS 40 should be used to distinguish between leases from a lessor’s perspective.

Question 1: The Boards discussed excluding multi-tenanted leased assets, instead of leases of investment property, from the scope of the receivable and residual approach. However, they tentatively decided on an asset-based definition of investment property for the purpose of distinguishing between leases, having been unable to find a satisfactory way to define 'multi-tenanted' (see paragraphs 4 to 8 below). Should leases of investment property be excluded from the scope of the receivable and residual approach or should the exclusion relate to multi-tenanted leased assets? If so, explain how you would define multi-tenanted?

Question 2: Assuming the Boards use the IAS 40 definition of investment property to distinguish between leases, should the definition of investment property be changed:

- to require lessors to split out integral equipment and account for it separately from the underlying investment property? (see paragraphs 11 to 13 below)
- so that the definition can be applied to a portion of land or of a building that can be sold or leased separately? (see paragraphs 14 and 15 below)
- to include leases of property where the lessor also provides significant services? (Are you aware of any property that is leased with significant services that would not meet the short-term lease definition?) (see paragraphs 16 and 17 below)

Question 3: The FASB's *Investment Property Entities* Exposure Draft (IPE ED) defines equipment integral to real estate property as "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". This definition would, therefore, include assets such as cell-towers as items of investment property (which are likely to be excluded from the IAS 40 definition), while still excluding other similar multi-tenanted assets such as satellites. Should the definition of investment property refer to the definition of integral equipment in the FASB's IPE ED, rather than referring to the current definition of integral equipment in IAS 40?

Definition of investment property

Background

4. At the October 2011 joint Board meeting, the Boards tentatively decided to exclude leases of investment property from the scope of the lessor receivable and residual approach. This decision was made in response to concerns raised about the difficulty of applying the receivable and residual approach to many real estate contracts. Real estate lessors had also noted that such an approach would result in accounting that, in their view, would not best reflect their leasing business.
5. 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 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 definition on an asset's ability to be a multi-tenanted leased asset could allow leases of many assets to be excluded from the scope of the receivable and residual approach. However, if the line was 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 number of lessees changes.
6. 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 using an asset-based approach to the investment property definition (rather than an entity-based approach included in the FASB's *Investment Property Entities* exposure draft).
7. 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 can 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, cargo ships and cell towers would be required to follow the receivable and residual approach for those leases, even if portions of the asset were concurrently leased to different lessees.

8. The Boards asked the staff to carry out further outreach on using the IAS 40 definition of investment property as the basis for excluding particular leases from the scope of the receivable and residual approach, to determine whether that definition would provide an appropriate basis to distinguish between leases from a lessor's perspective.

Current application of IAS 40

9. Requiring lessors with leases of investment property to apply operating lease accounting would address many of the concerns raised in relation to the application of the receivable and residual approach to real estate leases. Nonetheless, if using the current definition of investment property in IAS 40 for this purpose, there are some areas that require further consideration.

10. 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 of both, rather than for:
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> (a) use in the production or supply of goods or services or for administrative purposes; or
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> (b) sale in the ordinary course of business.

Inclusion of 'integral equipment'

11. Although IAS 40 defines property as "land or a building—or part of a building—or both", it also contains other guidance regarding the unit of account for investment property. 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 that investment property.

12. As a consequence, this guidance could result in, for example, equipment such as tractors that are leased with a farm, winery equipment leased with a vineyard, or container cranes leased with a port being considered to be investment property. If that were the case, leases of such equipment would not be accounted for using the receivable and residual approach.

13. Some may have concerns that the inclusion of non-real estate 'other assets' such as equipment or infrastructure as investment property could lead to inconsistent accounting for leases of equipment. This is because leases of equipment would be accounted for under the receivable and residual approach if they were leased by themselves, but would be accounted for using current operating lease accounting if they were leased with, and accounted for as, investment property. The alternative would be to require lessors to split out any equipment and account for it separately from the underlying investment property.

Portions of land or buildings

14. Another implication of using the definition of investment property in IAS 40 is that 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.

15. 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. For this reason, some would suggest that, for the purpose of lessor accounting, the definition of investment property in IAS 40 should be changed so that it can be applied to a portion of a building or land that could be leased out separately under *any* lease.

Leases of investment property with significant service components

16. 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.
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> 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.

17. 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. For this reason, some would prefer to remove the reference to 'significant services' from the definition of investment property for the purposes of lessor accounting. If that were the case, in the example above, the lessor of the retirement home would not be required to apply the receivable and residual approach when accounting for those leases.