STAFF PAPER

February 2013

IASB Meeting

Project	**Leases**
Paper topic	Sweep issue: Consequential amendments to IAS 40

CONTACT(S) Anna Heining aheining@ifrs.org +44 (0) 20 7246 6428

Introduction and objective of this paper

1. The revised *Leases* Exposure Draft (the revised ED) will include proposed amendments to other IFRSs that are a consequence of the changes being proposed to lease accounting. The objective of this paper is to discuss whether, as a consequence of the lessee accounting proposals, right-of-use assets that meet the definition of investment property should be within the scope of IAS 40 *Investment Property*.

Background

2. At present, a lessee is required to account for property that it holds under a finance lease in accordance with IAS 40 if the property meets the definition of investment property. *Investment property* is defined as 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.

3. A lessee is also permitted to account for property that the lessee holds under an operating lease using the fair value model in IAS 40 if that property meets the definition of investment property. Nevertheless, the lessee of such an operating

lease is not required to do so. The Appendix to this paper includes the relevant extract from IAS 40.

4. In the 2010 *Leases* Exposure Draft (the 2010 ED), the Board proposed that a right-of-use asset would be within the scope of IAS 40 if that asset met the definition of investment property. According to the proposals in the 2010 ED:

   (a) at initial recognition, a lessee would account for a right-of-use asset in accordance with the leases guidance.

   (b) after initial recognition, a lessee would choose to account for the right-of-use asset using either the cost model (in effect applying the leases guidance) or the fair value model in IAS 40, depending on whether the lessee accounts for its investment property under the cost model or the fair value model.

   The Appendix to this paper includes the relevant extract from the consequential amendments to IAS 40 in the 2010 ED.

5. The Board did not receive many comments from respondents to the 2010 ED on the proposal to change the scope of IAS 40.

6. At this meeting, the staff seek the Board's view on whether to change the current scope of IAS 40 with respect to right-of-use assets.

7. For the purposes of this discussion, we refer to:

   (a) a lease for which the lessee recognises interest on the lease liability separately from amortisation on the right-of-use asset, and the lessor recognises a lease receivable and residual asset, as a **Type 1** lease.

   (b) a lease for which the lessee recognises a straight-line single lease expense, and the lessor continues to recognise the underlying asset, as a **Type 2** lease.

Staff analysis and recommendation

8. There are two approaches the Board could propose regarding the scope of IAS 40.

9. The first is that the Board could decide to propose little change to the current scope of IAS 40. According to this approach, a lessee of property held under a

Type 2 lease (that meets the definition of investment property) would be permitted, but not required, to apply IAS 40 to that property. Nevertheless, if the lessee were to choose to apply IAS 40 to such property, the lessee would apply IAS 40 to all investment property held under Type 2 leases. In other words, the election would be an accounting policy choice, rather than available on a property-by-property basis (as currently permitted in IAS 40 for investment property held under an operating lease). A lessee of investment property held under a Type 1 lease would be required to account for that investment property in accordance with IAS 40. Such an approach would be largely consistent with the current scope of IAS 40 and would result in little, if any, additional cost for lessees with leases of investment property.

10. Nevertheless, the staff do not recommend that approach. The staff recommend that investment property held under any lease should be within the scope of IAS 40. In other words, a lessee should account for **all** right-of-use assets (not only right-of use assets arising from Type 1 leases) in accordance with IAS 40 if the leased property meets the definition of investment property in IAS 40.

11. The staff note that the recommendation would potentially broaden the scope of IAS 40. This is because, under the current IAS 40 requirements, a lessee is permitted, but not required, to account for investment property held under an operating lease in accordance with IAS 40. In contrast, if the Board agrees with the staff recommendation, such a lessee would be required (not permitted) to apply IAS 40 to all investment property held under a lease.

12. The staff recommendation would **not** require a lessee to measure its right-of-use asset arising from a lease of investment property at fair value, unless the lessee already measures other investment property at fair value. A lessee could still choose to use the cost model in IAS 40, which, in effect, would mean applying the proposals in the revised ED, if the lessee chooses to account for investment property using the cost model. Nevertheless, a lessee would be required to disclose fair value information about those right-of-use assets.

13. The staff think that the recommendation set out in paragraph 10 is consistent with the Board's proposals on lessee accounting (ie the Board has concluded that a lease creates an asset for the lessee). If that asset (ie the right-of-use asset) meets

the definition of investment property, then an entity should account for it as such. The staff's view is that users would benefit from greater consistency in accounting for investment property, ie the staff think it is appropriate for an entity with investment property to account for all investment property in the same way, regardless of whether it owns the property or leases the property.

14. The staff are aware of potential practical issues that could arise from requiring a lessee to provide, as a minimum, fair value disclosures for right-of-use assets (that meet the definition of investment property). This might be the case when an entity holds property that, as a consequence of unforeseen circumstances, meets the definition of investment property. For example, in some cases an entity holds property under an operating lease that is no longer needed for the entity's own operations. The entity, therefore, decides to lease out that property to third parties. In such a situation, providing fair value disclosures could potentially be burdensome because the lessee (sub-lessor) is not in the real estate industry and was not originally intending to hold investment property. Consequently, obtaining fair value information for its right-of-use asset could be costly.

15. Nevertheless, even in such a situation, the staff's view is that an entity would provide better information by accounting for any property that it leases to third parties as investment property. For example, assume a retailer holds a portfolio of retail stores of which 600 stores are leased. Because of an economic downturn, the retailer decides to close 50 of its leased stores before the end of the non-cancellable term of the respective leases. The retailer then subleases the 50 stores to third parties for the remainder of the non-cancellable terms. In such a situation, the staff think that the retailer would provide better information by accounting for 550 stores as right-of-use assets used in the retailer's own business/operations, and 50 stores as investment property.

16. The staff recommendation is proposing a change to the scope of IAS 40. If the Board agrees with the recommendation and because of the potential practical issues noted in paragraph 14, the staff recommend including in the revised ED a specific question on this issue.

Question 1
Does the Board agree with the staff recommendation to require an entity to account for **all** right-of-use assets in accordance with IAS 40 *Investment Property* if the leased property meets the definition of investment property?

Appendix

A1. Extract from IAS 40 *Investment Property*

6 A *property interest* that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33–55 for the asset recognised. This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model. When this classification alternative is selected, any interest so classified is included in the disclosures required by paragraphs 74–78.

A2. Extract from consequential amendments to IAS 40 (2010 ED)

IAS 40 *Investment Property*	Amend the model in IAS 40 to replace the requirements relating to lease accounting as follows: …

- A right-of-use asset is within the scope of IAS 40 if it meets the definition of investment property.
- Any right-of-use asset is accounted for at initial recognition in accordance with IFRS X. After initial recognition, a lessee chooses to account for the right-of-use asset using a cost or fair value model.
  - A lessee that uses the cost model accounts for the right-of-use asset in accordance with IFRS X.
  - A lessee that uses the fair value model accounts for the right-of-use asset in accordance with IAS 40 and recognises any changes in the liability to make lease payments in profit or loss.