STAFF PAPER

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IASB Meeting

Project	**Leases**
Paper topic	Consequential amendments to IAS 40

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Introduction and objective of this paper

1. The objective of this paper is to discuss whether, as a consequence of the lessee accounting proposals, investment property held under a lease should be within the scope of IAS 40 *Investment Property*. In other words, should a lessee account for right-of-use (ROU) assets in accordance with IAS 40 if the property otherwise meets the definition of investment property in IAS 40?

2. This paper is structured as follows:

   (a) Background

   (b) Summary of feedback

   (c) Staff analysis and staff recommendations

   (d) Appendix – Extract from IAS 40

Background

3. Investment properties, as defined in IAS 40, are properties that are held to earn rentals or for capital appreciation or both. Investment properties can either be owned or held under a lease. If the investment property is held under a lease, the entity typically acts as both a lessee (in the head lease) and a lessor (in the sublease) of the property.

4. At present, a lessee is *required* to apply IAS 40 in accounting for property that it holds under a finance lease if the property meets the definition of investment property. A lessee is also *permitted* to account for property that it holds under an operating lease using the fair value model in IAS 40 if that property meets the definition of investment property. Nonetheless, 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.

5. The 2013 ED proposed amendments to IAS 40 stating that a ROU asset arising from a property lease would be within the scope of IAS 40 if the property would otherwise meet the definition of investment property. Accordingly:

   (a) at initial recognition, a lessee would account for a ROU asset in accordance with the leases guidance.

   (b) after initial recognition, a lessee would account for the ROU 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 the remainder of its investment property under the cost model or the fair value model.

   This would represent a change to existing requirements because, according to the proposed amendments, a lessee would be *required* (not permitted) to apply IAS 40 to all investment property held under a lease, including leases currently classified as operating leases. Accordingly, a lessee would be required to, at a minimum, disclose fair value information about all investment property held under a lease, as compared to existing requirements that allow a lessee to simply account for investment property held under an operating lease as an operating lease.

Summary of feedback

6. The 2013 ED included a specific question on whether a lessee should account for ROU assets in accordance with IAS 40 if the property would otherwise meet the definition of investment property in IAS 40.

7. Most of the respondents that commented on this question agreed with the proposed amendments to IAS 40. The reasons given included the following:

   (a) Accounting for all investment property in the same way, regardless of whether an entity owns or leases the property, would result in greater consistency and comparability in accounting for investment properties. This would, in their view, provide better information to investors and analysts.

   (b) The proposed amendment would be a logical consequence of the right-of-use lease model. The Board has concluded that a lease creates an asset for the lessee. If that asset meets the definition of investment property, then an entity should account for it accordingly. Some respondents pointed out that the scope of IAS 40 already includes investment property held under a finance lease. These respondents think that applying IAS 40 to ROU assets is consistent with applying IAS 40 to existing finance leases.

8. Other respondents disagreed with the proposed amendments to IAS 40 (many of which are based in Japan and Germany, and include banks and insurers). They were of the view that the costs of measuring ROU assets arising from leases of investment property at fair value would outweigh the benefits of doing so, giving the following reasons:

   (a) *Operational difficulties in calculating the fair value of ROU assets* — Some respondents were concerned about the cost and complexity of calculating the fair value of leased investment property. They argued that there would rarely be a market in which leasehold interests in property are traded, and that a practical approach to determine the fair value of ROU assets has not been established in practice. A few of these respondents stated that requiring fair value disclosure for ROU assets would be inconsistent with the Boards' previous conclusion that determining the fair value of a ROU asset is impracticable. These respondents questioned why this conclusion has changed.

   (b) *The nature of leased investment property is different from owned investment property*— Some respondents think that a ROU asset is different in nature, and creates different rights, from owned investment property. For example, a ROU asset arising from leased investment property usually does not transfer ownership of the property. Accordingly, they think that a lessee is typically unable to sell a ROU asset and, thus, cannot realise its fair value in that manner. Additionally, the fair value of a ROU asset will always decrease to zero over time, which is not always the case for other owned investment property. These respondents questioned the usefulness of disclosing fair value information for ROU assets in such situations.

(c) *'Accidental lessors'* — A few respondents expressed concern about the cost and complexity of disclosing fair value information for entities that are not in the real estate industry but nonetheless hold property under a lease that meets the definition of investment property. For example, an entity could lease a property with the intention of using it for its own operations, but then conclude that the property is not needed for its operations and sublease the property. That entity would not be engaging in property leasing as its main business. In these cases, the main motivation of subleasing a leased property would be to reduce (vacant) property costs rather than to realise rental income. Providing fair value disclosures in such situations could be costly because the lessee (sub-lessor) is not in the real estate industry and does not have the resources to fair value investment property.

9. Some respondents requested more guidance on how to calculate the fair value of a ROU asset. In particular, they asked:

(a) whether items, such as variable or optional lease payments, that are not included in the initial measurement of the ROU asset should be included in the fair value measurement of the ROU asset; and

(b) whether extra guidance should be provided for cases in which there is no active market for the ROU asset.

Staff analysis and staff recommendations

10. The staff do not recommend making any changes to the IASB's tentative decision that leased investment property be accounted for in the same way as owned investment property. Accordingly, the staff recommend that a lessee should account for all ROU assets of property in accordance with IAS 40 if the property would otherwise meet the definition of investment property in IAS 40.

11. The staff think this conclusion is consistent with the right-of-use lessee accounting model. Under the right-of-use model, a lessee will now recognise a ROU asset for all of its leases. The staff think it would be misleading if some of those recognised ROU assets met the definition of investment property but were not accounted for accordingly.

12. The staff also think that an entity with investment property should account for all investment property in the same way, regardless of whether it owns or leases the property. This is because the staff think that investors and analysts would benefit from greater consistency in accounting for investment property. Investors and analysts have confirmed that the fair value of investment property gives them more useful information than other measurements. Rental income and changes in fair value are inextricably linked as integral components of the performance of the lessor and providing both pieces of information (ie rental income and fair value changes) results in a lessor reporting performance in a meaningful way. The staff note that a ROU asset arising from a lease of investment property often has underlying economics similar to the economics of the ownership of such property. For example, in some countries, interests in property are commonly held under long-term leases, rather than being owned.

13. The staff note that some respondents to the 2013 ED expressed concerns about the cost of measuring ROU assets at fair value when the property would otherwise meet the definition of investment property. The staff acknowledge that there would be costs involved with measuring ROU assets at fair value, particularly for 'accidental lessors' that are not in the real estate industry. However, the staff think there are two factors that will lessen the likelihood that 'accidental lessors' not in the property business would hold ROU assets in the scope of IAS 40:

(a) Given the Board's tentative decision to classify a sublease based on the ROU asset in the head lease, a lessor would classify a sublease as a finance lease in cases for which it subleases the asset for all or most of the remaining term of the head lease. In those cases, the lessor would apply finance lease accounting (ie recognise a lease receivable rather than the underlying ROU asset) and would not be required to apply the requirements of IAS 40. The staff think that 'accidental lessors' that wish to reduce property costs would generally intend to secure a sublease for the entire length of the head lease, which (if successful) would result in finance lease accounting.

(b) The staff think that 'accidental lessors' that are not in the property business may not be within the scope of IAS 40 if they sublease a leasehold interest under an operating lease and then would possibly use the property after the sublease for its own operations. Such a property may not meet the definition of an investment property because it would not be held solely for rentals, capital appreciation or both.

14. Nonetheless, the staff acknowledge that 'accidental lessors' could still hold ROU assets that would be within the scope of IAS 40, and there is likely to be costs associated with measuring such ROU assets at fair value. The staff think that it should be relatively straightforward to determine the fair value of a 'plain-vanilla' ROU asset for which the lease does not involve options or variable lease payments—determining the fair value in this case would involve projecting the cash flows one would expect to receive from subleasing the asset. That is likely to be easier to project for a ROU asset that would be expected to have a shorter life than owned property. It is also likely that a sublease is already in place—otherwise, the ROU asset would not be within the scope of IAS 40.

15. However, more judgement and cost would be involved in measuring a ROU asset at fair value when the lease involves options or variable lease payments. If the Board wishes to provide cost relief for this scenario, then they could consider providing some disclosure relief for entities that apply the cost model in IAS 40. For example, the Board could allow an entity to measure at fair value only the portion of the ROU asset which corresponds to the recognised lease liability for disclosure purposes (thereby excluding the need to fair value most options or

variable lease payments). For example, if an entity has an ROU asset within the scope of IAS 40 with a five-year noncancellable period and a five-year extension option (not included in the lease term), such disclosure relief would mean that the entity would only need to measure the noncancellable five-year portion of the ROU asset at fair value for disclosure purposes.

16. The staff also acknowledge constituents' requests that IAS 40 provide additional guidance about measuring the fair value of ROU assets when leases have variable and optional payments and in cases for which there is no active market for the ROU asset. The staff do not recommend providing any additional guidance on how to calculate the fair value of ROU assets. This is because, in the staff's view, the principles in IFRS 13 and IAS 40 are sufficient to help preparers to calculate the fair value of those ROU assets. The staff also note that the existing scope of IAS 40 already includes leasehold property interests, but without detailed guidance thereon.

17. The staff note, however, that paragraph 50(d) of IAS 40 (reproduced in the Appendix of this paper), in effect, provides guidance on whether to include in the measurement of the ROU asset options and variable lease payments that are not included in the measurement of the lease liability. This guidance ensures that there would not be a mismatch between the cash flows included in the ROU asset and cash flows included in the lease liability. It does so by stating that the fair value of investment property held under a lease should include both expected cash outflows and expected cash inflows. Consequently, the fair value of investment property held under a lease would be measured on a net basis to the extent that there are any cash flows associated with that lease not recognised in the lease liability.

18. In summary, the staff recommend confirming the consequential amendments to IAS 40 proposed in the 2013 ED; ie ROU assets should be included in the scope of IAS 40 if the property would otherwise meet the definition of investment property.

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 property would otherwise meet the definition of investment property?

Appendix

A1. Extracts from IAS 40 *Investment Property*

5 **Investment property is 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.

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.**

50 In determining the carrying amount of investment property under the fair value model, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:

(a)…

(d) the fair value of investment property held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the carrying amount of the investment property using the fair value model.