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IAS 17 Leases & IAS 40 Investment Property

Guidance Notes on Lease Classification for UK Investment Properties

The British Property Federation regrets it cannot accept any legal responsibility, whether in tort or otherwise, with regard to any action you may take or omit to take as a result of this guidance.

1. INTRODUCTION

1.1 The IASB issued final revised standards, published on 15th December 2003, and do not intend to issue any further guidance notes on the practical application of the above standards to Investment Properties.

1.2 The objective of these notes is to give guidance on the application, in a UK context, of these standards, in order to achieve a consistent approach by BPF members. For the avoidance of doubt this guidance does not supercede IAS 17 or IAS 40.

These notes are written specifically for the UK investment property market where:

- there is a legacy of long leases of 15 years or more;
- rents are subject to review;
- the tenant has the obligation to repair and insure the building and to return it to the landlord in its original condition at the end of the lease (if required by the landlord).

1.3 These notes have been developed after consultation with the IASB and the major accounting firms.

1.4 A practical and robust method is proposed, in section 2 of these notes, to achieve a consistent and reliable classification of leases under IAS 17 for investment property. An approach is recommended which enables lessors to reach a judgement that a lease is an operating lease without the need for calculations to support that judgement.

1.5 This approach deals with the many practical difficulties in applying IAS 17 and IAS 40 to investment property portfolios in the UK. In arriving at their judgement, the investor must review the leases to ascertain whether substantially all the risks and rewards of ownership of the property, land and building lease elements considered separately, are conferred on the landlord or the tenant. Land elements of leases are normally classified as operating leases unless title is expected to pass to the lessee. If a building element is clearly an operating lease also, there will be no need to split the lease into building and land elements.

1.6 By undertaking the approach detailed, in section 2 of these notes, in respect of each lease, investors will be led to the identification of possible finance leases, which then should fall to much more detailed consideration in deciding the appropriate accounting treatment. The correct accounting for possible finance leases is not covered in these guidance notes.

1.7 It is expected that conventional UK occupational leases will, in the main, be operating leases.

1.8 A statistical sample of leases covering a broad range of UK leases has been reviewed using this qualitative assessment and using numerical testing in accordance with IAS 17. The resulting positive correlation has been reviewed and following this review BPF recommends the qualitative approach outlined above as providing a robust consideration of the lease terms and equivalent to otherwise performing the calculations. BPF members should consult their auditors as soon as practical to confirm that they may adopt the BPF methodology for their IAS accounts.

1.9 References to the Standards are denoted as follows: Standard Number/paragraph (s) e.g. 40/2(a)

2. CLASSIFYING LEASES UNDER IAS 17

2.1 This proposed assessment routine is intended for use by lessors, taking into account the specific nature of the UK investment property market:

- the purpose of the routine is to identify which party to the lease, lessor or lessee, enjoys substantially all the risks and rewards of ownership of the different elements to the lease;
- the land and building elements are considered separately;
- IAS 17 looks at the substance of the transaction rather than the legal form;
- the assessment to classify the lease is from the date of the inception of the lease;

2.2 Primary Questions to be applied to land and building elements separately

		Yes	No
1	Does the lease transfer ownership of the asset to the lessee by the end of the lease term? **17/**10(a)		
2	Does the lease give the lessee the option to purchase the asset at less than open market value? **17/**10(b)		
3	Does the lease contain terms that result in the gains or losses from fluctuations in the residual value of the asset accruing to the lessee? **17/**11(b)		
4	At the inception of the lease, is it reasonable to assume that the lessee and lessor either (a) expected the lease term to be for the major part of the economic life of the building, or (b) or that the residual value on expiry of the lease term would be negligible? **17/**10(c)		
5	Has the payment structure of the lease been derived with reference to specific interest rates and returns on risk which would be required by a lender?*		
6	Does the lease allow the lessee to cancel the lease and if so does the lessee have to bear the lessor's losses, as predetermined in the lease terms? **17/**11(a)		
7	Are the buildings of such a specialised nature that only the lessee can use them without major modification? **17/**10(e)		

**If the lease were part of a broader transaction, such as a PFI project, structured to reflect a lender's risk and returns, this would be indicative of a possible finance lease. A rent substantially in excess of normal market rents, set in a sale and leaseback transaction might indicate a finance lease.*

2.3 If the answer to all the questions is no, no further work is required and the lease is considered an operating lease, unless there are other features of the lease that clearly show that the property risks and rewards remain substantially with the tenant.

2.4 If the answer to one or more of the questions is "yes", there is a possibility that the lease should be classified as a finance lease and a further review, including the numeric test set out in IAS 17/10d, may be required to determine whether the lease is indeed a finance lease.

2.5 Accordingly, in order for a lease subject to this further review to qualify nonetheless as an operating lease, it must be clearly demonstrated that the landlord retains substantially all the property related risks and rewards. The following prompts, if answered in the affirmative, might be suggestive of operating lease attributes:

- was there, at inception, a reasonable expectation that the building could have some useful remaining economic life and continue to be capable of letting and occupation under a new lease on expiry of the existing lease?
- does the lease provide for significant contingent rent variations during the term by reference to an open market or turnover?**
- were the initial passing rent and other aspects of the lease set at prevailing market rates?
- is the lease free of contractual terms which might oblige the lessor to continue the lease at substantially less than normal market terms? 17/11(c)
- if the lessee wishes to sublet or sell (or assign) their lease rights, are there terms in the lease that allow the lessor to control the key terms of the sublet / sale?

*** If the lease were to provide for fixed increases or increases linked to a non property market index, this might be indicative of a finance lease.*