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Accounting Alert – Retirement villages

Impact of AASB 16 *Leases* on retirement village accommodation arrangements

This Alert considers the accounting effect of applying the new Accounting Standard AASB 16 *Leases* to retirement village (independent living units) accommodation arrangements. AASB 16 became effective on 1 January 2019 and, for entities with a 30 June year end, applies for the first time for the financial year ending 30 June 2020.

Retirement village owners/operators use a variety of legal forms for their transactions with customers. These include 'sales' of units under strata title, 'leases' of units under 'loan/lease' arrangements and 'licences' of units under 'loan/licence' arrangements. Within these and other types of arrangements, the fees and other financial aspects can vary considerably. The most common type of arrangement in Australia is a 'lease' of a unit (or apartment) under a 'loan/lease' arrangement where value is obtained by the entity through an initial interest-free loan from the resident and a deferred management fee. The deferred management fee (DMF) is typically calculated as a percentage of the fair value of the unit on exit of the resident and deducted from the resident loan.

The first issue that needs to be considered is whether the arrangement is a sale that results in the transfer of control of the unit in accordance with AASB 15 *Revenue from Contracts with Customers* (and hence derecognition of the property asset) or a lease under AASB 16. AASB 15 is likely to apply to 'sales' of units under strata title, but this needs to be determined based on the specific facts in each case.

Where the arrangement does not result in derecognition of the property asset under AASB 15, we expect it to be a lease within the scope of AASB 16. This is the same conclusion that we would have expected under the previous standard, AASB 117 *Leases*. AASB 16 retains the distinction between operating leases and finance leases for lessors. In the vast majority of cases, these arrangements will be operating leases and thus have no effect on the statement of financial position.

This Alert explains the impact of AASB 16 on these arrangements. It also makes limited reference to the accounting under other Accounting Standards because of the close relationship between the accounting for retirement village accommodation arrangements under various standards.

As a property held to generate returns via rental arrangements, the property asset must be accounted for under AASB 140 *Investment Property* if it meets the definition of investment property and the resident loan liability and DMF receivable must be accounted for by applying AASB 9 *Financial Instruments*.

Does the arrangement contain a lease under AASB 16?

The accommodation arrangement is a contract with a resident that includes provisions for the specific unit (or apartment), payments by the resident on entry, payments by the resident during the period of residency, and payments to the resident on exit (including the agreed sharing of capital gains or losses). Relevant contractual rights and obligations that will result in an arrangement containing a lease within the scope of AASB 16 include:

- Contracts are executed in respect of a specific unit;
- The operator does not have a right to substitute the unit;
- The resident enjoys the exclusive use of the specific unit; and
- The resident has the right to determine within reason how the unit is used.

Where these circumstances apply, the arrangement contains a lease within the scope of AASB 16 because:

- There is an identified asset because the unit is specifically identified in the contract (refer AASB 16.B13);
- The operator does not have a substantive right to substitute the unit throughout the period of use (i.e. the total period of use of the room under the contract) (refer AASB 16.B14(a) and B18); and
- The resident has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use by having exclusive use of the asset throughout the period (refer AASB 16.B21).

The average period of residency in Australian retirement villages is between seven and eight years. Most arrangements will be classified as operating leases by operators given the expected period of the arrangement relative to the lives of the underlying assets, however, given the range of different arrangements used, this must be assessed based on the specific circumstances for each entity and its operations.

Accounting for property and resident liability

If an arrangement is classified as an operating lease, the retirement village owner/operator will:

- Continue to recognise the property on its statement of financial position as either investment property or property, plant and equipment as applicable. If the owner/operator supplies ancillary services to the resident, the property will not qualify as investment property unless these services are insignificant to the arrangement as a whole. AASB 140 mentions security and maintenance services as examples of services that are normally insignificant to the arrangement as a whole. In most cases, we expect the property to be investment property, however this needs to be assessed on a case by case basis.
- Recognise a financial liability under AASB 9 *Financial Instruments* for the obligation to repay the resident loan; and
- Recognise a financial asset for the DMF relating to the cumulative lease income (refer below for further discussion). In most cases these will be offset on the statement of financial position where there is a legally enforceable right of set off as determined by the contractual arrangement between the operator and the resident.

If the property is classified as investment property, the owner/operator has the choice of the cost model or the fair value model in AASB 140. If classified as property, plant and equipment, the owner/operator has the choice of the cost model or the revaluation model in AASB 116. This Alert is focussed on the property as investment property since that is expected to be the treatment in most cases.

The chosen accounting policy for the property has particular implications for the overall financial statements, particularly in the usual situation where the resident shares in capital gains and losses to some extent.

As mentioned above, where the arrangement is classified as an operating lease, the owner/operator will need to recognise a financial liability for the obligation to repay the resident loan. The specific requirements will depend on the particular contract. Where the amount payable on exit includes a share of capital gains (and capital losses), including the common position where this is based on the fair value of the unit on exit or amount payable by an incoming next resident to the particular unit, the financial liability will be based on the fair value of the unit. The financial liability will likely be measured at amortised cost. Changes in the carrying value of the financial liability will be recognised in profit or loss (refer AASB 9.B5.4.6).

Most owner/operators account for retirement village property as investment property using the fair value model, whereby changes in fair value are recognised in profit or loss. This results in symmetry between accounting for the property and the related resident liability. If owner/operators account for retirement village property as investment property using the cost model or as property, plant and equipment using either the cost model or the revaluation model there will be an accounting mismatch that will cause a distortion of the financial results and, where the cost model is used, the financial position.

Accounting for deferred management fees – lease income

The deferred management fee (DMF) represents the rent received by the owner/operator for permitting the resident to live in the unit for the full period of occupancy. This is determined by a formula in the resident's contract and is typically a percentage of the fair value of the unit on exit or amount payable by the incoming resident to the particular unit. This percentage will vary based on the number of years or part years of residency and will commonly reach a maximum percentage after say five years.

As explained above, the accommodation arrangement is likely to be an operating lease under AASB 16. Lessors account for operating leases under AASB 16 in a similar manner to the previous requirements under AASB 117.

Lessors recognise lease payments as income on either a straight-line basis or another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished (refer AASB 16.81). Lessors measure variable lease payments that depend on a rate or index using the current index or rate at the measurement date. The standard includes a market rent review as an example of a change in lease payments resulting from a change in an index or a rate (refer AASB 16.28, AASB 16.42(b)). Thus, where a DMF is determined as a percentage of the fair value of the unit on exit or amount payable by the incoming resident to the particular unit, this is considered to represent variable lease payments that depend on a rate or index and the cumulative DMF at each reporting date needs to utilise the fair value of the unit at that date.

There is another issue with the amount to be recognised as lease income relating to the cumulative DMF commonly reaching a maximum percentage after a certain number of years. This is typically less than the average period of residency of between seven and eight years. There is not likely to be another systematic basis that is more representative of the pattern in which benefit from the use of the underlying asset is diminished for retirement villages than a straight-line basis. Therefore, DMF income needs to be recognised on a straight-line basis over the full expected period of occupancy where this is different to the contractual terms for the DMF percentage calculation.

These two issues are illustrated in the following example:

Resident A leases a unit from the owner/operator at the beginning of Year 1. The DMF payable by Resident A is calculated as 5% pa of the fair value of the unit based on the amount payable by the next incoming resident. The DMF is capped at 25% of the fair value.

The fair value and the amount paid by Resident A on entry is $490,000. At the end of Year 1, the fair value of the unit has increased to $525,000. If Resident A had left the unit on that day, the owner/operator would be entitled to a DMF of $26,250 (5% x $525,000).

At the end of Year 1, the owner/operator estimates that residents will stay for an average of seven years and applies this to all residents of the village. At the end of Year 1, the owner/operator will record a resident liability of $525,000 and a DMF receivable (and income) of $18,750 (25% x $525,000 / 7)

At the end of Year 2, the fair value of the unit has increased to $542,500. If Resident A had left the unit on that day, the owner/operator would be entitled to a DMF of $54,250 (5% x $542,500 x2)

At the end of Year 2, the owner/operator still estimates that residents will stay for an average of seven years and applies this to all residents of the village. At the end of Year 2, the owner/operator will record a resident liability of $542,500, a DMF receivable of $38,750 (25% x $542,500 / 7 x 2) and lease income of $20,000 ($38,750 - $18,750).

The DMF lease income is recognised on a straight-line basis over the estimated period of occupancy of 7 years and based on the fair value of the unit at each measurement date.

Further information

If you wish to discuss any of the information included in this Accounting Alert, please get in touch with your local Grant Thornton Australia contact or a member of the Financial Reporting Advisory Team at fra@au.gt.com.