Technical Accounting Alert

Investment property held under a lease

Introduction

Investment properties held under a lease are required to be classified as either a finance or operating lease. This alert focuses on the definitions and the required accounting treatments for finance and operating leases.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 17 Leases	AASB 117 Leases
IAS 40 Investment Property	AASB 140 Investment Property

Overview

The main considerations in accounting for leased investment property are as follows:

- The lease should be classified as a **finance lease** or **operating lease** at its inception in accordance with the criteria in IAS 17.7 to 19;
- For this purpose, any **premium** paid to the lessor **or** to the previous lessee on entering into a new lease should be included in the **minimum lease payments** (MLPs) (IAS 40.26);
- If the leased property is classified as a **finance lease** and meets the definition of investment property, it **must** be accounted for in accordance with IAS 40. The investor/lessee has the choice in IAS 40 to apply either the fair value model (set out at IAS 40.33 etc) or the cost model (set out at IAS 40.56);
- If the leased property is classified as an **operating lease** and meets the definition of investment property, the investor/lessee **may** account for the property in accordance with IAS 40. If the IAS 40 option is taken (i) the lease is accounted for as a finance lease; and (ii) investor/lessee must apply the fair value model (IAS 40.6);
- The initial cost of the property is determined as the lower of its fair value or the present value of the MLPs (IAS 40.25). For this purpose, any premium paid is again included in the MLPs; and
- Separate measurement of the land and buildings elements is not required if the investor/lessee classifies both elements of the property as investment property and applies the fair value model (IAS 17.18).

Detailed Guidance

Investment property is defined at IAS 40.5. In summary, a property is an investment property if it is held to earn rentals and/or for capital appreciation rather than for use or sale in the ordinary course of business. Property investors commonly invest in leased properties as well as owned properties. Investments in leased properties are made both by leasing a new property and by purchasing an existing leasehold interest in a property from another investor/lessee. In the second case, the new investor/lessee often makes a payment to the previous lessee (sometimes referred to as a premium) to acquire the leasehold interest.

IAS 17 establishes the main requirements for lease accounting. However, there are a number of specific requirements (in both IAS 17 and IAS 40) for investment properties held under a lease. In broad terms, IAS 40 **must** be applied to finance-leased investment properties and **may** be applied to operating-leased investment properties. When IAS 40 is applied, that standard determines the accounting treatment of the asset whilst IAS 17 determines the accounting treatment of the liability. In more detail, important points to note include the following:

- An investor/lessee should classify the lease as operating or finance based on IAS 17's criteria. This is necessary in part because (as noted above) the investor/lessee must apply IAS 40 for a finance lease but can choose whether or not to do so for an operating lease (provided, of course, that the property meets the definition of investment property);
- The classification as an operating or finance lease should be made at the inception of the lease. If the entity acquires an interest in a leasehold property, a determination should be made as to whether this is in substance a new lease. For this purpose, a sub-lease is regarded as a new lease. A legal assignment of a lease, resulting in the entity becoming party to its terms, may also represent a new lease in substance depending on the specific facts and circumstances. The acquisition of an entity with an existing leasehold property interest does not result in a new lease;
- If the investor/lessee chooses to apply IAS 40 to a property held under an operating lease, it must apply the fair value model to that property interest and to all of its other investment properties (including owned property) - IAS 40.6. However, there is one exception to this rule: either model may be applied to properties that support liabilities ie liabilities that are linked to the fair value or returns from specified properties (IAS 40.32A);
- If IAS 40 is applied to a property held under an operating lease, the lease is then accounted for as a finance lease. Consequently a lease liability is recognised, calculated as the MLPs discounted at the interest rate implicit in the lease (see IAS 17.4 for definition). It is however often impractical to determine this interest rate, especially as the lease is an operating lease. If so, the investor/lessee's incremental borrowing rate is used (IAS 17.20);
- The normal requirements of IAS 17.15 and 16 for the separation of leases of land and buildings are relaxed for leased property if both elements are classified as investment property and the fair value model in IAS 40 is applied (IAS 17.18);
- If the investor/lessee does not wish to apply the fair value model to both the land and buildings elements, it must separate the lease unless the land element is immaterial. The land element is almost always an operating lease, unless title to the land is expected to transfer at the end of the lease term (IAS 17.14). The investor/lessee has the accounting policy choice outlined above for any operating lease element(s). For any element(s) classified as a finance lease, the investor/lessee applies IAS 40 and can choose between the cost model and the fair value model;
- In applying these requirements, any premium paid to the lessor or to the previous lessee to enter into the lease should be included in the MLPs both in determining the appropriate classification and in calculating the present value of the MLPs. However, the premium element is not part of the lease liability (because it has already been paid);

- If the IAS 40 fair value model is applied, the asset to be recorded at fair value is the leased interest, not the underlying property (IAS 40.26). The leased interest at initial recognition is the cost, net of the related finance lease liability. The fair value is the amount the lessee would expect to receive (ie the premium) for this interest. This will reflect the expected cash flows, discounted at a market rate. The expected cash flows include the rentals to be received from tenants and the rentals payable to the owner/lessor.

The requirements described above are summarised in a decision tree in the Appendix to this TA alert.

Example

An office building was constructed several years ago and leased by its owner to a property investor. The investor/lessee has sub-let parts of the property to tenants. The head-lease expires on 31.12.X2 and the sub-leases on various earlier dates. The sub-leases were classified as operating leases by the original investor/lessee. A second property investment entity, A, acquires the interest in the head-lease from the current lessee on 1.1.X1 by way of a legal assignment. This is considered to give rise to a new lease. Entity A pays a premium of $500,000 to the existing lessee for the interest. There is no transfer of title and no purchase options exist. Rentals payable under the head-lease are $50,000 per annum, due on 31.12 each year.

A intends to hold this property interest to earn rental income and for possible appreciation in the value of the leasehold interest.

The estimated fair value of the underlying property is $2,000,000. Its estimated remaining useful life is 40 years. The land element of the lease is determined to be immaterial.

A's incremental borrowing rate is 9%.

The transaction is determined not to be a business combination.

Analysis

Lease classification

In this example, the land element is immaterial. The lease is therefore classified as an operating or finance lease in its entirety. (Note - in most real property leases, the land element is not immaterial. The lease will then need to be analysed into the land and buildings element unless the investor/lessee decides to classify both elements as investment property and apply the fair value model).

The lease classification is assessed using a range of indicators. One important indicator is the relationship between the present value of the MLPs and the fair value of the underlying property. The present value of the MLPs is the sum of the premium ($500,000) and the present value of the twenty annual payments of $50,000 ($456,427, using a 9% discounted rate based on A's incremental borrowing cost). This totals $956,427. This is 48% of the fair value of the underlying property, which is not "substantially all the fair value" (IAS 17.10(d)). This indicates that the lease is probably an operating lease. Other indicators of operating lease classification are that:

- The lease does not transfer ownership at the end of the lease term (see IAS 17.10(a));
- There is no bargain purchase option (IAS 17.10(b));
- The lease term is not for the major part of the economic life of the asset (IAS 17.10(d));
- The asset is not of such a highly specialised nature that only the lessee can use it without major modifications (IAS 17.10(e)).

These indicators are conclusive as to operating lease classification.

Entity A therefore has a choice between:

- Accounting for the lease as a normal operating lease; or
- Applying the IAS 40 fair value model and accounting for the lease as a finance lease.

Accounting for the lease as an operating lease

If this option is chosen the annual rentals of $50,000 are recognised on a straight-line basis over the remaining 20 year lease term. The premium is recorded as a prepayment and also amortised straight-line over the term of the lease.

Applying the IAS 40 fair value model

If this option is chosen, a finance lease liability is recorded. This is initially determined as the present value of the future lease payments, discounted at 9% (as above). This is $456,427. The initial cost of the leasehold interest is that amount plus the premium ie $956,427.

Entries

01.1.X1 ($)	Debit	Credit
Investment property - Leasehold interest	$956,427	
Finance lease liability		$456,427
Cash (premium)		$500,000

Subsequently:

- Interest on the finance lease liability is accrued at 9% of the outstanding creditor and the creditor is reduced by the annual payments of $50,000; and
- The leasehold interest (ie the carrying value net of the related finance lease liability) is re-measured to fair value at every reporting date, with fair value changes recorded in profit and loss.

Because entity A has chosen to report this operating lease interest as an investment property, it should apply the IAS 40 fair value model to all of its owned and leased investment properties.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au

Appendix

Decision Tree for Leased Investment Property