Technical Accounting Alert

Rental guarantees on investment properties

Introduction

It is common when an investment property is purchased for the purchaser to receive a rental guarantee from the vendor as an incentive to enter into the sale. Often the guarantee will relate to occupancy levels, although guarantees may also be given relating to changes in the market value of rents, and other variables.

This document provides guidance on how the purchaser of an investment property should account for a rental guarantee and payments received under the rental guarantee in relation to the acquired investment property. Specifically:

1 Is the rental guarantee a separate asset?

2 If the guarantee is a separate asset, what kind of asset does it represent?

3 How should the cash inflows resulting from the rental guarantee be recognised?

Relevant Australian standards

References in this TA alert 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 40 Investment Property	AASB 140 Investment Property
IFRS 4 Insurance Contracts	AASB 4 Insurance Contracts
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

If the rental guarantee is material, an assessment should be made of whether or not the rental guarantee is separable from the property. A rental guarantee will be separable from the property if the acquirer can either transfer the guarantee without selling the property or if the property can be sold without the guarantee being transferred with it.

If the rental guarantee is separable, then it should be separated out from the value of the property and accounted for as a separate asset. If on the other hand the rental guarantee is not separable then it should be accounted for with the property as one asset.

Where the rental guarantee is accounted for separately from the property, the entire purchase price must initially be allocated to both assets based upon their relative fair values. Our view is that the asset recognised in respect of a rental guarantee will usually be accounted for under IAS 39. If the rental guarantee is dependent upon a financial variable such as market rents, then we believe it meets the definition of a derivative and should be accounted for at fair value through profit and loss. If on the other hand, the guarantee is dependent upon a non-financial variable specific to the party such as occupancy levels in the property, then we believe that the asset would be classified as 'available-for-sale'. (Note however that this may also be classified as a derivative in the future if the proposal in the IASB's Annual Improvements Project to amend the definition of a derivative by removing the current exclusion relating to non-financial variables specific to a party to the contract, is accepted.)

In rare cases, a rental guarantee may meet the definition of an insurance contract. For this to be the case, there must be uncertainty over whether money will be received under the guarantee or not and payments under the guarantee must be determined by a non-financial variable that is specific to a party to the agreement.

Is the rental guarantee a separate asset?

The question arises then as to how the purchaser of an investment property should account for a rental guarantee and payments received under the rental guarantee in relation to the acquired investment property.

The first question that needs to be addressed in such a situation is whether the rental guarantee should be recognised as a separate asset.

Alternative viewpoints can be taken. Some would say that the rental guarantee should be incorporated in the fair value of the investment property and should not be separated from it, citing IAS 40.50 which states that "an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities". They would also point out in support of their argument that often rental guarantees will be immaterial and that real estate companies therefore consider the investment property and the rental guarantee as a whole. The fair value of the investment property therefore includes the value of the rental guarantee. The opposite view would be that the acquisition of the property and the rental guarantee represent two separate components of a single transaction and should therefore be recognised separately.

Our view is that the answer depends on whether the rental guarantee is separable from the property or not. A rental guarantee will be separable from the property where the acquirer can either transfer the guarantee without selling the property or where the property can be sold without the guarantee being transferred with it.

Where the rental guarantee is separable, it should be separated out from the value of the property and accounted for as a separate asset. If on the other hand the rental guarantee is not separable then it should be accounted for with the property as one asset. When assessing whether a rental guarantee is separable or not, it should be borne in mind that the value of a guarantee is often immaterial, meaning it may not be necessary to separate out the guarantee in any case.

If the rental guarantee is a separate asset, what kind of asset does it represent?

Where the rental guarantee does need to be recognised as an asset separately from the property, the first thing that needs to be done is to allocate the purchase price to the two assets. As the assets are acquired in a single transaction, this requires allocating the entire purchase price to the two assets. In the absence of any specific guidance in IAS 40 on how to deal with such a situation, we recommend that the principle set out in IFRS 3 *Business Combinations (Revised 2008)* is followed, which says in relation to the acquisition of a group of assets that does not constitute a business that "the acquirer shall identify and recognise the individual identifiable assets acquired…and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase" (IFRS 3.2(b)).

Having done this, the next question that needs to be addressed is what kind of asset does the rental guarantee represent? There are two possible views here:

View A - rental guarantee recognised as a prepayment for an insurance contract

Under view A, the rental guarantee contract is seen as meeting the definition of an insurance contract in which the purchaser is acting as the policyholder, meaning that their (i.e. the policyholder's) rights and obligations are outside the scope of IAS 32 and IAS 39.

Under this view, the rental guarantee would be initially recognised as a prepayment for an insurance contract at cost (assessed as its relative fair value). Subsequently the prepayment for the rental guarantee would be amortised on an appropriate basis over the term of the guarantee period.

View B - financial instrument (rental guarantee recognised as a (group of) derivative(s))

Under view B, the rental guarantee is deemed not to meet the definition of an insurance contract as there is not a specified uncertain future event (it being known from the start that payments will need to be made under the guarantee). This means that the rental guarantee falls within the scope of IAS 39.

Whether the rental guarantee is accounted for as a derivative or as an available for sale financial asset will depend upon the terms of the rental guarantee as discussed below. Under either classification, the rental guarantee will be measured at fair value both initially and on an ongoing basis until the term of the guarantee period expires.

Our view

Our view in such a situation is that (as with many matters under IFRS), the answer will depend upon the terms of the rental guarantee.

Where there is no uncertain future event

Where a rental guarantee is separable from the property but does not involve an uncertain future event, then the rental guarantee will be accounted for under IAS 39 as it fails to meet the definition of an insurance contract.

An insurance contract is defined under IFRS 4 as "a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Example 1

V is the vendor of an investment property that is 90% let. On 1 January 2008, V sells the investment property to the purchaser P and provides P with a rental guarantee to compensate for rental income being less than 100% of the rent that would be receivable on a fully let property during the next 2 years (i.e. until 31 December 2009).

Looking at this definition in the context of the above example, it is not possible to say that there is an uncertain future event. The property is not fully occupied, and therefore payments will definitely be received. Consequently, the rental guarantee falls within the scope of IAS 39.

The question that follows from this is what type of financial asset does the rental guarantee give rise to under IAS 39? Specifically is it the guarantee is a derivative or an available for sale financial asset? Again the answer will depend upon the terms of the rental guarantee and how they interrelate with the definition of a derivative.

IAS 39.9 currently defines a derivative as a financial instrument or other contract within the scope of that Standard *"that has all three of the following characteristics:*

a *Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');*

b *It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and*

c *It is settled at a future date".*

The rental guarantee is settleable at a future date and the amount paid for it is negligible relative to the amount paid to acquire the property and therefore gain exposure to the overall rental value of the property, meaning that parts (b) and (c) meet the definition of a derivative. The key determinant then of whether a rental guarantee falls within this definition or not, will be the underlying factor (see (a) in the definition above).

If the underlying is a financial variable or a non-financial variable that is not specific to a party to the contract, it is clear that the definition is met. The guarantee will then be accounted for as a derivative with changes in its fair value being taken to profit and loss. Should the guaranteed event arise so that the owner of the investment property is reimbursed for the loss of rental income in the period, there would be no effect on income as this will have already been reflected in the fair value movements of the derivative; payments received would be treated as settlements rather than revenue.

Example 2

V is the vendor of an investment property that is 90% let. On 1 January 2008, V sells the investment property to the purchaser P and provides P with a rental guarantee under which V will compensate P for rental income being less than 100% of the rent that would be receivable on a fully let property during the next 2 years (i.e. until 31 December 2009). The amount of compensation that will be paid will vary in accordance with the market index of rents for commercial property in the country over that period. The guarantee is considered separable.
The guarantee depends upon a financial variable (the market index of rents for the country as a whole) and therefore meets the definition of a derivative. It should be measured both initially and subsequently at fair value with changes in fair value being recorded in profit or loss (IAS 39. 43, 46 and 55a).

If however the guarantee relates to a non-financial variable which is specific to a party to the contract, then it fails the definition of a derivative and should be accounted for as an available for sale financial asset. Again the asset will be measured both initially and subsequently at fair value; however, the changes in its value will be taken to equity.
It should be noted however that the IASB is currently considering amending the definition of a derivative as part of its Improvements Project by removing the exclusion of contracts that are linked to the movement in a non-financial variable which is specific to one of the parties to the contract. If this proposal is accepted, it would mean that this type of variable would also fall to be accounted for as a derivative.

Where there is an uncertain future event

In the above example, the rental guarantee was deemed not to meet the definition of an insurance contract as there is not a specified uncertain future event - both parties know at the time of entering the guarantee that part of the property is unlet, meaning that it is certain that payments will be made under the rental guarantee.

It is possible however to imagine some situations where a rental guarantee relates to a specified uncertain future event involving insurance risk and therefore meets the definition of an insurance contract, even if such situations are likely to be rarely encountered in practice. (NB Insurance risk is defined in IFRS 4 as "risk, other than financial risk, transferred from the holder of a contract to the issuer", with financial risk being defined as "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract".)

Example 3
V is the vendor of an investment property that is 100% let at the time of sale. V sells the investment property to the purchaser P. Under the terms of the current tenants' leases, they will be able to exercise a break clause in five years time. V provides P with a rental guarantee to compensate for up to one year's loss of rent should the tenants exercise their break rights after five years. At the time of entering the contract there is a specified uncertain future event, namely whether the tenants will exercise their break rights or not. This is a discrete event. The risk (of a tenant exercising a break clause) is specific to a party to the contract and is not a financial risk; it would therefore seem legitimate to treat the rental guarantee as an insurance contract.

The rights and obligations of an insurance contract policyholder (the purchaser of the property in the scenario given) are outside the scope of IAS 32 and IAS 39 (see IFRS 4.BC73, IAS 39.3(e) and IAS 32.4 (d)). Neither are they addressed by IFRS 4, the scope of which only applies to issuers of insurance contracts. In the absence of any specific Standard dealing with how the policyholder (i.e. the purchaser) should account for the asset that it holds, reference should then be made to the Framework for the Preparation and Presentation of Financial Statements ('the Framework'). Paragraph 96 of the Framework states:

> "When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures…"

We therefore believe an appropriate treatment would be to amortise the asset (which is effectively viewed as a prepayment) in a way that reflects the consumption of economic benefits in the particular circumstances of the situation required.

In this scenario, there is a secondary question relating to presentation which will arise should the guaranteed event occur so that the owner of the investment property is reimbursed for the loss of rental income in the period. When the break clause is exercised, the insured event occurs with the consequent effect that the purchaser of the investment property will recognise a separate asset for the amount of the reimbursement for the period concerned. A number of ways of presenting this asset can be envisaged. For example, it could be argued that the payment does not represent a payment received for services, and should therefore be presented as 'other income' or alternatively that the payment should be deducted from the carrying amount of the investment property on the grounds that it effectively represents a discount given by the seller of the property.

Should such a situation occur, our preference would be to recognise the reimbursement as income on the grounds that it is compensating the purchaser of the investment property for lost revenue. The nature of these payments should of course be disclosed in order to assist the reader of the financial statements in understanding the financial performance achieved and making projections of future results.

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