

## PROFIT IMPACT OF PROPERTY WHEN RENTS GO UPWARD-ONLY

**If property leases are capitalised, not only will there be an impact on the balance sheet, there could be an impact on profit as well. Two senior finance professionals explain the issues.**

There are some practical difficulties in the application of IAS 17 in the UK and FDs need to be aware of the issues so they can plan accordingly. Companies with a large number of long leases, such as retailers, should take particular note of the requirements of the new accounting standard.

### Effect on profits

In the early years of a lease, the interest charge is front-loaded, so the interest plus depreciation exceeds the rent that would otherwise have been charged to the profit and loss account. In the later years, the charge is less than the rent. However, this is of little comfort to retailers that, as a result of recent expansion, may have a number of relatively new leases.

### Practical problems

When companies start trying to calculate the effect of the standard on their properties, they will realise quickly the difficulties inherent in making the calculations. These are caused largely by the need to assess the land and buildings element separately.

IAS 17, like SSAP 21, says that finance leases are those which transfer substantially all the risks and rewards incidental to ownership of an asset. However, the guidance notes to SSAP 21 make it clear that property leases are unlikely to be accounted for as finance leases because the

existence of upward-only rent reviews is a clear indication that the rewards of ownership remain with the lessor. IAS 17 contains no such guidance.

It is also arguable that the upward element of the rent is due to the increasing attractiveness of the location and that the building rent could be considered fairly flat throughout the life of a building. Hence, under IAS 17, the existence of the upward-only rent reviews underlines the fact that leases over the land element will rarely be classified as finance leases.

We won't rehearse all the tests to be applied in determining the proper classification of any given lease as these are set out clearly in the standard. We believe, in common with the author of a recent *Financial Director Briefing* (see 'Impact of IAS on property leases', June 2004, page 38), that the two tests of major concern are the test relating to the length of the lease in comparison with the building's economic life and the net present value test.

### Building life

Retail sheds are built to specifications that mean they should have a life in excess of a standard 25-year lease commonly taken by retailers. The foundations and the structures may well last in excess of 50 years, but some of the cladding may require replacing in that time. On the high streets, retailers may have leases on listed buildings that are more than 100 years old, but while the façades are old the interiors will have undergone several refurbishments.

The retailing industry should

consult with auditors and surveyors to develop a common view on building lives as it is of the utmost significance in determining the status of a lease over property.

### NPV test

This arithmetical test requires that the fair value of the site be split between the land and buildings element. UK surveyors are unused to splitting site values between the two elements. As yet there is no guidance available from their professional bodies as to how such a valuation should be made.

The rent must also be allocated between the two elements. The standard seems to say specifically that the rent should not be allocated in the same proportion as the land buildings split. Close reading of the notes indicates that the allocation should reflect the fact that landlords will require a greater return on buildings that wear out than on land which does not. However, the standard does not make it clear how the split should be achieved. As the rental allocation is critical to the determination of the lease, companies should consider taking professional advice at an early stage to establish a method of its calculation.

### Other issues

Further issues arise with the record-keeping that will be required. When the standard is first adopted, a company must evaluate all its existing leases and decide which, if any, needs to be reclassified. The professional and administrative cost of this exercise should not be underestimated. A prior year adjustment will be required to restate those leases

that are classified as finance leases. Records will then have to be kept for each lease so that the correct amount of interest can be charged in subsequent years. The finance teams will need to examine their existing accounting systems to assess their suitability for finance lease accounting. The surveying teams will also need to start planning how they are going to approach the task of reviewing each property and making the land/buildings split. It should be recognised that this is further complicated by the fact that the allocation has to be carried out as if at the inception of the lease so the valuations will have to be made without the benefit of hindsight.

As well as the adjustment needed to put leases onto a different footing, there may also be an adjustment required to reserves where profits have been made from sale and leaseback transactions, where on re-examination the leaseback of the property is found to have been a finance lease.

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