

IMPACT OF IAS ON PROPERTY LEASES

Applying international accounting standards could have an impact on how property is treated in company accounts.

Leases IAS 17 v SSAP 21

The UK's SSAP 21 *Accounting for Leases and Hire Purchase Contracts*, and IAS 17 *Leases*, follow similar approaches in distinguishing between finance and operating leases; in other words, a finance lease transfers substantially all the risks and rewards incidental to ownership to the lessee. However, under the revised IAS 17 issued in December 2003:

- The land and buildings elements must be classified separately.
- The land element will normally be an operating lease (unless title passes to the lessee at the end of the lease term) and the attributable rent expensed on a straight-line basis.
- The buildings element could be treated as a finance lease. This could happen, for example, where the lease term is for the major part of the economic life of the asset, even if title is not transferred. It could also occur when, at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

Impact of buildings element treated as a finance lease

If the buildings element is treated as a finance lease, a matching capitalised asset and liability will appear on the lessee's balance sheet – calculated as the lower of fair value and the present value of the minimum lease payments

attributable to the buildings. Although the net effect will be zero, the company's gearing will be affected.

"Firms with a substantial number of leasehold properties are likely to be affected," says David Wood, director in the investment consulting team at property consultants Nelson Bakewell. These would include retailers operating out of large-format 'retail warehouse' stores, where the length of the lease taken is usually equal to the economic life. Consider a retailer operating from 200 warehouses, 95% of which have leases equal to the economic life of the building and are treated as finance leases. Nelson Bakewell estimates that with leases lasting 20 years, the present value of the minimum lease payments attributed to the 95% of the warehouses could be as much as £315m. In other words, a matching £315m asset and liability would appear on the retailer's balance sheet, having a potentially huge impact on its gearing.

If all the leases were shorter than the warehouses' economic life, the leases would be treated as operating leases with no balance sheet impact. IAS 17 could therefore affect two similar companies very differently.

IAS 17's potential to impact the balance sheet could make leases of older buildings less attractive because of the increased likelihood that their useful economic life expires at the end of the lease. "It may also make long leases of new buildings unattractive," says Wood. "There's a general move anyway towards short leases, but IAS 17 is another nail in the coffin for longer

leases. It could also make freeholds more attractive."

Onerous leases IAS 17 and IAS 37 v FRS 12

Where companies have surplus buildings held under operating leases that they choose to sublet but market rents have fallen, FRS 12 requires companies to provide for a liability (the difference between the headlease rent and the sublease rent). The net impact under IAS 17 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, will be similar but achieved by the capitalised buildings element under a finance lease being impaired and recorded alongside a larger liability. Again, gearing could be seriously affected.

The impact of IAS could lead more companies to consider making more use of flexible, serviced office space. "The cost of flexible serviced office space compares very favourably with leased building costs," says Andrew Blurton, finance director of property company MWB Group. "As property occupancy costs become more transparent, it is estimated that larger corporate occupiers should outsource at least 20% of their property requirements to the operators of flexible space."

Freehold property IAS 16 v FRS 15

Under FRS 15 *Tangible Fixed Assets*, the typical valuation method for most owner-occupied freehold properties is existing use value, which ignores the properties' development or change of use potential. However, IAS 16 *Property, Plant and Equipment*, focuses on fair value. Exactly what fair value means in this context is still uncertain, but the development potential of property could be taken into account; in other words,

property in desired locations could have a higher fair value. That said, companies will have a choice between using historic cost or fair value.

However, if fair value is used, deferred tax could become an issue. "In the UK, you don't recognise deferred tax on a revaluation gain, unless you have a binding sale agreement at the year end," says Brian Creighton, director in the financial reporting unit at BDO Stoy Hayward. "Under international standards you do recognise deferred tax on a revaluation. That would clearly reduce net assets."

Time for review

With the deadline for applying international standards fast approaching, companies are advised to review their property portfolios and the associated accounting implications now.

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● For summaries of the IASB's standards, go to www.iasb.org/standards/summaries.asp

● Also see www.nelson-bakewell.com and www.bdo.co.uk