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The World According to IAS

How Serviced Offices Can Solve a Painful Headache

A Research Note by

Business Centre Capital Company Limited (B3C)

Private Equity for Flexible Business Space



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The World According to IAP

This is one of a series of occasional research notes produced by Business Centre Capital Co Ltd. (B3C) the specialist fund management advisory company for the business centre industry.

Introduction

This note was inspired by a discussion the writer had with Giles Denney, owner of The Malthouse Business Centre, a well-established serviced office in Egham, Surrey. Giles took exception to a statement in our previous note entitled “*The Importance of Flexible Managed Offices as a Catalyst For Regeneration*”, published in April 2007, that accounting standards required companies to put the cost of leases on their balance sheets to the detriment of their financial ratios.

Having considered Giles’ comments, I concluded that I needed to set out more clearly the point I was trying to make and I therefore wish to acknowledge Giles’ role in inspiring this latest note.

Executive Summary

- All companies quoted on a recognised investment exchange must now report to shareholders using International Financial Reporting Standards and as a result a substantial minority UK property leases should be considered as finance leases of the building, which means that there will be a negative impact on the financial ratios of the lessee.
 - Additional professional fees are likely to be incurred in making the assessment whether a lease is a finance lease or not, so there will be a cost even if it isn’t a finance lease.
 - Companies using serviced office space do not have to address these issues so serviced office companies should market their product to finance directors.
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International Accounting Standards

From 5th April 2007 all companies listed on AIM have to report to shareholders according to International Financial Reporting Standards. Fully listed companies have been subject to IFRS since 2005 and there is a plan to extend this requirement to all companies by 2009 although there is doubt as to whether this timetable will be maintained.

How does this impact on property? The relevant IFRS standard is International Accounting Standard (IAS) 17.

IAS 17

IAS 17 issued in December 2003, distinguishes between operating and financing leases which as does SSAP 21 of the UK's Generally Accepted Accounting Principles (GAAP). What is new are the criteria for distinguishing between the two types of lease and the rules applied to finance leases. As explained below there are potentially serious consequences for a company if its property leases are considered to be finance leases.

Shortly after IAS 17 was issued, the British Property Federation issued a guidance note to its members in which it expressed the view that typical UK property leases should be categorised as operating leases rather than finance leases and thus not subject to the onerous rules applicable to the latter.

Whilst it may be true that the majority of UK occupational leases are operating leases within the meaning of IAS 17, we think that a significant minority are not, and should in fact be classified as finance leases, so there is no room for complacency.

Operating or Finance – How to Categorise?

The definition of a finance lease is a lease that transfers substantially all of the risks and rewards incidental to ownership of an asset to the lessee and an operating lease is every lease that is not a finance lease. IAS 17 lists a number of tests that may make a lease into a finance lease, most of which are not relevant to this discussion, but two that are relevant are that a lease will be a finance lease if:

- i) the lease term is for the major part of the economic life of the asset; or
- ii) at the inception of the lease, the net present value (NPV) of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

If you look at these tests in practice you can see that a classic 15 year lease of a building that is say, 10 years old already, may well be for the major part of its economic life and even if it is not, the NPV of the lease payments may well amount to substantially all of the fair value of the building, bearing in mind that this is the value not including the land. So, a lot of leases of 1960s, 1970s or 1980s buildings may well be finance leases.

The BPF's advice would seem to us to be somewhat optimistic to the extent that it suggests that UK lessees have nothing to worry about. The RICS in its guidance note of 30th November 2004 also struck a positive note saying,

“Because many long leases have market rent reviews, which mean that the lessor retains a significant element of risk and reward, the buildings element of most property leases will be Operating Leases; Finance Leases will generally arise only where the lease is clearly designed as a way of funding the eventual purchase of the property outright by the lessee.”

In our view the first clause of the paragraph quoted is correct, but the second clause does not follow logically from the first and is wishful thinking.



Consequences

There are two unpleasant consequences of IAS 17 for occupiers, the first being a substantial increase in professional fees because of the need to undertake a new and difficult valuation exercise and the second being the balance sheet consequences of a lease being categorised as a finance lease.

Valuation

Because land has no finite life, leases of land are generally deemed to be operating leases, but where the lease covers land and buildings, as is normally the case, the two elements should be considered by themselves, so the valuer has to split the two parts appraising the land and the building separately, not an easy task in practice.

Where the lease of the land and of the buildings are obviously the same type of lease, whether it be finance or operating, there is no need to apportion the rent between them, but in other cases, which we feel are the majority, it is necessary to make an apportionment in order to determine whether the building element is a finance lease.

Thus in order to work out whether a lease of land and buildings is in fact a finance lease of the building, a valuation exercise has to be carried out apportioning both the value of the assets and the rent between the two elements. This inevitably carries a cost for the occupier.

Where the building in question is either brand new, or ancient, it may be possible to avoid going through this process because it will be obvious that the economic life exceeds the lease length by a hefty margin and that the NPV of the rent is a lot less than the value of the building. In many other cases going through the whole process will be unavoidable.

Effect on Lessor

Where, as a result of this exercise, a lease is considered to be a finance lease of the building, the lessee has to recognise the lease as an asset in its balance sheet at its fair value with a countervailing liability in the amount of the net present value of the minimum lease payments as seen from the commencement of the lease.

Although the asset and liability value will in most cases be equal, so there is no net effect on the balance sheet, the amount of the gross assets and of the gross liabilities will increase by the value of the building and this will have a negative effect on certain important financial ratios of the occupier, which will lead to an increased cost of capital.

So the mere fact of leasing a building will, in an accounting sense, negatively affect the financial situation of the tenant.

Implication for Serviced Offices

The above analysis may make painful reading for conventional landlords and for the finance directors of tenant companies, but it should be good news for operators of serviced and managed offices and business centres.



The legal document between a supplier and customer in a flexible managed office is normally an occupational licence not a lease and even where a lease is used, it will be of such a short duration as not to present any difficulty under IAS 17. Serviced office customers are thus not affected by the accounting changes described above.

We think that serviced office and business centre operating companies have been a little slow in capitalising on this advantage and we recommend that in addition to marketing their product to the property directors of potential client companies, serviced office companies should market direct to finance directors emphasising the negative aspects of IAS 17 for conventional space.

The Future

Early this year the Financial Accounting Standards Board and the International Accounting Standards Board announced a joint project,

“to comprehensively reconsider the guidance in FASB 13 Accounting for Leases and IAS 17 Leases.....to ensure that investors and other users of financial statements are provided useful, transparent and complete information about leases....”

This project is likely to lead to a new accounting standard that will abolish the distinction between operating and finance leases and require all companies to show the asset and liability created by a lease on the balance sheet as is currently required only for finance leases, so even if unlisted companies do not presently have to comply with IAS 17, the writing is on the wall.

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