International Accounting Standard 17

Leases

Basis for Conclusions on IAS 17 *Leases*

This Basis for Conclusions accompanies, but is not part of, IAS 17.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 17 *Leases* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 17. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within existing Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for leases established by IAS 17, this Basis for Conclusions does not discuss requirements in IAS 17 that the Board has not reconsidered.

Classification of leases—leases of land and buildings

BC4 Paragraph 14 of the Standard requires a lease of land with an indefinite economic life to be normally classified as an operating lease, unless title is expected to pass to the lessee by the end of the lease term. The previous version of IAS 17 was not explicit about how to classify a lease of land and buildings.

BC5 This is a matter of concern in countries where property rights are obtained under long-term leases and the substance of those leases differs little from buying a property. Therefore, the Board decided to deal with this matter in its Improvements project and not to defer its resolution until the more fundamental project on leases was completed.

BC6 The Board noted that two approaches are applied in practice. The first is to treat such a lease as a single unit and to classify it as an operating lease in its entirety. The second is to split the lease into two elements—a lease of land and a lease of buildings. The Board decided that the first approach does not adequately reflect the assets controlled by the entity or their usage and financing. It is also inconsistent with the classification and the measurement of other leases. Therefore, the Board rejected the first approach of classifying a lease of land and buildings as an operating lease in its entirety.

BC7 The Board agreed on the second approach of splitting the lease into two elements—a lease of land and a lease of buildings. The land element would normally be classified as an operating lease in accordance with paragraph 14 of the revised Standard and the buildings element classified as an operating or finance lease by applying the conditions in paragraphs 7–13. The Board noted that generally accepted accounting principles in Australia, Canada and the United States all explicitly require a lease of land and buildings to be split into two elements.

BC8 The Board also discussed a third approach, namely whether to delete the requirement (in paragraph 14 of the Standard) normally to classify a lease of land as an operating lease when title does not pass at the end of the lease and to require such a lease to be classified as a finance lease when all other conditions for finance lease classification in the Standard are met. The Board noted that such an accounting treatment would conflict with the criteria for lease classification in the Standard, which are based on the extent to which the risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Indeed, land normally has an indefinite economic life and hence there are significant risks and rewards associated with the land at the end of the lease term, which do not pass to the lessee. Therefore, the Board rejected this approach.

Allocation of minimum lease payments between land and buildings

BC9 The Exposure Draft proposed that the allocation of the minimum lease payments between land and buildings should be made in proportion to their relative fair values at the inception of the lease. Respondents to the Exposure Draft questioned whether the allocation basis referred to the land and buildings components of the fair value of the property or the fair value of those components to the extent they were the subject of the lease.

BC10 The Board noted that an allocation of the minimum lease payments by reference to the relative fair values of the land and buildings would not reflect the fact that land often has an indefinite economic life, and therefore would be expected to maintain its value beyond the lease term. In contrast, the future economic benefits of a building are likely to be used up, at the least to some extent, over the lease term. Therefore, it would be reasonable to expect that the lease payments relating to the building would be set at a level that enabled the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. In the case of land, the lessor would not normally need compensation for using up the land.

BC11 Therefore, the Board decided to clarify in the Standard that the allocation of the minimum lease payments is weighted to reflect their role in compensating the lessor, and not by reference to the relative fair values of the land and buildings. In other words, the weighting should reflect the lessee's leasehold interest in the land and the buildings. In the extreme case that a building is fully depreciated over the lease term, the minimum lease payments would need to be weighted to provide a return plus the full depreciation of the building's value at the inception of the lease. The leasehold interest in the land would, assuming a residual value that equals its value at the inception of the lease, have a weighting that reflects only a return on the initial investment.

Impracticability of split between land and buildings

BC12 A question that arises is how to treat leases for which it is not possible to measure the two elements reliably (eg because similar land and buildings are not sold or leased separately). One possibility would be to classify the entire lease as a finance lease. This would prevent a lessee from avoiding finance lease treatment for the buildings by asserting that it cannot separately measure the two elements. However, it may be apparent from the circumstances that classifying the entire lease as a finance lease is not representationally faithful. In view of this, the Board decided that when it is not possible to measure the two elements reliably, the entire lease should be classified as a finance lease unless it is clear that both elements should be classified as an operating lease.

Exception to the requirement to separate the land and buildings elements

BC13 The Board discussed whether to allow or require an exception from the requirement to separate the land and buildings elements in cases in which the present value of the land element at the inception of the lease is small in relation to the value of the entire lease. In such cases the benefits of separating the lease into two elements and accounting for each separately may not outweigh the costs. The Board noted that generally accepted accounting principles in Australia, Canada and the United States allow or require such leases to be classified and accounted for as a single unit, with finance lease treatment being used when the relevant criteria are met. The Board decided to allow land and buildings to be treated as a single unit when the land element is immaterial.

BC14 Some respondents to the Exposure Draft requested guidance on how small the relative value of the land element needs to be in relation to the total value of the lease. The Board decided not to introduce a bright line such as a specific percentage threshold. The Board decided that the normal provisions on materiality should apply.

Transitional provisions

BC15 The Board decided that the requirement to separate the land and buildings elements in a lease of land and buildings should be applied retrospectively. It noted that there will be cases when it will be impracticable to reassess the treatment of these leases retrospectively, because doing so requires estimating what the fair value of the two elements was at the inception of the lease, which may have been many years before. The Board also noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* contains guidance on when it is impracticable to apply retrospectively a change in accounting policy and therefore decided not to provide specific transitional provisions for the implementation of this revision to IAS 17.

Inception of the lease and commencement of the lease term

BC16 The previous version of IAS 17 did not define the commencement of the lease term. It implicitly assumed that commencement (when the lease begins) and inception (when the agreement is entered into) are simultaneous. Some respondents questioned what should happen if there is a time lag between the two dates, particularly if the amounts change—for example, because the asset is under construction and the final cost is not known at inception. The Standard now specifies that recognition takes place at commencement, based on values measured at inception. However, if the lease is adjusted for changes in the lessor's costs between the inception of the lease and the commencement of the lease term, the effect of any such changes is deemed to have taken place at inception. These revisions are consistent with generally accepted accounting principles in Australia, Canada and the United States, and are consistent with the present accounting treatment of most ordinary purchases and sales.

BC17 In agreeing on this treatment, the Board noted that measurement at commencement would have been more satisfactory in principle. However, this cannot be done properly within the framework of IAS 17 because the Standard generally requires a finance lease receivable or payable to be recognised at an amount based on the fair value of the asset, which is inappropriate at any date after inception.

Leases in the financial statements of lessors other than manufacturers and dealers

BC18 Lessors may incur direct costs in negotiating a lease, such as commissions, brokers' fees and legal fees. The previous version of IAS 17 contained a choice on how to account for such costs—they might be either charged as an expense as incurred or allocated over the lease term. The choice of treatment applied to operating and finance leases. In the case of a finance lease, paragraph 33 of the previous version of IAS 17 stated that allocation over the lease term might be achieved by recognising the cost as an expense and, in the same period, recognising an equal amount of unearned finance income.

BC19 The Board decided that this treatment was not in accordance with the *Framework for the Preparation and Presentation of Financial Statements*. Its effect was to recognise some future finance income as income and an asset at the commencement of the lease term. However, at that date, the *Framework*'s definitions of income and assets are not met. Therefore, the Board decided that if direct costs incurred by lessors are to be allocated over the lease term, this should be achieved by including them in the carrying amount of the lease asset.

BC20 The Board noted that standard-setters in Australia, Canada, France, Japan, the United Kingdom and the United States either permit or require initial direct costs to be allocated over the lease term. The Board also noted that other Standards permit or require the recognition of a range of similar costs in the carrying amount of assets, generally subject to those costs being directly attributable to the acquisition of the asset in question. Hence, for reasons of convergence and comparability with other Standards, the Board decided to require initial direct costs to be included in the carrying amount of the lease asset.

BC21 For consistency with other Standards, in particular IAS 39 *Financial Instruments: Recognition and Measurement*, the Board decided that recognition in the carrying amount of assets should be restricted to costs that are incremental and directly attributable to negotiating and arranging a lease.

Guidance on implementing IAS 17 *Leases*

This guidance accompanies, but is not part of, IAS 17.

Illustrative examples of sale and leaseback transactions that result in operating leases

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The table below shows the requirements of the Standard in various circumstances.

Sale price at fair Value (paragraph 61)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	no profit	recognise profit immediately	not applicable
Loss	no loss	not applicable	recognise loss immediately

Sale price below fair value (paragraph 61)			
Profit	no profit	recognise profit immediately	no profit (note 1)
Loss <u>not</u> compensated for by future lease payments at below market price	recognise loss immediately	recognise loss immediately	(note 1)
Loss compensated for by future lease payments at below market price	defer and amortise loss	defer and amortise loss	(note 1)

Sale price above fair value (paragraph 61)			
Profit	defer and amortise profit	defer and amortise excess profit (note 3)	defer and amortise profit (note 2)
Loss	no loss	no loss	(note 1)

Note 1 These parts of the table represent circumstances dealt with in paragraph 63 of the Standard. Paragraph 63 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2 Profit is the difference between fair value and sale price because the carrying amount would have been written down to fair value in accordance with paragraph 63.

Note 3 The excess profit (the excess of sale price over fair value) is deferred and amortised over the period for which the asset is expected to be used. Any excess of fair value over carrying amount is recognised immediately.