Institute of
Certified Public Accountants
of Kenya

Position Paper on Certain Aspects of IAS 17, leases.

Incorporating Comments on the Exposure Draft on Limited Revisions to IAS 17 Revised 1997

Preamble

The International Accounting Standards were adopted in Kenya as the financial reporting framework with effect from 1st January 1999. We have studied IAS 17 (revised 1997) and we have the following comments which are two fold;

i) Areas which in our view should be revised by the Board during the current limited revisions to the standard and;
ii) Our comments to the amendments proposed by the Board through the exposure draft on limited revisions to IAS 17 whose comments are due by the 16th of September 2002.

Issues

Concerns on this Standard emanate from paragraph 11 which rules out the possibility of treating leasehold land as finance lease unless title is expected to pass at the end of the lease term on the premise that land has an infinite life and therefore the lessee does not receive substantially all the risks and rewards incident to ownership if title is not expected to pass at the end of the lease term.

We are aware that the Board has in the past received suggestions to amend the concerned paragraph as indicated by paragraphs B11 to B13 of the Appendix B to International Accounting Standards 40 (basis of conclusions). While our circumstances may be similar to those in the UK and Hong Kong, we certainly have a different argument.

Our argument is two fold.

1. **Substance over form**

   Paragraph 8 of IAS 17 (revised 1997) provides for the classification of a lease based on the substance of the transaction rather its legal the form. This and the proceeding paragraph 9 provide for circumstances which will lead to the classification of a lease as a finance lease which we are of the view that it is not exhaustive.

   In most cases land is acquired for different purposes such as construction and agriculture among others. The economic benefits to the Organisation is directly related to the purpose for which it was acquired. In this respect, if land was acquired for the construction of a building whose economic life is estimated at 40 years, the economic life of the land to the enterprise will also be 40 years. In our view it is not correct to assume that the lessee considers what transpires after, say 99 years to be of substance at the time of entering into the contract with the Government. I.e. whether the title will pass or not is of no significance to the lessee who enters into a lease for 99 years and the fact that the lease in renewable even nullifies any such fears.

Furthermore in the context of Kenya, leases of land entitle lessees with the rights to;

a) Sell the rights embodied in the lease. In practice long term leases can be sold at the same price as a similar parcel of freehold land.
b) Renew the lease contract at a rate which is substantially lower than prevailing market rate. The renewal may not be automatic but the Government respects the renewal right and so far we have not had cases of rejection of applications.

It is our considered view that prohibiting classification of leasehold land as a finance lease if title does not pass to the lessee at the end of the lease term is based on a wrong assumption that the passing of ownership at the end of the lease is the overriding factor. It is also against the spirit of developing principle based rather than prescriptive standards envisaged by the Board.

2. Fair value principle

The treatment of leasehold land under paragraph 11 of IAS 17 (revised 1997) goes against the principle of fair value which we believe is the spirit of the International Accounting Standards. The Board has advocated for use of fair value in presenting assets and liabilities unless it is impracticable to do so in which case alternative treatment is allowed.

Having indicated to you that leasehold land in Kenya will attract the same price as similar freehold land, presenting it on the balance sheet at a value other than the fair value will lead to misrepresentation of the financial position of an entity. It is our considered view that the IAS 17 is not intended to override other standards in this respect.

In view of the foregoing our comments on the **Exposure Draft of Limited Revisions to IAS 17 (Revised 1997).**

Question 1

Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements—a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs 3-10 of IAS 17.

Response.

While we do not disagree with the splitting of a lease of land and buildings into the two elements described, we do not agree that the land element is to generally be treated as an operating lease. Our argument is based on the substance over form and fair value principle explained above. We advocate for the deletion of paragraph 11 of IAS 17 to bring about consistency with paragraph 8 and IAS 40 which when amended as proposed will allow leasehold land to be treated as investment property and carried at fair value.

We are also of the view that paragraph 11B on allocation of the lease payment at inception will cause further disparity in reporting where it is not possible to separate the value of land from the value of the development thereon even when the two elements may be considered material. Furthermore the definition of the term "materiality" has not been given in specific terms. This is also likely to lead to inconsistency in reporting as materiality can be determined using different approaches.

It is our view that if paragraph 11 is deleted there is no need to split a lease of land and building into the two elements proposed.

Question 2

> Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?

Response

We agree to both part parts of this question.