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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 18 July 2007, London

Project: Annual Improvements

Subject: Classification of leases of land and buildings
(Agenda paper 5D)

1. The staff has identified that the following issue would be most appropriately resolved via the annual improvements process.

Issue: Should the guidance in IAS 17, *Leases*, relating to the classification of leases of land and buildings be amended to address a perceived inconsistency?

Staff recommendation

2. The staff recommends that the Board:
 - should add this issue to the annual improvements project; and
 - should amend IAS 17 as proposed in paragraph 11 of this paper.

Background

3. The staff has been notified of a perceived inconsistency in the guidance on the classification of leases of land and buildings in IAS 17.
4. IAS 17 requires that leases of land and buildings should be bifurcated and accounted for separately in certain situations. The bifurcation of such leases is relevant when the classification of the lease identifies one asset (usually the building) as being subject to a finance lease and the other (usually the land) subject to an operating lease. Bifurcation is not relevant when both components of the lease are classified the same way or when one component is not material relative to the other.
5. Paragraphs 8 to 12 of IAS 17 provide general guidance on the classification of leases as finance leases and operating leases. Paragraphs 14 to 18 provide guidance on the bifurcation of leases. These paragraphs are reproduced in the appendix to this paper for information. Paragraph 14 also provides additional guidance on how to assess the classification of leases of land and buildings. The additional guidance included in paragraph 14 is as follows:

‘However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease.’

6. There is concern that this additional guidance is unnecessary and potentially hinders the application of the general lease classification guidance in paragraphs 8 to 12. The consequence of the current wording is that more leases of land and buildings are bifurcated between an operating lease for the land and a finance lease for the building than might otherwise arise from a simple application of the criteria in paragraphs 8 to 12.
7. An example of a lease that might be affected by this issue is a 999 year lease of land and buildings. It is reasonable that when such a lease is assessed using

the criteria in paragraphs 8 to 12 the conclusion might be that the entire lease is classified as a finance lease, depending of course on the specific terms of the lease. The lessee in leases of this type will typically be in an economically similar position to an entity that has purchased the land and buildings. Accounting for the land element as a finance lease would therefore be consistent with the economics of the transaction. However, the application of paragraph 14 to the analysis would be viewed by many as requiring the land component of the lease to be bifurcated and classified as an operating lease, even though this may not necessarily reflect the economic position of the lessee.

8. The staff believes that deleting the sentence reproduced above from paragraph 14 of IAS 17 would allow the guidance in paragraphs 8 to 12 of IAS 17 to be applied consistently to all leases and address the concerns raised.

Staff recommendation

9. The staff recommends that IAS 17 is amended as proposed in paragraph 11 of this paper to delete the perceived inconsistency in the guidance on classification of land and buildings.
10. **Does the Board agree?**

Drafting

11. The staff recommend that IAS 17 should be amended as follows:

Classification of leases

...

- 14 Leases of land and of buildings are classified as operating or finance leases in the same way as leases of other assets. ~~However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease.~~ A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided.

Basis for Conclusions on Proposed Amendments to IAS 17 Leases

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Current liabilities

- BC1 The Board identified a perceived inconsistency in the guidance on the classification of leases of land and buildings.
- BC2 The Board notes that the guidance in paragraph 14 of IAS 17 on classification of leases of land and buildings may be read by some as conflicting with the general guidance on lease classification in paragraphs 8 to 12 of IAS 17.
- BC3 The Board concluded that the guidance in paragraph 14 relating to lease classification was unnecessary and decided to address this perceived inconsistency by deleting the sentence concerned.

Appendix – Extract from IAS 17

Classification of leases

7 The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

8 **A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.**

9 Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

10 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.¹ Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

¹ See also SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- (d) 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; and
- (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

- (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

- (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
 - (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
- 12 The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.
- 13 Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7–12 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.
- 14 Leases of land and of buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided.
- 15 The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification. If title to both elements is expected to pass to the lessee by the end of the lease term, both elements are classified as a finance lease, whether analysed as one lease or as two leases, unless it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership of one or both elements. When the land has an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term, in accordance with paragraph 14. The buildings element is classified as a finance or operating lease in accordance with paragraphs 7–13.
- 16 Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the

entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

- 17 For a lease of land and buildings in which the amount that would initially be recognised for the land element, in accordance with paragraph 20, is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with paragraphs 7–13. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.
- 18 Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted. Detailed calculations are required for this assessment only if the classification of one or both elements is otherwise uncertain.