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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **February 2009, London**

Project: **Annual Improvements**

Subject: **IAS 17 Classification of leases of land and buildings: Transition issues (Agenda paper 7)**

PURPOSE OF THIS PAPER

1. This paper discusses the two issues the staff identified during the pre-ballot process on the modified retrospective transition provision that the Board adopted to finalise this amendment. It also discusses potential solutions.

STAFF RECOMMENDATION

2. If the Board still wishes to issue this amendment separately now before the Leasing Project is completed, the staff recommends the Board require an entity:

   a) To reassess the classification of land elements in leases of land and buildings and stand-alone land leases for unexpired leases based on conditions existing as of the inception of the lease; and

b) To recognise land leases that are now classified as finance leases retrospectively based on fair values determined as of the inception of the leases.

If information as of the inception of the lease is not available, an entity would be permitted to reassess the classification of unexpired land leases and to recognise those classified as finance leases based on conditions existing on and fair values determined as of the adoption date.

BACKGROUND

3. At its December 2008 meeting, the Board reaffirmed its view that this proposed change would be an improvement and decided to finalise the amendment after redeliberating and considering respondents' comments.

4. The Board agreed with the additional drafting changes the staff proposed and rejected the prospective transition some respondents suggested due to the lack of comparability. The Board modified the transition to be limited retrospective from the ED's originally proposed fully retrospective transition.

5. The modified transition requires an entity to reassess the classification of unexpired land leases at the date the amendment is adopted and to recognise finance leases using the fair values at that date unless previous fair value information is available.

6. In the pre-ballot draft the Board recently reviewed, the transition provision is drafted as a new paragraph 68A added to IAS 17. See Appendix A [omitted from observer note].

7. The staff identified two issues with the modified transition provisions as drafted:

   a) *Issue 1* – Should an entity apply the tests to reassess lease classification based on the conditions existing on (a) the date of adoption; or (b) the inception of the lease?

b) *Issue 2* – Should an entity recognise the asset and liability related to a finance lease based on amounts determined as of (a) the date of adoption; or (b) the inception of the lease?

STAFF ANALYSIS

8. When an entity adopts this amendment, it must perform two tasks:

    a) Step 1 – reassess the classification of unexpired land leases as operating or finance leases, and

    b) Step 2 – for those now classified as finance leases, recognise assets and liabilities in the financial statements.

9. Regardless of which date the entity uses to adopt the amendment in these two steps, the staff does not think it would affect those land interests held under operating leases that meet the criteria as investment properties and are already fair valued.

10. However, potential implementation issues arise for owner-occupied land elements of land and building leases accounted for on the cost basis, and stand-alone land leases always accounted for as operating leases.

***Issue 1* – Should an entity apply the criteria to reassess lease classification (in Step 1) based on the conditions existing on (a) the date of adoption; or (b) the inception of the lease?**

11. The staff is unclear from Board discussions which date the Board intended to be used to reassess lease classification in Step 1. The staff thinks that the amendment as currently drafted needs revision to clarify the Board's intent.

12. Consider the following two examples.

13. *Example 1* – Company A has a 20 year lease which it entered into 15 years ago, its remaining payments are $300K. On January 1, 2010 it adopts the amendment. The lessee has a purchase option for the land of $1M which 20 years ago was not considered to be a bargain purchase option. At January 1, 2010 the land is worth $2M.

14. If Company A applies the lease classification criteria at January 1, 2010 the lease will be classified as a finance lease. However, had it been applying the standard all along, it would have been classified as an operating lease.

15. *Example 2* – Company B has a 30 year lease which it entered into 25 years ago. On January 1, 2010 the present value of the remaining minimum lease payments for the last 5 years of the lease is 50% of the fair value of the land.

16. Using conditions as of the adoption date of January 1, 2010, Company B has an operating lease. However, had it applied the classification criteria 25 years ago, the lease would have been a finance lease because the present value of the minimum lease payments would have amounted to more than substantially all of the fair value of the leased land.

17. Under IAS 17, lease classification is normally assessed at inception and not subsequently changed absent significant modification of terms. In addition, classification is not reassessed in the event of a business combination in accordance with IFRS 3 (amended in 2008).

18. The staff thinks that the two potential problems illustrated will be more prevalent for those leases nearing the end of their terms if the entity is required to reassess classification based on current conditions on adoption date.

19. On the other hand, for the owner-occupied land and building leases most affected by this amendment, such as a 300-year lease for a corporate headquarters with only 20 years of the lease term expired, the staff thinks they would likely be classified as finance leases even if the reassessment is done as of the adoption date.

20. The staff thinks that requiring entities to reassess unexpired leases on the date this amendment is adopted is not an initial measurement. The link in lease contracts between the fair value of the leased asset and the obligation that exists on the inception date is lost after that initial measurement.

***Issue 2* – Should an entity recognise the asset and liability of a finance lease (in Step 2) based on amounts determined as of (a) the date of adoption; or (b) the inception of the lease?**

21. As mentioned earlier, the staff thinks that if an entity recognises the asset and liability of a finance lease using current fair value amounts calculated on adoption date, the asset and liability amounts in the financial statements are likely to be different from each other because of changes in their fair values since the inception of the lease.

22. IAS 8 would require this difference upon adoption of a new standard to be recognised in opening retained earnings in the period of adoption. The staff sees no reason to propose another treatment in this case.

23. However, the staff also notes that IAS 17 requires the leased asset of a finance lease to be recognised at the lower of its fair value and the present value of the minimum lease obligation. In the transition proposed in the pre-ballot draft, the Board requires the leased asset to be recognised based on its current fair value on adoption date, without restriction to the fair value of the minimum lease payments if they are lower. If the Board prefers the newly recognised asset and liability to be measured at the same amount, that condition could be added to the alternatives discussed below that reflect the Board's previous decision. This is considered as a separate possibility following consideration of those alternatives.

POTENTIAL SOLUTIONS

24. There are various alternative transitions for the two steps in paragraph 8. Balancing among conflicting objectives of achieving comparability, providing relevant information and avoiding undue costs and complexity, the staff would like the Board to consider the following three alternatives:

    a) Option 1 – A retrospective adoption. An entity would

        i. reassess classification of unexpired land leases based on conditions existing as of the inception dates of the leases; and

ii. recognise land leases that are now finance leases retrospectively based on the fair values as of the inception dates of the leases.

b) Option 2 – A modified retrospective adoption. An entity would apply Option 1 to all leases for which retrospective information is available. For those unexpired land leases for which retrospective information is not available, entities would be permitted to reassess lease classification and recognise lease assets and liabilities based on conditions that exist and fair values determined as of the adoption date.

c) Option 3 – A prospective adoption. An entity would

i. reassess classification of unexpired land leases based on conditions existing as of the adoption date; and
ii. recognise the assets and liabilities arising from land leases that are now finance leases based on their fair values as of the adoption date.

25. At its December 2008 meeting, the Board expressed concerns that a retrospective application is not possible without hindsight and believed that current fair values would be more relevant. Therefore, the Board decided to require recognition based on current fair values on the adoption date unless prior fair value information is available. This is what the pre-ballot draft reflects.

26. Based on the analysis above and the two implementation issues identified, the staff would like the Board to reconsider that decision and to further clarify the transition it intended.

27. At that meeting, the staff recommended a retrospective application only to unexpired leases. The staff noted that the Board required fully retrospective application when it adopted the 2003 amendment that requires the split of land and building elements of leases for purposes of lease classification. The Board already explained in 2003 that IAS 8 provided guidance for retrospective application when it is impracticable to do so.

28. Therefore, for land and building leases of entities that have already adopted IFRS, the staff thinks retrospective fair value information of the land element would already be available as a result of applying the 2003 amendment to IAS 17. The staff still thinks that a fully retrospective application for unexpired leases is the best answer.

29. However, the staff is conscious of practical difficulties and thinks that inception date fair value information may still be missing, requiring hindsight to recreate that information in some circumstances, for example:

a) for entities that have already adopted IFRSs – stand-alone land leases without title transfer or upfront prepayments would have been classified as operating leases; and

b) for entities that have not yet adopted IFRSs.

30. For those entities in paragraph 29(a), the staff thinks that relief from retrospective application for those leases is reasonable. Absent a fully retrospective application, it is difficult to achieve full comparability among entities. It is unlikely to retain the link between leased assets and liabilities of the same as an initial measurement on inception date.

31. Adopting the relief described in either Option 2 or Option 3 has disadvantages. In Option 3, prospective application to unexpired leases is the easiest for entities without retrospective information and would provide a consistent approach for all entities. However, as illustrated earlier in the analysis, reassessing classification and recognising finance leases based on fair values on adoption date de-links the leased assets and remaining minimum lease obligations of the lessee. Adopting Option 2 limits this problem by requiring retrospective application for those leases for which the information is available. However, it achieves this by accepting inconsistent treatment both between leases and between entities.

32. For those entities in paragraph 29(b), the Board decided to treat first-time adopters of IFRS in the same way as entities that already apply IFRS (paragraph BC63D of IFRS 1). Paragraph 25F of IFRS 1 allows first-time

adopters to apply the transitional provisions in IFRIC 4 *Determining whether an Arrangement contains a Lease.* Therefore, a first-time adopter may determine whether an arrangement existing at the date of transition to IFRS contains a lease based on the conditions existing at that date.

STAFF RECOMMENDATION

33. Based on the analysis discussed above, the staff recommends Option 2. See the proposed drafting changes to the first pre-ballot draft of the amendment in Appendix B [omitted from observer note]. The staff included revised drafting only for the transition.

Questions to the Board:

34. Does the Board agree with the staff recommendation in paragraph 33? If not, what transition would the Board prefer?

35. Does the Board want to limit the amount recognised for the lease asset to the present value of the remaining minimum lease payments?

Appendix A – PRE-BALLOT DRAFT THE BOARD REVIEWED

[Omitted from observer note]

Appendix B – PROPOSED (REVISED) DRAFTING

[Omitted from observer note]