

## STAFF PAPER

March 2012

## IFRS Interpretations Committee Meeting

Project	<b>IAS 16 <i>Property, Plant and Equipment</i>, IAS38 <i>Intangible Assets</i> and IAS 17 <i>Leases</i></b>		
Paper topic	Purchase of right to use land		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

## Introduction

1. In January 2012, the IFRS Interpretations Committee (the Committee) received a request to clarify whether purchase of land (right) should be accounted for as a purchase of property, plant and equipment or as a purchase of an intangible asset or as a lease of land. The submission was from Indonesia, where the laws and regulations do not permit entities to own freehold title to land. Entities can purchase the right to exploit or build on land (which will be discussed in paragraph 4 below). In this paper, this right will be referred to as land (right).
2. The staff conducted an outreach to the National Standard-Setters Group and the result indicates that some other jurisdictions have a similar legal framework to that of Indonesia (which will be discussed in paragraph 8-10 below). In this paper, the specific case in Indonesia will be introduced as a ‘case study’, from which some key features will be extracted and generalised for the purpose of staff analysis and the conclusion. That is, the scope of this paper is a general examination of a purchase of the right to use land that has such features, not the specific case in Indonesia itself.
3. This agenda paper is organised as follows:
  - (a) background information on the issue;

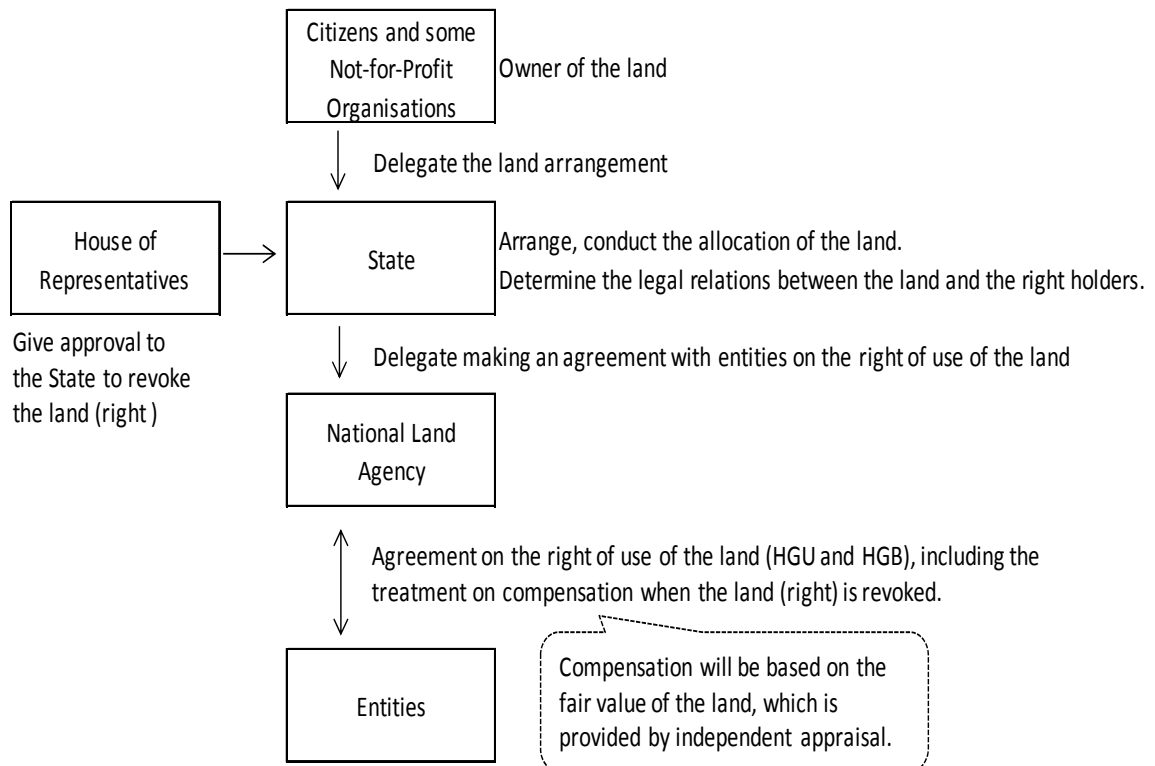
- (i) laws and regulations in Indonesia;
  - (ii) concerns raised by the Indonesian standard-setter; and
  - (iii) outreach conducted by the staff.
- (b) Key features extracted and generalised from the case in Indonesia
- (c) Staff analysis
  - (i) View 1: Purchase of property, plant and equipment  
(IAS 16 *Property, Plant and Equipment*)
  - (ii) View 2: Purchase of an intangible asset  
(IAS 38 *Intangible Assets*)
  - (iii) View 3: Lease of land (IAS 17 *Leases*)
- (d) agenda criteria assessment
- (e) staff recommendation
- (f) Appendix A—Proposed changes
- (g) Appendix B—Submission

## Background

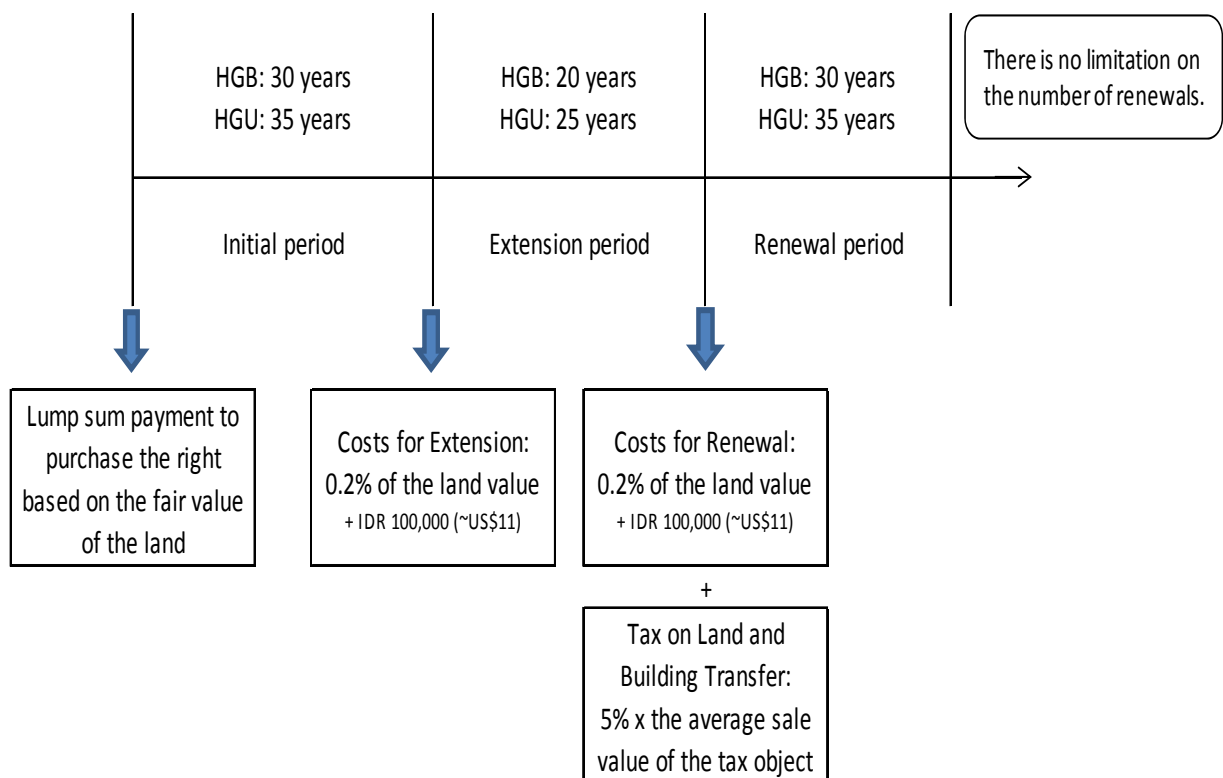
### ***Laws and regulations in Indonesia***

4. The laws and regulations in Indonesia do not permit entities to own freehold title to land, but instead the State grants HGU (Hak Guna Usaha) (the right to exploit or cultivate land for agricultural or fisheries purposes) or HGB (Hak Guna Bangunan) (the right to build upon the land). Here are two illustrations to show the structure and the scheme for payment, extension and renewal:

## [Structure]



## [Scheme for payment, extension and renewal]



5. The laws and regulations state:

- (a) The State has the authority to arrange and conduct the allocation of use of the land, and to determine legal relations between land (right) holders and the actual land. In principle, the State does not have the authority to own the land. Ownership of land in Indonesia falls to the individual citizens and certain types of not-for profit organisations (hereinafter ‘Indonesian citizens’) unless it has been transferred to other (individual) parties through sale or other transactions.
- (b) When a sale transaction occurs, an Indonesian citizen submits an application to the State to change the type of land (right) from freehold to HGU or HGB and pays a nominal amount of legal and administrative fee to the State. After the application is processed, the Indonesian citizen transfers the land (right) to the buyer (eg entity) and receives a lump sum payment based on the fair value of the land from the buyer through the State. On the other hand, payment for extension and renewal is made by an entity directly to the State, not made to the Indonesian citizen. Once the entity purchases HGU or HGB, the Indonesian citizen will not retain any rights over the land (in other words, Indonesian citizens substantially lose their ownership over the land through the transfer in the form of HGU or HGB, although entities are not permitted to have ownership). The entity has to return the land *only if* the State revokes the entity’s right on the ground of public interest and/or if there is a change in the allocation of use of the land (which is discussed in (c) below).
- (c) The right bestowed to land (right) holders can be revoked by the State only if it is on the ground of public interest (and/or a change in the allocation of use of the land). If this happens, adequate compensation will be provided to the land (right) holders, where:
  - (i) Full compensation will be provided if the land (right) is revoked during the period of land (right). Types of rights associated with the land (ie either HGU or HGB) or the length of the remaining period of land (right) does not

affect the determination of the amount that will be provided as compensation. The compensation provided will be based on the agreement between the right holders and the National Land Agency. The amount of minimum compensation is based on the valuation provided by independent appraisal, which is based on the fair value of the land at that point in time.

- (ii) Compensation for the assets (such as a building) on the surface of the land will be provided if the land (right) is revoked when the period of land (right) has ended/expired or if the application to extend or renew the right is declined by the State through the National Land Agency. The law itself is silent on whether the State must provide compensation for the land if the period of land (right) has ended/expired. However, there is a slight chance that the State will reject the request for renewal on the grounds of public interest when the period of land (right) has ended/expired. Public interest is for the good of the public, which will benefit a larger number of citizens. There is no incentive for the State to wait for the expiration of the land (right) to make a rejection, in order to avoid compensating for the land.
- (iii) Compensation will also be provided to owners of assets (such as a building) that are constructed on the land even if the owners do not hold HGU/HGB over the land, in the case when the right to use the land is revoked on the grounds of public interest.
- (iv) The State's authority to revoke the land (right) is limited to being used only after obtaining approval from the House of Representatives, which is assumed to represent the public, which is a long and thorough process.
- (d) HGU and HGB can be extended and renewed with no limitation on the number of renewals. In extending and/or renewing the rights, the land (right) holders must meet several requirements that are prescribed by the State. The land (right) holders have a legally protected right to obtain the extension/renewal, they must meet all the

legal and administrative requirements and the land must not be claimed by the State through the National Land Agency to be used for public interest purposes. There has been no case of rejection by the National Land Agency as long as the application has fulfilled all the requirements.

- (e) For HGU and HGB, an entity is required to pay 0.2 per cent of the land value + IDR100,000 (~USD\$11) upon extension, and to pay 0.2 per cent of the land value + IDR100,000 (~USD\$11) plus 5 per cent of the average sale value of the tax object upon renewal.
- (f) HGU and HGB can be used as collateral for debts and can be transferred to another party through sale, exchange, in-kind capital contribution, grant or inheritance. If the HGU/HGB is transferred to an individual, the individual can directly convert it to freehold. (Individuals, unlike entities, are allowed to own land freehold.)

### ***Concerns raised by the Indonesian standard-setter***

- 6. According to the submitter, different interpretations among entities in Indonesia have triggered different practices on how to account for land (right) based on the interpretation of existing laws and regulations. They believe that such multiple interpretations have created tensions between entities and their auditors in regard to accounting for land in accordance with IFRSs and have resulted in low comparability among reporting entities in Indonesia.
- 7. To deal with these concerns, the Indonesian Accounting Standards Board—the Indonesian Institute of Accountants (DSAK IAI)—has recently issued an interpretation (ISAK-25). The interpretation states that the cost related to the acquisition of HGU and HGB over the land is recognised as an asset in accordance with IAS 16, and that the useful life of the asset is assumed to be indefinite and thus not depreciated, unless it is proved that the probability of obtaining the extension or renewal is low.

### ***Outreach conducted by the staff***

8. We sent out a request for information to the National Standard-Setters Group in order to help assess the Committee's agenda criteria. Specifically, we asked:
- (a) Q1. In your jurisdiction, do you have a similar legal framework with the one in Indonesia? If similar, but not identical, please tell us about the differences.
  - (b) Q2. If yes to Q1:
    - (i) How do entities in your jurisdiction account for such purchases of land (right)?
    - (ii) How consistent is the accounting for such land (rights) in your jurisdiction?
    - (iii) When the State sells the land (right) for a defined period of time, do the purchasers of the land (rights) in your territory have the right or only the option to renew at the end of that period?
9. The views expressed below are informal feedback from the National Standard-Setters Group. They do not reflect the formal views of the boards of those organisations. In addition they exclude the views of the submitter, because the submitter is also a national standard-setter. The geographical breakdown for the responses is as follows:

<b>Geographical area</b>	<b>Number of respondents</b>
South America	0
Asia-Oceania	6
Africa	1
Europe	6
North America	1
<b>Total respondents</b>	<b>14</b>

10. The result from the outreach indicated the following:

(a) Nine respondents answered that they do not have a similar legal framework with that of Indonesia. Three of them cited the legal framework in their jurisdiction:

- (i) Jurisdiction 1: both freehold land and land lease exist. Freehold land is accounted for under IAS 16 and land lease is accounted for under IAS 17. Generally, the renewal of the land lease involves a significant amount of payment that is almost the same as buying the land again (some discount might be given). The duration of land lease is usually 30, 60, 99 or 999 years and the long-term leases such as 99 to 999 years are generally accounted for as finance leases.
- (ii) Jurisdiction 2: the laws permit entities to own freehold title to land. However, significant tracts remain as Federal or provincial Crown land, and some land remains with indigenous people. Businesses may be granted rights with respect to these lands. Some diversity in practice may exist, but there appears to be general agreement that, regardless of whether a specific right is considered tangible or intangible, the asset should be amortised over its expected life unless the asset has an indefinite life. Further outreach is needed to determine whether diversity in practice exists on whether these rights have finite or indefinite lives.
- (iii) Jurisdiction 3: the concept of freehold land exists, but a compulsory purchase order can be made in relation to freehold land. The compulsory purchase order is a legal function that allows certain bodies that need to obtain land or property to do so without the consent of the owner. It may be enforced if a proposed development is considered one for public betterment (eg when building motorways where a landowner does not want to sell, or when a town council wishes to develop a town centre). It must be demonstrated that the taking of the land is necessary and that there is a compelling case in the public interest. Compensation rights usually include the value of



the property, costs of acquiring and moving to a new property, and sometimes additional payments.

- (b) Four respondents answered that they do have a similar legal framework in their jurisdictions, respectively as follows:
  - (i) Jurisdiction 4: land is generally leased for 99 years from the government in a specific capital territory. The land is treated as owned (and controlled) by the lessees and not depreciated, on the basis that the leases are renewed without charge by the government. Many of the leases were started in the 1920s, and the government has already indicated (although not formally) that they will be renewed for a further 99 years at no charge. If the lease of the land is not renewed, the government is required to reimburse the lessee for any improvements to the land (eg buildings). The amount payable is based on a valuation. However, there is no payment required for the land itself. This is also the case if the land is acquired by the government before the expiry of the lease. The common accounting treatment is that the land and buildings are recognised as PPE (no different to if the land were owned outright) on the ground that the government will roll over the leases at the end of 99 years. No diversity in practice in accounting for such land has been identified.
  - (ii) Jurisdiction 5: transferable ownership interests in land and buildings generally take the legal form of a right granted by the government to occupy a designated portion of land for a specified period of time (50 years except for some cases) and for a specified purpose. Title to the land itself, in the sense of a freehold interest, is not passed through the land grant. However, present ownership interests in relation to the land grant are registered with the government's land registry as evidence of a person's title to that right. Provided that the use of the land does not contravene the conditions of the government land grant, the holder of that right enjoys the risks and rewards of the right to occupy that land for the period of the lease. In

particular, the holder of the right may freely transfer the right to others through a sale and purchase agreement. Entities generally account for such purchases of land right (ie land leases) as finance leases if they meet the criteria of IAS 17.

- (iii) Jurisdiction 6: a particular type of right is acquired for the construction of pipelines, access roads to mining activities and exploration activities. The right is perpetual and can be registered at the deeds office. The holder is granted a right to the land, which would exist irrespective of future changes or changes in ownership of the remaining land. Rights with an indefinite useful life are capitalised as intangible assets. Rights with a restricted period of use are accounted for as operating leases. These are consistent practices based on the observations. Right of use of land could also be categorised into: way leave, right of way or construction to consent. These cannot be capitalised, because the land is not controlled by the entity and ownership is not transferred. These rights allow the entity to use the land for specific purposes and the owner would be able to revoke the right at any time.
- (iv) Jurisdiction 7: we have a similar legal right called 'leasehold right'. Leasehold right is the right to use the land and is granted from the owner of the land. It is different from the ownership of the land. There are various types of leasehold rights under the relevant laws. Some leasehold rights have a specified time period of at least 50 years without any rights to renew. Others have a specified time period of at least 20 or 30 years with rights to renew. In addition, in some cases, the contract requires the right-holder to pay a certain amount of money to the owner of the land at the inception of the contract. Although we may not fully understand the characteristics of the land (right) described in the submission, there may be some differences such as a limited number of renewals, depending on the types of leasehold right. Regarding Question 2, under IFRSs, the leasehold right would often

be considered as operating leases and accounted for as such if the term of the right is fixed without any renewals. However, depending on the characteristics of the rights and the existence of upfront payment, some rights may be considered as the right that should be accounted for as indefinite intangible assets.

- (c) One respondent indicated that the Committee would need to consider other types of arrangements such as leasehold assets and usufructs in other jurisdictions.

### **Key features extracted from the case in Indonesia**

11. Here are the key features that are extracted and generalised from the case in Indonesia for the purpose of staff analysis and the conclusion.
  - (a) The laws and regulations in the jurisdiction do not permit an entity to own freehold title to land. Ownership of land falls to individual citizens.
  - (b) An entity acquires the right to use land based on the contractual agreement for the production or supply of goods or services and intends to use it during more than one period. The agreement is made with the government, delegated by the individual citizen.
  - (c) Payment is made to the individual citizen through the government to purchase the right based on the fair value of the land. Once the entity purchases the right, the citizen will not retain any rights over the land and only the government can revoke the entity's right on the ground of public interest.
  - (d) The right can be extended and renewed indefinitely with insignificant costs paid to the government.
  - (e) An entity has a legally protected right to obtain the extension/renewal, provided that all the legal and administrative requirements are met

and that the land is not claimed by the government to be used for public interest purposes.

- (f) Adequate compensation will be provided for the assets (such as a building) on the surface of the land if the government revokes the entity's right. On the other hand, compensation for the land based on the fair value will be provided only if the government revokes the entity's right during the period of right. No compensation will be provided for the land, if the government revokes the entity's right when the period of the right has ended/expired or if the application to extend or renew the right is declined by the government.
  - (g) The right can be used as collateral for debts and can be transferred to another party through sale, exchange, in-kind capital contribution, grant or inheritance.
12. The staff analysis in the following section deals with a general purchase of right to use land that has the features described in the preceding paragraph (hereinafter 'the Right'), not the specific case in Indonesia itself.

## Staff analysis

### View 1: Purchase of property, plant and equipment (IAS 16)

13. Paragraph 6 of IAS 16 defines property, plant and equipment as follows:
- Property, plant and equipment are tangible items that:*
- (a) *are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and*
  - (b) *are expected to be used during more than one period.*
14. Proponents of this view think that the Right would meet the descriptions in Paragraph 6 (a) and (b) of IAS 16, because an entity acquires and retains the

Right to use in the production or supply of goods or services and intends to use it during more than one period.

15. The Right is not land itself. However, proponents of this view think that the Right is in substance a purchase of land for the following reasons:
  - (a) Payment is made to purchase the Right based on the fair value of the land, and the Right could be extended and renewed indefinitely with insignificant costs. An entity does not have to make a payment again to obtain the Right itself, but instead pays only insignificant costs to the government, whose characteristics are assumed to be same as those of a stamp fee or a tax on the land.
  - (b) An entity has a legally protected right to obtain the extension/renewal, provided that all the legal and administrative requirements are met and that the land is not claimed by the government to be used for public interest purposes.
  - (c) An entity obtains the significant risks and rewards of ownership of the land by acquiring the Right, for the following reasons:
    - (i) Adequate compensation based on the fair value of the land will be provided to the entity even if the government revokes the entity's right during the period of Right on the ground of public interest.
    - (ii) The entity can use the Right as collateral for debts and can transfer it to another party through sale, exchange, in-kind capital contribution, grant or inheritance.
16. Accordingly, proponents of this view think that a purchase of the Right is in substance a purchase of land and that, therefore, IAS 16 should be applied to represent faithfully the substance of the Right.
17. Paragraph 6 of IAS 16 defines useful life as follows:
 

*Useful life is:*

  - (a) *the period over which an asset is expected to be available for use by an entity; or*
  - (b) *the number of production or similar units expected to be obtained from the asset by an entity.*

18. The period over which the Right is expected to be available for use by an entity is subject to the agreement. However, the entity has a legally protected right to obtain the extension or renewal with insignificant costs and, therefore, it would be economically expected that the entity chooses to extend or renew as long as it operates a business. Furthermore, even if the entity decides not to continue to operate a business on the land, there would be an incentive for it to extend or renew because the entity could sell the Right based on the fair value of the land.
19. Some might think that the Right should be depreciated over the expected years (eg xx years for the initial period). However, even if the period of Right is being terminated by the government exercising its right of revocation, the amount of compensation to the entity would not be influenced by the remaining period of the Right. Such a fact would indicate that the number of production or similar units expected to be obtained from the Right (ie net cash inflows expected to be generated by the Right for the entity) would not be directly affected by the usage or time passed.
20. Accordingly, proponents of this view think that it would be appropriate for the Right not to be depreciated.

## **View2: Purchase of an intangible asset (IAS 38)**

21. Paragraph 8 of IAS 38 defines an intangible asset as follows:

*An intangible asset is an identifiable non-monetary asset without physical substance.*

22. Paragraph 12 of IAS 38 refers to identifiability:

*An asset is identifiable if it either:*

- (a) *is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or*
- (b) *arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other*

*rights and obligations.*

23. Proponents of this view think that the Right would meet the definition of an intangible asset for the following reasons:
  - (a) The Right can be identifiable because it can be transferred to another party through sale, exchange, in-kind capital contribution, grant or inheritance.
  - (b) It arises from contractual rights—based on the agreement.
  - (c) The Right is non-monetary and does not have physical substance.
24. Proponents of this view think that the Right should not be regarded as a purchase of land because it does not have physical substance and it is a right of use for a certain period of time.
25. Paragraph 8 of IAS 38 defines useful life as follows:

*Useful life is:*

- (a) the period over which an asset is expected to be available for use by an entity; or*
- (b) the number of production or similar units expected to be obtained from the asset by an entity*

Paragraph 88 of IAS 38 refers to the useful life of an intangible asset:

*An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.*

Paragraph 94 of IAS 38 further refers to the useful life of an intangible asset (emphasis added):

*The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but*

*may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. The useful life of a reacquired right recognised as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.*

26. The period over which the Right is expected to be available for use by an entity is subject to the agreement. However, the entity has a legally protected right to obtain the extension or renewal with insignificant costs, which would be sufficient evidence to support the view that the entity can be expected to choose to extend or renew as long as it operates a business.
27. Even if the period of the Right is being terminated by the government exercising its right of revocation, the amount of compensation to the entity would not be influenced by the remaining period of the Right. That is, there would be no foreseeable limit to the period over which the Right is expected to generate net cash inflows for the entity.
28. Accordingly, proponents of this view think that the Right would have an indefinite useful life.

### **View 3: Lease of land (IAS 17)**

29. IAS 17 defines a lease as follows:

*A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.*

30. Proponents of this view think that the Right would meet the definition of a lease for the following reasons:



- (a) The Right is an agreement, whereby the government (lessor), delegated by the individuals, provides an entity (lessee) with the right of use of land.
- (b) The Right is provided for an agreed period of time, in return for a lump sum payment.

31. The next question would be whether the transaction is a finance lease or an operating lease. IAS 17 defines each lease as follows:

*A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.*

*An operating lease is a lease other than a finance lease.*

32. Ownership of land is not transferred through the Right, but proponents of this view think that an entity obtains substantially all the risks and rewards incidental to ownership of the land by acquiring the Right, for the following reasons:

- (a) Adequate compensation will be provided to the entity even if the government revokes the entity's right during the period of the Right on the ground of public interest.
- (b) The entity can use the Right as collateral for debts and can transfer it to another party through sale, exchange, in-kind capital contribution, grant or inheritance.

Accordingly, proponents of this view think that the Right would meet the definition of a finance lease.

### **Agenda criteria assessment**

33. The staff's preliminary assessment of the agenda criteria is as follows:

- (a) *The issue is widespread and has practical relevance.*

Yes. The result from the outreach indicates that some other jurisdictions have a similar legal framework to that of Indonesia.

- (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). An item will not be added to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

There are divergent interpretations in Indonesia. On the other hand, the fact patterns in other jurisdictions seem different even though some of them have a similar legal framework, and it is not clear whether there is diversity from country to country. Therefore, we would like to ask the Committee members to share your own experience of whether there is diversity on this issue in regard to this criterion.

- (c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes.

- (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the Committee and its constituents to undertake the due process associated with an interpretation?*

Yes.

- (e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes, we think that the conclusion can be determined.

- (f) *If the issue relates to a current or planned IASB project, there is a pressing to provide guidance sooner than would be expected from the IASB activities. The Committee will not add an item to its agenda if*

*an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

The Leases project is in progress and the second exposure draft is expected to be issued in Q2 2012. However, the staff think that the conclusion on the Right is outside the scope of the Leases standard for the reasons stated in the staff recommendation in paragraph 34 below.

### **Staff recommendation**

34. The staff support View 1. The Right is not land itself. It is in form the right that allow an entity to use the land for a certain period of time. Nonetheless, we agree with the proponents of View 1 that a purchase of the Right is in substance a purchase of land, for the following reasons:
  - (a) The fact pattern of the Right is very similar to a purchase. Payment is made to the owner of land to purchase the Right based on the fair value of the land. The Right could be extended and renewed indefinitely with insignificant costs paid to the government. Such a fact pattern of the Right is very similar to purchasing land based on the fair value from the seller and paying stamp fee or tax to the government in order to use the land continuously. Overall, the laws and regulations do not permit freehold title for reasons that are unique to the jurisdiction's history, but instead provide an equivalent right to the entity. Consequently, the right should be treated in a same way as a purchase of land where the laws and regulations permit freehold title, if the right has the same characteristics as a purchase.
  - (b) Substantial ownership is assumed to be transferred to an entity, because:
    - (i) Once an entity purchases the right, the owner of land will not retain any rights over the land, and only the government could revoke the entity's right. In other

words, the owner loses its ownership in the form of transfer of the Right.

- (ii) An entity has a legally protected right to obtain the extension/renewal (as long as all the legal and administrative requirements are met and the land is not claimed by the government to be used for public interest purposes), whereas the owner of land does not have right to refuse the extension/renewal.
- (iii) An entity obtains the significant risks and rewards of ownership of land, in that the Right could be used as collateral for debts or sold to another party and that adequate compensation based on the fair value of the land will be provided if the government revokes the entity's right during the period of right. (No compensation will be provided for the land, if the government revokes the entity's right when the period of the right has ended/expired or if the application to extend or renew the right is declined by the government.)

35. We also considered the Right within the context of a lease. A lease transaction must have both a lessee and a lessor, but we do not see a lessor in the transaction of the Right. Individual citizens cannot be lessors because they will not retain any rights over the land when entities purchase the Right. The government is not qualified as a lessor because it does not own the land and does not receive payment for the land. In addition, the government has very limited right over the land, which is to revoke the entity's right *only* on the ground of public interest. Consequently, we think that the transaction of the Right is outside the scope of IAS 17.
36. Does the transaction of the Right then fall within the scope of IAS 38? As we analysed in paragraph 34 in this paper, the underlying asset (ie the Right) is in substance a tangible fixed asset (ie land) and not an intangible asset, judged by the fact pattern. Furthermore, the substantial ownership of land is assumed to be transferred to an entity. Consequently, we think that IAS 38 should not be applied to the transaction of the Right.

37. Accordingly, we think that IAS 16 should be applied to represent faithfully the substance of the Right. However, we accept that it would be difficult to make such an interpretation based on the current standard. Consequently, we think that the Committee should recommend to the Board that it should clarify IAS 16 by adding paragraph 8A (refer to Appendix A in this paper) and that the amendment should be included in the next Annual Improvements cycle.

<b>Question to the Committee</b>
Does the Committee agree with the staff analysis and the conclusion?

## Appendix A—Proposed changes

A1. The proposed amendment in IAS 16 is presented below.

### **Amendment to IAS 16 *Property, Plant and Equipment***

Paragraph 8A is added.
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#### **Recognitions**

- 8A When an entity purchases a right to use an item of property, plant and equipment, notwithstanding the fact that title does not transfer, the right is accounted for as an item of property, plant and equipment in accordance with this Standard unless the right to use the item of property, plant and equipment is a lease as classified in IAS 17 *Leases*.

A2. We propose adding the paragraph below to the Basis for Conclusions of IAS 16:

### **Basis for Conclusions on proposed amendments to IAS 16 *Property, Plant and Equipment***

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.
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#### **Purchase of right to use**

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- BC1 The Board received a request to clarify whether purchase of right to use land should be accounted for as a purchase of property, plant and equipment or as a purchase of an intangible asset or as a lease of land. The Board observed that the right qualifies as an item of property, plant and equipment if the substance of the transaction is a purchase, notwithstanding the fact that title does not transfer. Consequently, the Board proposes to make an addition of paragraph 8A to clarify that a purchase of a right to use an item of property, plant and equipment is accounted for as a purchase of an item of property, plant and equipment when the right does not represent a lease of the asset.

**Appendix B—Submission**



**Indonesian Accounting Standards Board  
Indonesian Institute of Accountants**

Indonesian Accounting Standards Board  
Indonesian Institute of Accountants

**Accounting Treatment  
for Land (in Indonesia)**

- February 2012 -



## I. BACKGROUND

As explained in the Agenda Consultation 2011 of the IASB, one of the five strategic areas driving the work of IASB is to improve consistency and quality of the application of IFRSs. This implementation issue is one key factor in ensuring the success of IFRSs convergence in different jurisdictions, each with its own sets of characteristics, local regulations, common practices, and problems.

Indonesia as the only G-20 member from the South East Asia region is fully aware of the importance in adopting or converging to IFRSs, as the recognised global sets of financial reporting standards. As it stands, Indonesia has been converged to IFRSs since 1 January 2012. During the convergence process, one major accounting issue related to accounting treatment for land has arose, leading to differences in accounting treatments used by the constituents in Indonesia due to multiple interpretations of the standards. Indonesian Accounting Standards Board – Indonesian Institute of Accountants (DSAK IAI) as the national standard-setter in Indonesia believes that this inconsistency in interpretation and implementation of IFRSs-based standards need to be dealt with in an accurate, effective, and swift manner.

In regard to accounting for land in Indonesia, since 1998 Indonesia have a distinctive accounting standard for land (namely the Indonesian Financial Accounting Standard (PSAK) 47: *Accounting for Land*), which has recently been revoked by DSAK IAI in 2011 as part of the IFRS convergence process in Indonesia. This PSAK 47 was the main reference used by constituents in Indonesia in accounting for land (right), on how it should be accounted for, measured, and presented on the financial statements.

Upon withdrawal of PSAK 47, starting 1 January 2012, the financial report preparers in Indonesia need to refer to other PSAK standards relevant to land



(right), which are based from IAS 16 and IAS 17. Due to interaction between these standards and the land laws and regulations, there have been multiple interpretations among preparers on how to account for land.

Land in Indonesia is governed through laws and regulations (Government Decree) dated from 1960. The two main laws and regulations that regulates land in Indonesia are Law Number 5 year 1960 about Basic Agrarian and Government Regulation Number 40 year 1996 about Right to Cultivate, Right to Build, and Right of Use Over Land (extracts on the related Articles are presented in Appendix A). In 2012, the House of Representatives passed the Law Number 2 year 2012 about the Land Procurement for Public Interest. These laws and regulations define the legal position, ownership, and rights over the land in Indonesia.

The laws and regulations in Indonesia do not permit corporations to own freehold title to land, therefore, the State grants **HGU** (right to cultivate– Provides the right to exploit or cultivate land for agriculture or fishery purposes) or **HGB** (right to build– Provides the right to build upon the land) as a replacement. Only individual citizens and certain types of not-for-profit organizations have freehold title to land.

In essence, the laws and regulations on land in Indonesia stated that:

- The State has the authority to arrange and conduct the allocation of use of the land, and to determine legal relations between land (right) holders and the actual land. In principle, the State does not have the authority to own the land. Ownership of land in Indonesia falls to the natives unless it has been transferred to other (individual) parties through sale or other transactions.
- The right bestowed to land (right) holders can be revoked by the State only if it is for the sake of public interest (and/or change in allocation of use of the land). Should this happen adequate compensation will be provided to the land (right) holders, where:

- Full compensation will be provided if the land (right) is revoked during the period of land right. Types of land or the length of the remaining period of land right are relatively irrelevant in deciding the amount that will be provided as compensation. Newest update based on Law Number 2 year 2012 reiterates that the compensation provided will in fact be based on the agreement between the right holders and the National Land Agency. The minimum compensation value is based on the valuation provided by independent appraisal, which is based on the fair value of the land at that point of time;
- Compensation for the assets (building, etc) will be provided if the land (right) is revoked when the period of land right has ended/expired or if the application to extend or renew the right is declined by the State through the National Land Agency. Newest update based on Law Number 2 year 2012 is that the Law itself is silent on whether the State must provide compensation for the land should the period of land right has ended/expired. Compensation will be given for the assets (building, etc) on top of the land;
- Compensation will also be provided to owners of assets (building, etc) constructed on top of a land despite if the owners do not hold HGU/HGB over the land, if the land is revoked for the sake of public interest; and
- The State's authority to revoke the land right is limited only after obtaining approval from the House of Representatives which is assumed to represent the public, which is a long and comprehensive process.
- HGU and HGB could be given for a defined period and could be extended for another period. There is no limitation on the number of renewals. So in theory, the renewal should not be limited. On expiration renewal might be granted for both HGU and HGB. In extending and/or renewing the rights, the land (right) holders must meet several requirements required by the State. Essentially, the land (right) holders should have a legally protected right to obtain the extension/renewal provided all the legal and administrative requirements are

met and the land is not claimed by the State through the National Land Agency to be used for public (interest) purposes. There is no case of rejection by the National Land Agency as long as the application has fulfilled all the requirements.

- The costs related to the extension and renewal of both HGU and HGB are considered to be immaterial, where only a nominal amount of 0.2% of the land value + IDR100,000 (~USD\$11) required to be paid upon extension. The amount paid on renewal is 0.2% of the land value + IDR100,000 (~USD\$11) plus 5% of the average sale value of the tax object, which is considered to be a minor cost compared to the actual value of the land (as illustrated in Illustration A).

Both the main land rights available to corporations in Indonesia, namely HGU and HGB can be used as collateral of debts and can be transferred to another party through sale, exchange, in-kind capital contribution, grant or inheritance. If the HGU/HGB is transferred to an individual, the individual can directly convert it to freehold. Thus, it reiterates the facts that in essence control of the land has in fact been transferred to the land (right) holders.

Interpretation on these laws and regulations has been confirmed through formal communication and discussion between DSAK IAI and the National Land Agency as the representative of the Government.

The aim of this paper is to provide analyses on whether existing guidance in IFRSs are sufficient to capture the substance of land right in a country that has laws and regulations similar to Indonesia. Based on the result of the analysis, we propose to consider the issuance of additional guidance for land (right) by the International Financial Reporting Interpretation Committee.

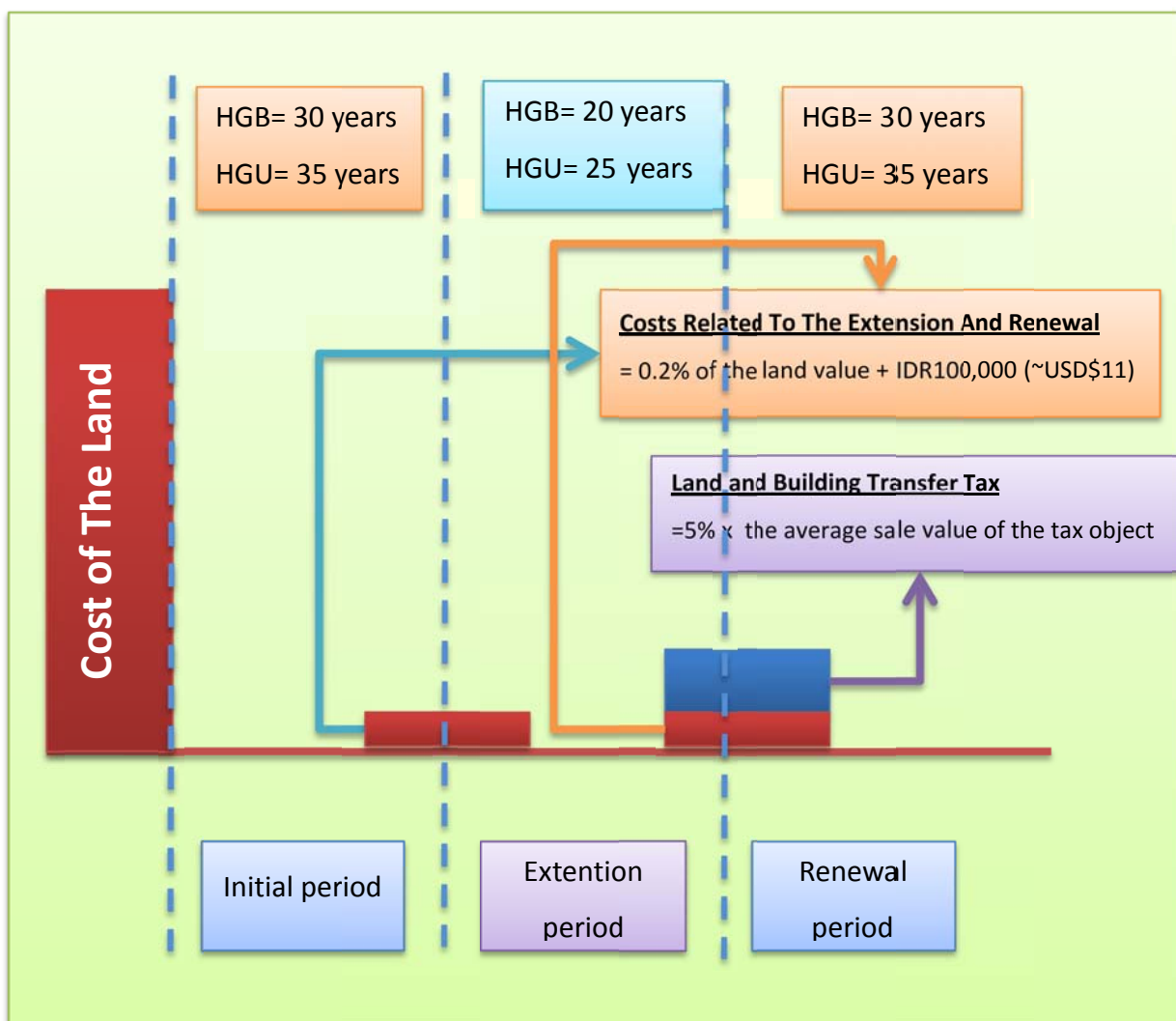


Illustration A – Extension and Renewal of Land (Right) in Indonesia

## II. EXISTING GUIDANCES

There are three relevant guidance in regard to land (right). The first guidance is stipulated in IAS 16- Property, Plant and Equipment. This standard defines Property, Plant and Equipment as follows:

### Paragraph 6-Definition

*Property, plant and equipment are tangible items that:*

- a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and*

*b) are expected to be used during more than one period.*

Using this definition it could be inferred that the land (right) in Indonesia meets the definition of Property, Plant and Equipment, as both HGU and HGB essentially provide the right holder with the right similar to ownership.

Furthermore, in paragraph 37, IAS 16 stated clearly that the land (right) is an example of a class of property, plant and equipment as follows:

*A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:*

- a) land;*
- b) land and buildings;*
- c) machinery;*
- d) ships;*
- e) aircraft;*
- f) motor vehicles;*
- g) furniture and fixtures; and*
- h) office equipment.*

However, it seems that there is no explicit guidance on whether the land stated in IAS 16 includes land under the right with characteristics similar to HGU or HGB in Indonesia. Therefore, some entities argue that the type of land stated in IAS 16 is limited to freehold land.

On the other hand, IAS 17-Leases also provide a definition on lease as follows:

#### **Paragraph 4**

*A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.*

Some entities argue that both HGU and HGB are in substance a right to use the land, therefore it meets the definition stated in IAS 17 paragraph 4.

Furthermore, paragraph 15A and 15 B of IAS 17 and paragraph BC8B of Basis for Conclusions of IAS 17 stated that:

#### **Paragraph 15A**

*When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.*

#### **Paragraph 15B**

*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.*

#### **Paragraph BC8B**

*For example, consider a 999-year lease of land and buildings. In this situation, significant risks and rewards associated with the land during the lease term would have been transferred to the lessee despite there being no transfer of title.*

The characteristics of HGU and HGB in Indonesia similar to the example stated in the paragraph BC8B of the basis for conclusions of IAS 17. This standard also does not give clear guidance about the type of ownership over the land.

Other than IAS 16 and IAS 17 few entities also refer to IAS 38 where stated that:

*An intangible asset is an identifiable non-monetary asset without physical substance.*

In Indonesia, different interpretations among the entities in Indonesia about IAS 16 and IAS 17 trigger different practice on how to account land based on the interpretation of existing laws and regulations. This multiple interpretations have developed tensions among entities with their auditor in regard to accounting for land in accordance with IFRS and resulted to low comparability among reporting entities in Indonesia.

The different interpretations among IFRS' based entities are as follows:

1. Acquisition of land by a mean of HGU/HGB is recognised as a purchase of PPE and the cost is not depreciated

Main argument for this interpretation is that accounting treatment for land (right) under IAS 16 better reflects the substance of the arrangement. Although in principle the State owns the land but through the Government it granted rights (and the associated privileges) to the land right holders which are substantially and economically similar to ownership (right) over the land.

The land right can be transferred to other parties through a mean of sale transaction, or even can be used as collateral. Should the State claims the land for public interest before the right ended/expired the right holders are entitled to receive compensation based on fair value determined by independent appraiser, appointed by the Government.

Other arguments are as follows:

- The land right holders have legally protected right to obtain renewal with insignificant administration and tax fee, provided all the legal and administrative requirements are met and the land is not claimed by the government for public interest;
- If the government procure the land for public interest purpose before the expiration of the land right, the land right holders should be compensated at a fair value determined by appraiser appointed by the government in accordance with the process under the Law on Land Procurement for Public Interest, which became effective in January 2012. This Law is silent on whether the amount of compensation should be pro-rated with the remaining period of the land title;
- There is no case of rejection by the National Land Agency as long as the application has fulfilled all the requirements, so evidence can be drawn about the likelihood of renewal. This is also supported by market evidence – i.e. the value of the land rights on the secondary market does not decline through passage of time and as the date of renewal approaches;
- There is only a slim chance that the State will refuse the request for renewal due to public interest purpose. Consider for example whether the State will realistically wait for the expiration of significant number of land rights so that it can claim the land without paying compensation. Public interest is for the good of the public and with good intention, the State does not need to wait for the expiration of the land to implement a project that will benefit a bigger number of its citizen or the public. It could possibly happen for a few but there is only a slim chance of such scenario (i.e. the State waiting for the



end of the 1st extension to claim the land without paying compensation) to affect a significant number of land right holders, and this may not be significant to affect the assessment that the land is non-depreciable. In case such event happen, the supporters of this view believes that it is more appropriate to recognise an impairment loss at the time it has been determined that the land right holders will not receive compensation from the State due to the land claimed by the State for public interest.

2. Payment for HGU/HGB is recognised as finance lease and the cost of land subject to depreciation over the life of the land right

It is argued that the payment for HGU/HGB is in substance a payment for the right to use the land and therefore meets the criteria of a lease.

With the case of HGU/HGB in Indonesia, it is argued that the land right can be classified as finance lease based on the table of criteria shown on Appendix C. Before 1 January 2010, the position of IASB suggests that the lease of land is an operating lease. However in the annual improvement of 2009, IASB deleted paragraph 14 that suggest such position and IAS 17 became silent about land lease ever since. Although IASB made a suggestion in their basis for conclusion that land lease may be classified as finance lease, the example of 999 year of lease term (like Hong Kong case) as suggested in the BC would be very unlikely to occur again in this modern world. This would make any entities applying IAS 17 exercise their professional judgment in classifying land lease as a finance lease or operating lease using the criteria in the standard.

It is also argued that the State through the National Land Agency still have the final discretion on the extension of the land right, thus, the useful life of land is deemed to be limited. Therefore the cost of the land needs to be depreciated over the life of the land right.

3. Payment for HGU/HGB is recognised as an operating lease. The initial payment was recognised as deferred payment

The argument is based on the term of land right given by the State which is a lot shorter than the economic useful life of the land. Although it can be renewed and extended indefinitely and there has been no rejection from the State to the renewal and extension submission, there is always inherent risk that the State may deny the submission.

4. Acquisition of land by a mean of HGU/HGB is recognised as acquisition of indefinite intangible asset, and is not amortised

The argument is based on the actual asset being purchased is the right of use over the land and not the physical land itself. Furthermore the right can be identified because it arises from contractual or other legal rights. Thus, intangible asset classification is more appropriate. In substance it is similar with acquisition of land as PPE, without the physical substance

### **III. PROPOSAL**

Observing different multiple interpretations may cause lack of comparability, DSAK IAI as the national standard-setter recently issued a pronouncement, an Interpretation on the Accounting for Land (ISAK-25 extracts on the interpretation presented in Appendix B). DSAK IAI believes that acquisition of land by a mean of HGU/HGB is recognised as a purchase of PPE and the cost is not depreciated. The land starts to be depreciated if the entity believes that the useful life of the land becomes limited. The interpretation issued by DSAK IAI is based on the analysis of the substance of land ownership in Indonesia according to the existing laws and regulations. DSAK IAI believes that the arguments used to support this view are valid.

The purpose of this Interpretation is to provide guidance on how land should be accounted, based on the land laws and regulations in Indonesia. DSAK IAI believes

that further clarification is needed on this issue, thus acknowledges the importance of bringing up this issue to IFRS Foundation through IASB or International Financial Reporting Interpretation Committee.

Taking into consideration the issues discussed in this paper, DSAK IAI believes that the two main problems that should be clarified are as follows:

1. How should an entity account for HGU and HGB in the context of Laws and Regulations similar to Indonesia?
2. Should HGU and HGB be depreciated?

\*\*\* The End of Issue Paper\*\*\*

## APPENDIX A – EXTRACTS OF RELEVANT LAWS AND REGULATIONS

### Law Number 5 year 1960 about Basic Agrarian

#### Article 2

*“...Earth, water and space, including natural resources contained therein is **controlled by the State....**”*

*“Control rights of the State **give the authority to the State to:***

- a) Arrange and conduct the allocation, use and maintenance of the earth, the water and the space;*
- b) Determine and regulate the legal relations between people and the earth, the water and the space; and*

- c) *Determine and regulate the legal relations between people and legal actions concerning the earth, the water and the space.*”

## Article 18

*“For the sake of public interest, including the interests of the nation and the state and the interests of the people, the rights over the land **can be revoked by giving adequate compensation** in accordance to the applicable laws and regulations.”*

## **Government Regulation Number 40 year 1996 about Right to Cultivate, Right to Build, and Right of Use over Land**

## Article 8

*“The HGU could be given for a period of 35 years and **could be extended** for a period of 25 years. After a period of the HGU (including its extension period) expires, the holders **might be granted renewal** of the HGU on the same land.”*

## Article 9

*“HGU could be extended or renewed at the request of the right holders, if they **meet several requirements** as follows:*

- *The land is still being used properly in accordance with circumstances, the nature and purpose of granting such rights;*
- *Conditions of the entitlement are met by the right holders, and*
- *Right holders still qualify as right holders.”*

## Article 15

*“HGU can be used as collateral of debts...”*

## Article 25

*“The HGB could be given for a period of 30 years and **could be extended** for a period of 20 years. After a period of the HGB (including its extension period) expires, the holders **might be granted renewal** of the HGB on the same land.”*

## **Article 26**

*“HGU could be extended or renewed at the request of the right holders, if they **meet several requirements** as follows:*

- *The land is still being used properly in accordance with circumstances, the nature and purpose of granting such rights;*
- *Conditions of the entitlement are met by the right holders, and*
- *Right holders still qualify as right holders.*
- *The land is still being used in accordance with the regional spatial plan.”*

## **Article 33**

*“HGB can be used as collateral of debts...”*

## **Law Number 2 year 2012 about the Land Procurement for Public Interest**

## **Article 40**

*The provision of compensation provided to revoke the land (right) is given to the eligible parties.*

### **Further Guidance on Article 40:**

*“The compensation should be given to the eligible parties... The parties eligible for the compensation are as follows:*

- a. *The land right holders;*
- b. *Holders of the right to manage the land;*

- c. Person who is responsible for the endowment of land;*
- d. Former owner of the land owned by indigenous peoples;*
- e. Indigenous people;*
- f. Other party who control of state land in good faith;*
- g. Holders of the basis for control over the land;*
- h. The owner of the building, plant, and other objects associated with land.*

*Compensation awarded to the holders of land right. The amount of the compensation given to the HGU/HGB holders over the lands which are not owned by them is based on the value of the building, plant, and other objects associated with land. The compensation with regards to the land is given to the holders of the freehold land right and the holders of the right to manage the land...”*

## **Article 41**

### **Paragraph (1)**

*“The amount of compensation provided is based on the agreement between Indonesia National Land Agency as the representative of the Government and the right holders or/and based on the verdict of the District Court/Supreme Court...”*

## **APPENDIX B – EXTRACT OF INTERPRETATION ISSUED BY DSAK IAI (ISAK 25)**

### **SCOPE**

This interpretation applies to accounting for HGU and HGB.

### **ISSUE**

The Interpretation covers three main problems as follows:

1. How should an entity account for HGU and HGB?
2. Should the HGU and HGB be depreciated?
3. How should an entity account for the legal cost related to the acquisitions/extensions/ renewals of HGU and HGB?

### **CONSENSUS**

1. The cost related to acquisition of HGU and HGB over the land is recognised as an asset in accordance with IAS 16 – Property, Plant, and Equipment.
2. If the asset meets the definition on investment property or inventory, then the asset should be accounted for in accordance with related standards.
3. The useful life of the asset is assumed to be indefinite therefore it is not depreciated unless it could be proven otherwise which indicate that the probability of the failure to extent or renew the land right is high.
4. Some examples which indicate that the economic life of the land become definite are as follows:
  - a. The management expect that the quality of the land is not eligible anymore to be used in the main business of the entity;
  - b. The characteristic of the main activities of the entity is to abandon the land after the activities are completed. For example, the land used for the

main project of the entity is located in the remote areas. The land should be depreciated based on the estimated duration of the project;

- c. The government decides that the land would be revoked for the sake of public interest and the probability of the failure to extent or renew the land right is high.
5. The legal cost related to the acquisition of the land should be recognised as part of the acquisition cost of the land in accordance with IAS 16.
6. The legal cost related to the extensions or renewals of the land should be recognised as an intangible asset and should be depreciated over the over the extension/renewals period or useful life of the land whichever is shorter.



## APPENDIX C – EVALUATION OF LEASE CLASSIFICATION

CRITERIA	EVALUATION
a. <i>the lease transfers ownership of the asset to the lessee by the end of the <u>lease term</u></i>	Arguably met. In substance, the HGU/HGB holder owns the land. But in order for them to use their land, they need to apply for continuous renewal and extension to the Government.
b. <i>the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the <u>fair value</u> at the date the option becomes exercisable for it to be reasonably certain, at the <u>inception of the lease</u>, that the option will be exercised</i>	Not applicable for Land Lease
c. <i>the lease term is for the major part of the <u>economic life</u> of the asset even if title is not transferred</i>	<p>1. Criteria Met, based on the definition of lease term as follows:</p> <p><i>“The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.”</i></p> <p>2. The land right holder will certainly request for an extension of the land right and the request can be granted provided the land</p>

	<p>right holder met the requirements. There is a big disincentive if the land right holder will not comply with the requirements that would result in the request for extension being denied. This in effect is equivalent to having an option to continue to lease the asset and it is reasonably certain the lessee will continue to lease the asset</p> <p>3. The lease period is therefore the initial 30 years (non-cancellable period) and the further extensions which may last for several decades as long as the land right is not sold or appropriated by the government for public use.</p>
<p><b><i>d. at the inception of the lease the present value of the <u>minimum lease payments</u> amounts to at least substantially all of the fair value of the leased asset; and</i></b></p>	<p>Criteria Met. Land rights are ordinarily acquired at market value plus legal processing cost.</p>
<p><b><i>e. the leased assets are of such a specialized nature that only the lessee can use them without major modifications</i></b></p>	<p>Not Applicable</p>