

STAFF PAPER

September 2012

IFRS Interpretations Committee Meeting

Project	IAS 16 <i>Property, Plant and Equipment</i> , IAS 38 <i>Intangible Assets</i> and IAS 17 <i>Leases</i>		
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 Interpretations Committee (the Committee) received a request to clarify whether the purchase of a right to use land should be accounted for as:
 - (a) a purchase of property, plant and equipment;
 - (b) a purchase of an intangible asset; or
 - (c) a lease of land.
2. The Committee deliberated this issue in the March and May 2012 meetings. At the meetings, the Committee identified characteristics of a lease in the fact pattern submitted. Nevertheless, the Committee tentatively decided not to take this issue onto its agenda because the particular fact pattern considered is specific to a jurisdiction.
3. The objective of this paper is to provide the Committee with a summary of comment letters received on the tentative agenda decision reached by the Committee in the May 2012 meeting and with a staff analysis on the comment letters.
4. This agenda paper is organised as follows:
 - (a) Analysis of comment letters

- (b) Fact pattern submitted, with clarification by the submitter
- (c) Staff analysis based on the clarified fact pattern
- (d) Staff recommendation to the Committee
- (e) Questions for the Committee
- (f) Appendix A—Proposed agenda decision
- (g) Appendix B—Comment letters received to the tentative agenda decision reached by the Committee in the May 2012 meeting
- (h) Appendix C—Extract of an article from the Indonesian National Land Agency (translated into English by the submitter)

Analysis of comment letters

5. We received four comment letters¹ with respect to the tentative agenda decision.
6. Two of them² support the Committee’s decision not to add this issue onto its agenda for the reasons set out in the tentative agenda decision.
7. One respondent³ generally agrees with the Committee’s decision. However, they advocate that the agenda decision should not include the Committee’s specific view on the issue, given that the issue was specific to a particular jurisdiction and therefore did not meet a criterion “the issue is widespread and has practical relevance.” They suggest removing the descriptions about the Committee’s specific view from the agenda decision.
8. The fourth comment was from the submitter⁴ of this issue. First of all, they clarified some aspects of the fact pattern for the issue, which is addressed in the following section in this paper. They also note that the fact pattern is not specific

¹ Deloitte Touche Tohmatsu, the Canadian Accounting Standards Board (AcSB), the Accounting Standards Board of Japan (ASBJ) and the Indonesian Accounting Standards Board (DSAK-IAI) in the order of receipt

² Deloitte and AcSB

³ ASBJ

⁴ DSAK-IAI

to their jurisdiction but can be observed in other jurisdictions⁵, which is supported by the result of outreach conducted by the staff in March that four respondents answered they have a similar legal framework in their jurisdictions as the submitter has. Accordingly, the submitter requests that the Committee should consider obtaining further information from these jurisdictions before making a final decision.

9. In addition, the submitter iterates the fact that they have already issued an interpretation on this issue for entities that apply their local GAAP⁶. They are concerned with the diversity observed in practice among IFRSs reporters in their jurisdiction. They request that the Committee (and the IASB) resolve such potential diversity.

Fact pattern submitted, with clarification made by submitter

10. Below is a summary of the submitted fact pattern from the May 2012 staff paper, with some clarification made by the submitter (bolded). Further details can be found in the original submission that was attached to Agenda Paper 10⁷ at the March 2012 meeting and in the comment letter attached to this paper.
 - (a) The laws and regulations in the jurisdiction stipulate that only individual citizens are allowed to have freehold title of land. They do not permit entities to own freehold title to land. Instead, entities can purchase the right to cultivate or build on land, for which agreement is approved by the government. **The government determines the legal relationship between the land and the right holder, where the**

⁵ We communicated with the submitter after we received their comment letter. The submitter notified us that they have conducted their own outreach to these jurisdictions and found that details of each fact pattern are different and thus the accounting can be different. Therefore the submitter thinks that the fact pattern in their jurisdiction is unique.

⁶ The local GAAP interpretation (ISAK 25) states that the cost related to the acquisition of right to cultivate or build on land is recognised as an asset in accordance with the local standard PSAK 16 (equivalent 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.

⁷ <http://www.ifrs.org/NR/rdonlyres/67D78350-B22F-4B45-9304-9A6A8FC73C12/0/101203AP10IAS16IAS38Purchaseofrighttouse.pdf>

government acts as the administrator and the regulator for the State.

- (b) Payment is made **directly** to the individual owner to purchase the right generally based on the fair value of the land. Once the entity purchases the right, the owner will not retain any rights over the land. Only the government can revoke the entity's right, only on the ground of public interest or if the entity fails to meet the administrative requirements.
- (c) The right can be extended and renewed indefinitely at only an insignificant cost (administrative fees and related taxes) to be paid to the government. 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.
- (d) Adequate compensation will be provided for the assets (such as a building) on the surface of the land in any circumstances. However, 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.
- (e) 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.

11. The submitter further clarified (bolded):

- (a) **There are mainly two types of transactions on the right to use land in the jurisdiction—'outright sale' and 'entities' right over the owners'. The submission to the Committee in January 2012 was strictly focusing on the outright sale transactions, which is more common in the jurisdiction.**

- (b) **In case of outright sale transactions, an entity purchases the right over the land from the individual owner of the land in a sale and purchase agreement. The entity pays an agreed amount to the land owner, and nominal administration fee and related taxes to the government. The government provides the approval for the new utilisation of the land, from right of ownership (that the individual owner has) to right to use – cultivate or build over the land (the entity will have).**
- (c) **The land reverts to the State (not to the individual owner) if an entity decides not to extend or renew the right to use the land, as opposed to the transaction under ‘entities’ right over the owners’ where the land reverts to the individual owner. The land will be a State land—it will be under the State’s administration until new applications are received from individuals or entities to use the land. If an individual or entity applies for the land, it shall pay certain administrative fees and related taxes to the government. In other words, the amount of payment does not represent the fair value of the land.**

12. Following the above clarification, the submitter argues that the purchase of a right to use land under outright sale transactions should not be accounted for as a lease of land, mainly for the following reasons:

- (a) It is unclear who the lessor is. An individual owner loses its right over the land if an entity purchases the right to use land. The land reverts to the State when an entity does not extend or renew, to be administrated by the government.
- (b) Ownership is considered to be transferred to the entity when the agreement is made, because the right can be used as collateral for debts. On the other hand, the submitter advocates that one of the examples of situations in paragraph 10 of IAS 17 that lead to a lease being classified as a finance lease is that ownership is transferred to the lessee ‘at’ the end of the lease term.

- (c) Paragraph 11 of IAS 17 indicates that a lease can be a finance lease if the lessee cancels the lease and the lessor's losses associated with the cancellation are borne by the lessee. In the submitted fact pattern, the reimbursement of the loss is not limited to those associated with the cancellation—the fair value of the land is compensated to an entity if the government revokes the entity's right for public interest purposes.
- (d) Generally a leased asset can only be transferred through a sublease transaction, whereas the right to use land is transferrable by several means such as collateral. These rights of transfer are rights that usually only owners have and lessees do not.

Staff analysis based on the clarified fact pattern

- 13. At its March and May meetings, the Committee identified characteristics of a lease in the fact pattern of this issue in accordance with IAS 17. On the other hand, in the submitter's jurisdiction, an interpretation has been issued for entities that apply their local GAAP. According to the interpretation, the cost related to the acquisition of right to cultivate or build on land shall be accounted for as an item of property, plant and equipment.
- 14. Now that we have some clarification on the fact pattern, we will analyse in the following paragraphs those two views as to how the purchase of a right to use land should be accounted for.

View A: lease of land (IAS 17)

- 15. Proponents of this view note that the submitter clarified that the land will revert to the State, not to the individual owner, if an entity does not make an extension or renewal. Given the clarification, proponents of this view think that the State, regulated by the government, is identified as a lessor. The individual owner loses its right in return for a lump sum payment from the entity, but the State obtains the residual interest of the land which never transfers to the entity. In substance, the individual owner sells the right to use land to the entity and surrenders the land to the State.

16. Entities do not substantially own the land because the government has a right to reject the renewal. In addition, compensation for land would not be provided if the government revokes the entity's right when the period of the right has ended. There is a distinction to be drawn between this revocation and the compulsory purchase by government that could happen in other jurisdictions where entities are permitted to own freehold title to land. Such entities in those other jurisdictions would not have to renew their rights to the land in the first place if they own the land.
17. The submitter distinguishes the right to use land from a leased asset because the right to use land is transferrable by several means. A leased asset may only be transferred through a sublease transaction. However, this argument by the submitter is not relevant. This is because benefits an entity receives from either sublease or collateral are economically the same, in that the entity obtains certain amount of money in return for providing the asset.
18. Given the above analysis, proponents of this view think that they identify characteristics of a lease in the clarified fact pattern, based on the definition of a lease, which is "*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*" (paragraph 4 of IAS17). Such characteristics are:
- (a) Right to use an asset: a right to use land is a right to use an asset.
 - (b) Existence of lessor and lessee: the State, regulated by the government, is identified as a lessor, and the entity is a lessee.
 - (c) A payment or series of payments: payment to purchase the right is made directly from the entity to the individual owner who surrenders the land to the State.
 - (d) Agreed period of time: there is an agreed period of time between the State and the entity including renewal options.

View B: purchase of property, plant and equipment (IAS 16)

19. Proponents of this view think that the right to use land would meet the descriptions in paragraph 6 (a) and (b) of IAS 16 (below), 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.

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.*

20. Proponents of this view note that, in the outright sale transaction, payment is directly made to the individual owner to purchase the right generally based on the fair value of the land. The State receives a nominal amount from the entity for administrative fees and related taxes, which indicates that the State does not obtain any significant economic benefit from this transaction. Such a fact pattern 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.

21. In addition, proponents of this view think that an entity obtains substantial ownership of land and thus owns the land, because:

(a) Once an entity purchases the right to use land, the owner of land will not retain any rights over the land, and only the government could revoke the entity's right.

(b) The entity has a legally protected right to obtain the extension/renewal, whereas the original owner of land does not have right to refuse the extension/renewal because the land is placed under the administration of the State.

(c) The entity obtains the significant risks and rewards of ownership of land, in that the right to use land can be used as collateral for debts or sold to another party.

22. According to the submitter, if an entity decides not to renew the right to use land, the land reverts to the State and the land will be under the State's administration. Then another individual or entity can obtain the right to use the land for a fixed period by paying only administrative fees and related taxes to the government. Proponents of this view think, however, that it is extremely rare for the (original)

entity to decide not to renew the right to use land. This is because it would be economically expected that the entity chooses to renew the right to use land and sell it to third parties based on the fair value of the land. This supports the argument that the entity substantially owns the land.

23. Proponents of this view note the background of the laws and regulations in the submitter's jurisdiction (refer to Appendix C to this paper). The laws and regulations do not permit freehold title for reasons that are unique to the jurisdiction's history, but instead they provide an equivalent right to the entity. Proponents of this view think that the right to use land 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.

Staff analysis

24. We reiterate that the Committee tentatively reached a conclusion in May that the characteristics of a lease can be found in the fact pattern associated with the right to use land. Therefore, we think that we should focus on any new information that could affect our analysis in the submitter's clarification, which are:
- (a) The government determines the legal relationship between the land and the right holder, where the government acts as the administrator and the regulator for the State.
 - (b) The land reverts to the State if an entity decides not to extend or renew the right to use the land. Another individual or entity pays only administrative fees and related taxes to the government to obtain the right to use the land.
25. With regard to the first point, the fact pattern before the clarification was that the State has the authority to arrange and conduct the allocation of use of the land, and to determine legal relationships between land holders and the land. In our view, the clarification by the submitter only switches the role of the government and the State. Accordingly, in the transaction concerned, we think that the individual owner sells the right to use land to the entity and surrenders the land to

the State because the land will be placed under the administration of the State until a new buyer is found.

26. The submitter also clarifies that the land reverts to the State if an entity decides not to extend or renew the right to use the land, as opposed to what the Committee was informed at its May meeting (ie the land would revert to the individual owner). We do not think that this clarification affects the Committee's tentative conclusion. This is because the State obtains the residual interest of the land by way of administration and thus ownership of the land substantially transfers to the State who is the lessor in this transaction. The Committee's view in May was that an individual owner is identified as a lessor, who is delegating the irrevocable right to the government. This clarification of the fact pattern also leads to a switch of a lessor. Therefore, we agree with View A that the State, regulated by the government, is identified as a lessor.
27. Consequently, we agree with View A that the characteristics of a lease can be found in the fact pattern associated with the right to use land.
28. We note the submitter requests that the Committee should conduct further outreach and that it (and the IASB) resolve diversity. We acknowledge that four respondents answered they have a similar legal framework in their jurisdictions as the submitter has. However, we note that the Committee's primary purpose was to look at the fact pattern submitted and test whether the current Standards enable it to reach a certain conclusion, which has been already achieved.
29. In addition, whilst these other jurisdictions might have similar fact patterns, any detailed differences between the fact patterns that might exist could reasonably lead to different conclusions. Consequently, the existence of different accounting treatments in these jurisdictions does not necessarily mean that there is diversity in practice. Therefore, this issue does not meet a criterion 'the issue is widespread and has practical relevance.' We note that the submitter now thinks that the fact pattern in their jurisdiction is unique based on the outreach they conducted (refer to footnote 5 of this paper).
30. One respondent suggested in its comment letter that the agenda decision should not include the Committee's specific view on the issue. In our view, however, the

direction given by the IASB to the Committee is the opposite. One of the tentative agreements by the IASB at its meeting held on 27 February through 2 March 2012 was ‘when the Interpretations Committee reaches a conclusion on an issue, but for which it has decided not to add the item to its agenda, it should explain its decision in a rejection notice.’ The Trustees’ report on the efficiency and effectiveness of the Committee also supported that the agenda rejection notices should provide helpful guidance in those circumstances when the Committee has reached a view on an issue. We therefore think that the Committee’s agenda decision should retain the explanation of how it has reached its conclusion.

31. The respondent may be concerned that the Committee’s specific view could affect the accounting currently in place. We note that the IASB also tentatively agreed at the above meeting that ‘the rejection notices are not intended to determine whether certain accounting practices are errors; that judgment is left to entities, their auditors and their regulators.’ This is supported by the conclusion in the Trustees’ report that the agenda rejection notices should remain outside the body of IFRSs, and not form part of the requirements.

Staff recommendation

32. Consequently, we recommend that the Committee should reaffirm its decision not to take this issue onto its agenda and should not change the wording to the tentative agenda decision agreed at the May meeting which is reproduced in Appendix A to this Agenda Paper.

Questions for the Committee

Questions for the Committee
<p>Does the Committee agree with the staff recommendation to reaffirm its decision not to take this issue onto its agenda and not to change the wording to the tentative agenda decision agreed at the May meeting?</p>

Appendix A—Proposed agenda decision (reproduce of the tentative agenda decision from the May 2012 meeting)**IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 17 *Leases*—
Purchase of right to use land**

In January 2012, the Committee received a request to clarify whether the purchase of a right to use land should be accounted for as:

- a purchase of property, plant and equipment;
- a purchase of an intangible asset; or
- a lease of land.

In the fact pattern submitted, the laws and regulations in the jurisdiction concerned do not permit entities to own freehold title to land. Instead entities can purchase the right to exploit or build on land. According to the submitter, there is diversity in practice on how to account for a land right in the jurisdiction.

The Committee identified characteristics of a lease in the fact pattern considered, based on the definition of a lease as defined in IAS 17.

The Committee noted that the useful life for depreciation purposes might include the renewal periods and that judgement will need to be applied in making this assessment. The Committee further noted that a lease could be indefinite with extensions or renewals and, therefore, the existence of an indefinite period does not prevent the right to use from qualifying as a lease in accordance with IAS 17.

The Committee, notwithstanding the preceding observations, noted that the particular fact pattern is specific to a jurisdiction.

Consequently, the Committee [decided] not to take this issue onto its agenda.

Appendix B– Comment letters received

B1 The staff received the following four comment letters with respect to the Committee’s tentative agenda decision. All information has been copied without modification and is shown below.



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Mr Wayne Upton
Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London
United Kingdom
EC4M 6XH

Email: ifric@ifrs.org

18 July 2012

Dear Mr Upton,

Tentative agenda decision: IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets and IAS 17 Leases – Purchase of right to use land

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretation Committee's publication in the May 2012 *IFRIC Update* of the tentative decision not to take onto the IFRIC's agenda a request for interpretation of whether a purchase of a right to use land under the laws and regulations of a specific jurisdiction should be accounted for as a purchase of property, plant and equipment, a purchase of an intangible asset or a lease.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0)20 7007 0884.

Yours sincerely,

Veronica Poole
Global IFRS Leader
Technical



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July 23, 2012

(by e-mail to ifric@ifrs.org)

IFRS Interpretations Committee
30 Cannon Street,
London EC4M 6XH
United Kingdom

Dear Sirs,

Re: Tentative agenda decision on IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 17 *Leases* — Purchase of right to use land

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the IFRS Interpretations Committee's tentative agenda decision on the accounting for the purchase of a right to use land. This tentative agenda decision was published in the May 2012 IFRIC Update.

The view expressed in this letter takes into account comments from individual members of the AcSB staff but does not necessarily represent a common view of the AcSB or its staff. Views of the AcSB are developed only through due process.

We agree with the Committee's decision not to add this item to its agenda for the reasons provided in the tentative agenda decision.

We would be pleased to provide more detail if you require. If so, please contact me at +1 416 204-3276 (e-mail peter.martin@cica.ca), or Kathryn Ingram, Principal, Accounting Standards at +1 416 204-3475 (e-mail kathryn.ingram@cica.ca).

Yours truly,

A handwritten signature in black ink that reads "Peter Martin".

Peter Martin, CA
Director,
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July 26, 2012

IFRS Interpretations Committee

30 Cannon Street

London EC4M 6XH

United Kingdom

Dear Sir or Madame,

**Tentative agenda decision on IAS 16 Property, Plant and Equipment,
IAS 38 Intangible Assets and IAS 17 Leases—Purchase of right to use land**

We welcome the opportunity to express our comments on the IFRS Interpretations Committee's tentative agenda decision regarding *IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets and IAS 17 Leases—Purchase of right to use land*. This tentative agenda decision was published in the May 2012 IFRIC Update.

1. We generally agree with the Committee's decision not to add this item to its agenda. However we believe the Committee should not include any explanations in the wording of the agenda decision which might be misinterpreted as the Committee's view, reasoning or analysis regarding this issue. Because the Committee noted that the issue is specific to a particular jurisdiction and finally rejected, we do not think further explanations are necessary in the agenda decision.
2. We observe that the Committee decided to reject the issue, taking into consideration the current agenda criteria described in paragraph 25 of *Due Process Handbook for the IFRS Interpretations Committee*. In particular, we believe this issue does not meet the criteria of paragraph 25(a), which states, "The issue is widespread and has practical relevance". As noted above, as the issue is specific to a particular jurisdiction, it is too narrow to address in the Committee and therefore, does not meet this criteria. On this basis alone we believe that this issue should not be added to the agenda. In addition however, we also note that lease of land is not excluded from the scope of the current Lease Project being undertaken by the Board. Therefore, we think that the issue may also not to meet the criteria of paragraph 25(f) of *Due Process Handbook for the IFRS Interpretations Committee*, which states, "If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities".
3. As a result, we recommend amending the current tentative agenda decision by removing the

wording that seems to be the Committee's view in order to avoid misleading interpretations by the stakeholders and unintended consequences of the Committee. Therefore we suggest amending the tentative agenda decision as shown in the appendix below.

Appendix

IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets and IAS 17 Leases—Purchase of right to use land

In January 2012, the Committee received a request to clarify whether the purchase of a right to use land should be accounted for as:

- a purchase of property, plant and equipment;
- a purchase of an intangible asset; or
- a lease of land.

In the fact pattern submitted, the laws and regulations in the jurisdiction concerned do not permit entities to own freehold title to land. Instead entities can purchase the right to exploit or build on land. According to the submitter, there is diversity in practice on how to account for a land right in the jurisdiction.

~~The Committee identified characteristics of a lease in the fact pattern considered, based on the definition of a lease as defined in IAS 17.~~

~~The Committee noted that the useful life for depreciation purposes might include the renewal periods and that judgement will need to be applied in making this assessment. The Committee further noted that a lease could be indefinite with extensions or renewals and, therefore, the existence of an indefinite period does not prevent the right to use from qualifying as a lease in accordance with IAS 17.~~

~~As a result of the discussion, The the Committee, notwithstanding the preceding observations,~~ noted that the particular fact pattern is specific to a jurisdiction.

Consequently, the Committee [decided] not to take this issue onto its agenda.

We hope our comments will contribute to the forthcoming deliberations in the IFRS Interpretations Committee.

Yours sincerely,



Atsu Kato

Vice Chairman of the Accounting Standards Board of Japan

No: 0482/DSAK-IAI/VII/2012
2012

Jakarta, 26 July

Mr. Wayne Upton

Chairman of the IFRS Interpretation Committee

By email: ifric@ifrs.org, wupton@ifrs.org

Dear Mr. Upton,

Re: IFRS Interpretation Committee tentative agenda decisions – Purchase of right to use land

The Indonesian Accounting Standards Board (DSAK-IAI) as part of the Indonesian Institute of Accountants is the national accounting standard-setter in Indonesia. DSAK-IAI is a proud member of the Asian Oceanian Standards-Setters Group (AOSSG), and an active contributor in the Emerging Economies Group (EEG) forum.

Our appreciation to the IFRS Interpretation Committee (IFRIC), in discussing the issue of accounting for land in Indonesia that long has become a debatable subject in Indonesia. We acknowledge the position that IFRIC has took with regard to this issue, as stated in the IFRIC Update, May 2012. Tentatively, IFRIC has decided that this particular issue would not be included in the IFRIC's agenda, for various reasons.

With this letter, we would like to present our comments on the tentative decision, as explained in detail in *Appendix 1 – DSAK-IAI Analysis of IFRIC's Tentative Decision on Purchase of Right to Use Land*. In general, we would like to clarify some statements made in the tentative decision, where necessary, to update some of the initial information that we have submitted to IFRIC, and to reiterate our position in this particular issue. Hopefully this could be considered by IFRIC during the next meeting in September 2012.

Please do not hesitate to contact us should you have any queries. Thank you for your attention and kind consideration.

With best regards,



Rosita Uli Sinaga

Chairperson of the Indonesian Accounting Standards Board – Indonesian Institute of Accountants

APPENDIX 1 – DSAK-IAI ANALYSIS OF IFRIC’S TENTATIVE DECISION ON PURCHASE OF RIGHT TO USE LAND

References

This analysis is made using the following documents, for reference purposes:

1. IFRS Interpretation Committee Meeting – Staff Paper (March 2012)
2. IFRS Interpretation Committee Meeting – Staff Paper (May 2012)
3. IFRIC Update (May 2012)
4. IAS 17: *Leases*
5. ED *Leases*
6. Indonesian Accounting Standards Board Paper – Accounting for Land in Indonesia (February 2012)

Background

At the March 2012 meeting, the IFRS Interpretation Committee (IFRIC) discussed a request to clarify whether, based on the fact pattern submitted, the purchase of a right to use land should be accounted for as:

- a) A purchase of property, plant and equipment;
- b) A purchase of an intangible asset; or
- c) A lease of land.

IFRIC noted that the particular fact pattern considered is specific to a jurisdiction and the issue is therefore too narrow to address.

IFRIC decided not to propose an amendment to IFRSs in respect of this issue.

Analysis

In making the tentative decision IFRIC relied on some background information and facts on the legal and operational structure of land in Indonesia, as submitted by the Indonesian Accounting Standards Board (DSAK-IAI). First, it is important to clarify that there are two main scenarios or patterns of transaction that are present in Indonesia, in the context of corporation’s right over a land. They are:

1. Outright sale – The corporation (buyer) bought the right over the land from the individual owner of the land (seller) in a sale and purchase agreement. The corporation paid an agreed sum to the land owner, and nominal administration fee and related tax to the government. The government provides the approval for the new utilisation form the land, from right of ownership (individual owner) to right to use – cultivate or build over the land (corporation). The land owner essentially

transfers his/her right over the land to the corporation when the agreement is finalised. In this scenario, should the corporation decided not to extend or renew the right, the land would revert back to the State, and not the previous (individual) owner.

2. Corporation's right over the owner's – Similar to outright sale, except that in this scenario the corporation made an agreement with the individual land owner to create a right to use – cultivate or build over the land, on top of part or all of the owner's land. The difference being the individual owner still holds the legal ownership over the land. Should the corporation decided not to extend or renew the right, the land would revert back to the land owner, provided that he/she still holds the legal ownership over the land.

Both scenarios are relevant in Indonesia, with the outright sale scenario being the much more common case. The paper submitted by DSAK-IAI to IFRIC is strictly focussing on the outright sale scenario only, considering that most of the multi-interpretation issues are based on this particular scenario.

Below are some of the facts in the IFRIC Paper that need to be clarified:

1. Point 5 – *“The right to make such agreement is delegated to the government by the individual citizen”*.

Clarification

In an outright sale transaction (agreement) between an individual (title holder) and a corporation, the right of ownership must be transformed into either a right to cultivate (HGU) or a right to build (HGB). The State does not permit a corporation to own a right of ownership (as stated in Indonesian Law). The State – government acts as the regulator, who determines the legal relation between the right holder(s) and the land. In essence, the individual transfers his/her right over the land to the corporation who bought the right over the land.

The term “delegated” is relevant in term of the role of the government who regulates the legal relation between the land and the right holder. Technically, when the individual sold his/her right, the government will establish the new legal relation (new use/function of land) between the land and the corporation. The role of the government is to act as the administrator of the land right and its right holder. The only economic benefits received by the government in this transaction are the administrative fee and any tax related to the sale and purchase agreement, which are considerably minimal.

In substance, transaction where an individual sold his/her right of ownership over a land to another individual or to a corporation, both should be accounted in a similar manner (sale and purchase of an asset – IAS 16). The only reason why there is a “delegation” from the individual to the State – government in a sale to a corporation is due to a certain law which limit the right of ownership that a corporation have over a land.

2. Point 6 and 11 (c) – *“Payment is made to the individual citizen through the government to purchase the right based on the fair value of the land”*.

Clarification

In an outright sale transaction (agreement) between an individual (title holder) and a corporation, the payment is paid directly from the corporation as the buyer to the individual as the seller. The purchase price is the agreed price between the buyer and the seller, generally based in the fair value of the land. The government as the regulator/administrator determines the legal relation between the right holder(s) and the land. The only payments received by the government in this transaction are the administrative fee and any tax related to the sale and purchase agreement, which are considerably minimal.

3. Point 11 (b) – *“An individual citizen is identified as a lessor, who is delegating the irrevocable right to the government, and the entity is a lessee. The Committee was informed that the government can sell the right to another entity if an entity does not extend or renew, and the land would revert to the original owner if the government does not find a buyer”*.

Clarification

In an outright sale transaction (agreement) between an individual (title holder) and a corporation, the individual transfers his/her right over the land to the corporation who bought the right over the land.

The right over the land would only revert to the original owner under a different transaction (agreement) where the transaction is for the corporation to have a HGB on top of a land owned by an individual (title holder) – corporation’s right over the owner’s right. This scenario is outside the scope of the Paper submitted by DSAK-IAI. In this scenario, the agreement would be for the corporation to agree on a sum with the title holder, to establish an HGB (approved by the State) on top of the individual’s land. In substance, ownership over the land is still with the individual owner, although there is no significant difference on the rights that the corporation have over the land (compared to

when it is a straight sale). In this scenario, the transaction could be seen as a lease transaction.

The main difference between this scenario and the outright sale is that the land would revert back to the individual owner when the corporation decided not to extend or renew the right.

To identify the individual (owner) as a lessor (in a lease transaction) in the context of the submitted fact pattern is not aligned with the concept in IAS 17. One reason being that should the corporation as a lessee decided not to extend or renew the right it would revert back to the State, not the individual. This is because the individual transfers his/her right over the land to the corporation (with the approval of the government) when the agreement was made. The lease (IAS 17) concept could be relevant in the corporation's right over the owner's right scenario.

Another point of view that must also be considered is the fact that in reality, the chance that a corporation would decide not to extend or renew the right and return the land to the State is very slim. The reason being the significantly bigger economic benefit that the corporation would receive by taking the route to extend or renew the right and sell it at a fair value based price in the market.

4. Point 12 – *“The Committee acknowledged that in some jurisdictions entities account for a right to use land as either an intangible asset or as a property, plant and equipment. The Committee noted, however, that a right to use land is generally accounted for under IAS 17 and that such a right would be classified as a finance lease if it met the criteria described in paragraph 4 of IAS 17 (assets leased under finance leases would be disclosed according to each class of asset)”*.

Tentative agenda decision (wording)

“The Committee identified characteristics of a lease in the fact pattern considered, based on the definition of a lease. The Committee specifically noted that a lease could be indefinite with extensions or renewals and that, therefore, the existence of an indefinite period does not itself prevent the right to use from being accounted for as a lease in accordance with IAS 17”.

Clarification

Should the specific fact pattern as present in Indonesia be treated as a lease in accordance with IAS 17, the question would be whether the requirements in IAS 17 are relevant.

Looking at the definition and disclosure of a lease in IAS 17, there are some concepts that might not be relevant or appropriate to be applied to the specific fact pattern as submitted by Indonesia. Among the concepts in question are:

1. Definition of a lease

The definition of lease according to IAS 17 is 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”

In the specific fact pattern (in Indonesia), it is not as clear as to how to identify the individual owner of the land (the seller) or even the government as a lessor in a lease transaction.

Could the individual land owner be identified as a lessor? It should be noted that the right associated with the land is de-attached from the individual and transferred to the corporation when the agreement was made, with the approval from the government (for the new land arrangement). If for any reason the corporation decided not to extend or renew the right, or the government decided to revoke the right, the land would revert back to the State, and not the individual. This shows that from the moment the agreement was signed, the individual has ended his/her right and association over/with the land.

Looking at one of the criteria of a finance lease (IAS 17), transfer of ownership to the lessee happen at the end of the lease term, which is different to the outright sale scenario in Indonesia. In this scenario indications such as the right can be used as collateral shows that ownership is transferred when the agreement is made. Another criteria based on IAS 17 is the amount of losses borne by the lessor when the lessee cancel the lease. Rather than limited to the losses associated with the cancellation (remaining use/term of the right), in the Indonesian scenario, if the government decided to take the right from the corporation for public purposes, the amount given to the corporation would be based on the full fair value of the land.

All of the reasons above clearly show that it is not appropriate to identify the land owner as a lessor in the transaction.

Could government be identified as a lessor? One important thing that must be noted is the differentiation between the State and government as separate entities. From the facts above the residual right related to the land is with the State (as the land would revert back to the State from the corporation). Government only received nominal amount (administrative fee and related tax) from the corporation. Most of the amount paid by the corporation (generally based on the fair value of the land) is paid to the original owner of the land. This is clearly does not aligned with the concept of lessee and lessor in a lease transaction, as described in IAS 17.

Another point to consider is the fact that when a particular land reverts back to the State, it is open for enquiry from individuals or corporations. Should an individual or a corporation would like to use the land for particular purposes, they can obtain the specified right from the State through the government, by meeting the government's requirements, and pay a specified amount for administration fee, and where relevant, the related tax only. The individual or corporation does not pay a "purchase" price to the State in acquiring the land (right). This shows that the government as the representation of the State is never in a position to be the beneficiary similar to a "seller" in a sale and purchase agreement. The State does not the right to own the land, and thus to gain economic benefit through a mean of sale. Its right is only limited to the administration and allocation of rights to right holders. In this case, it is difficult to see how government, or even State, can be identified as a lessor.

From the two explanations above it can be seen that to identify either the individual land owner or the government as a lessor in a lease transaction, where the corporation is supposedly be identified as the lessee, is not quite appropriate. Would it be correct to identify this transaction as a lease, when clearly there is no lessor that can be clearly identified?

2. Transfer of leased asset

In a general lease context, a leased asset can only be transferred via a sublease transaction. In the case of the transaction (in Indonesia) in question, the right over the land (asset) is transferable to means such as sale and in-kind capital contribution. It can also be used as collateral. This is an evidence that in essence, ownership (right) over the land is belong to

the corporation (who bought the right over the land from the individual owner). Conceptually, this is a different transaction to that of a lease transaction.

3. Disclosure requirements

The disclosure requirements as stated in IAS 17, particularly those applied to the lessee are not relevant to the specific transaction as described in the Paper submitted by Indonesia. Taking the assumption that the scenario in Indonesia would be considered as finance lease, which is also one of the points expressed by IFRIC, below are the analysis on each of the disclosure requirement in IAS 17:

- a) *for each class of asset, the net carrying amount at the end of the reporting period.*

Clarification

This requirement is generally relevant for asset both under IAS 17 (leased asset – finance lease) and IAS 16 (fixed asset). The net carrying amount would be based on the agreed amount paid by the corporation to the land owner. Taking into consideration the indefinite nature of the right (extension and renewal), the only subsequent element that is relevant would be impairment.

- b) *a reconciliation between the total of future minimum lease payments at the end of the reporting period, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the end of the reporting period, and their present value, for each of the following periods:*
 - i. *not later than one year;*
 - ii. *later than one year and not later than five years;*
 - iii. *later than five years.*

Clarification

This requirement is not relevant for the specific transaction, as the full payment is paid by the corporation to the land owner when the agreement is made – single payment. Thus, there is no future payments element present in the agreement.

- c) *contingent rents recognised as an expense in the period.*

Clarification

In term of contingencies, the continuous extension and renewal of the right could be seen as contingent rental to the initial period of right over the land. For the extension and renewal process, there would be an administrative fee and related tax that could be considered as the expense for the contingencies.

- d) *the total of future minimum sublease payments expected to be received under non-cancellable subleases at the end of the reporting period.*

Clarification

The scope of the transfer of right associated with the HGB held by the corporation is not limited to sublease, but also include sale, in-kind capital contribution, and even to be used as collateral. However, different to a typical sublease transaction these kinds of transfers also transfer the right (HGB) from the initial right holder to the new holder (buyer, creditor, etc).

- e) *a general description of the lessee's material leasing arrangements including, but not limited to, the following:*
- i. the basis on which contingent rent payable is determined;*
 - ii. the existence and terms of renewal or purchase options and escalation clauses; and*
 - iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.*

Clarification

Some of the information relevant to this requirement related to the specific transaction are the continuous extension and renewal of the right, and also the restriction from the government in term of the strict use of the right (HGB) and the land.

The nature of other information that could be disclosed under this requirement would be different between those transaction that is

considered to be a lease and those that in-substance is really a sale and purchase transaction.

For comparison, the disclosure requirements of IAS 16 can be used. Below are those requirements (to be disclosed for each class of property, plant and equipment):

- a) *the measurement bases used for determining the gross carrying amount;*

Clarification

The right over the land (HGB) held by the corporation is generally measured using the initial agreed amount (historical cost). This however does not rule out the possibility of implementing the revaluation method to measure the right (land), especially considering the nature of the value of the land which generally appreciates over time.

- b) *the depreciation methods used;*

Clarification

In the specific pattern of transaction in question, it can be assumed that due to the continuous extension and renewal the right has an indefinite life, thus it would not be depreciated. Any subsequent measurement that is relevant would be any impairment that is associated with the possibility of the deterioration of the land value (for any reason).

- c) *the useful lives or the depreciation rates used;*

Clarification

Due to the continuous extension and renewal of the right, and taking into consideration both the protected right of the right holder and the non-existence of any precedence on the rejection from the government (when all requirements are met), the right could be considered to have an indefinite useful life.

- d) *the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and*

Clarification

As explained in the previous two points (b and c).

- e) *a reconciliation of the carrying amount at the beginning and end of the period showing:*
- i. *additions;*
 - ii. *assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;*
 - iii. *acquisitions through business combinations;*
 - iv. *increases or decreases resulting from revaluations under paragraphs 31, 39 and 40 and from impairment losses recognised or reversed in other comprehensive income in accordance with IAS 36;*
 - v. *impairment losses recognised in profit or loss in accordance with IAS 36;*
 - vi. *impairment losses reversed in profit or loss in accordance with IAS 36;*
 - vii. *depreciation;*
 - viii. *the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and*
 - ix. *other changes.*

Clarification

Most of these are very relevant in the context of right (HGB) ownership over a land. The corporation hold the significant risk and reward associated with the right, and has the right to implement various subsequent transactions/measurements over the right, such as impairment, transfer to other parties, etc.

The financial statements should also disclose:

- a) *the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;*

Clarification

This is highly relevant to the scenario in Indonesia as the right (HGB) to build over the land can be used as collateral. Should the transaction be considered as a lease, this information might not be disclosed to the users of financial statement.

- b) *the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;*

Clarification

In the outright sale scenario, there could be expenses related to the sale of the right over the land, among others the administrative fee and related tax paid to the government and also legal fee paid to legal consultant. This is in-line with the local Interpretation released by DSAK-IAI as the standard setter in Indonesia, where the initial amount paid along with the related expenses are recognised as PPE, and the fee related to the extension and renewal is recognised as a depreciable intangible asset.

- c) *the amount of contractual commitments for the acquisition of property, plant and equipment; and*

Clarification

Depend on the agreement this requirement could be relevant in the sale of right over the land, where the corporation (buyer) might have some commitments against the seller or any other parties such as the government.

- d) *if it is not disclosed separately in the statement of comprehensive income, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.*

Clarification

This requirement could be relevant depending on the facts and circumstances surrounding the agreement.

From the comparison of disclosure requirements above the general view is that the specific outright sale transaction as raised by Indonesia is closer in nature to a sale and purchase of a fixed asset (PPE), compared to a leased asset in a lease transaction. One of the main reasons for this is the transfer of significant risk and reward associated with the right over the land that has been fully transferred from the seller (individual owner) to the buyer (corporation). Also, the right held by the buyer (corporation) can be transferred to other parties by means of sale, in-kind capital contribution, and to be used as collateral.

5. Point 13 – *“The Committee noted the ongoing Leases project. The Committee did not find a reasonable ground to provide guidance on the issue at this stage, given that the Leases project is silent on whether a right-of-use asset is a tangible or an intangible asset. In addition, the Committee considered the tentative decision made by the Board that long-term leases of land would not be excluded from the scope of the Leases project”.*

Clarification

Taking into context the ED *Leases* project, ideally it should be able to provide clear guidance on what constitute as a lease, and in general on whether a right-of-use asset is a tangible or intangible asset.

The question on whether a right-of-use is a tangible or intangible asset is a crucial one, considering the implication to how the current lease practice is seen. In the other scenario that is present in Indonesia, the corporation has a right to build (HGB) on top of a land owned by an individual owner. This right (HGB) is closer to an intangible than a tangible asset, considering that the corporation does not have the right over the physical land.

6. Point 14 – *“The Committee, notwithstanding such observations, noted that the particular fact pattern considered at the meeting is specific to a jurisdiction and*

thus it is too narrow to undertake the due process associated with an interpretation or an annual improvement”.

Clarification

The particular fact pattern in Indonesia, as illustrated in the submission to IFRIC is not specific to a jurisdiction only (Indonesia). Based from preliminary communications with other jurisdictions, similar pattern are also used in these jurisdictions, where right over the land is treated as an asset (part of property, plant and equipment).

Referring to the IFRS Interpretation Committee Meeting – Staff Paper (March 2012), based on the outreach conducted by the IFRIC staff, there are four respondents who have a similar legal framework, and to certain extents fact pattern with those submitted by Indonesia. Extracts of the four responses are as follows:

1. Jurisdiction 4 – Land is generally leased for 99 years from the government, and treated as owned (and controlled) by the lessees and not depreciated, on the basis that the leases are renewed without charge by the government. If the lease of the land is not renewed, the government is required to reimburse the lessee for any improvements to the land (amount based on valuation). The accounting treatment is f 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.
2. Jurisdiction 5 – Transferable right over the land is granted by the government for a specified period of time (50 years) and for a specified purpose. Provided that the use of the land does not contravene the conditions as agreed with the government, the right holder enjoys the risks and rewards associated with the occupation of the land. Right holder may freely transfer the right to others through sale and purchase agreement. The accounting treatment for the right is finance lease (provided meeting the criteria of IAS 17).
3. Jurisdiction 6 – Holder of specific right (construction of pipelines, access roads to mining/exploration activities) is granted a right to the land, which would exist irrespective of future changes in ownership of the remaining land. The accounting treatment varies, depending on the term (indefinite – intangible asset, restricted period – operating lease). Right of use of land is not capitalised because the land is not controlled by the entity, and ownership is not transferred.

4. Jurisdiction 7 – Leasehold right (right to use the land, granted by the owner of the land – different from ownership of the land) which can be either renewable or limited (based on agreement). In some cases the agreement requires right holder to pay certain amount to the land owner at the inception of the agreement. The general accounting treatment for the limited (fixed with no renewals) agreement is operating lease (IAS 17). However, depending on the characteristics of the rights and the existence of upfront payment, some rights may be accounted as indefinite intangible asset.

Taking this into consideration, IFRIC should consider obtaining further information from other jurisdictions, particularly those who responded that they have similar pattern to that found in Indonesia.

DSAK-IAI's Position

The initial objective of DSAK-IAI in submitting the Paper (Indonesian Accounting Standards Board Paper – Accounting for Land in Indonesia) to IFRIC was to resolve the multi-interpretation issue associated with land in Indonesia. Domestically, DSAK-IAI as the standard setter in Indonesia has issued an Interpretation (ISAK 25: *Rights over the Land*) to resolve this issue. However, this does not resolve the issue for entities in Indonesia who are required to prepare IFRS-based financial report for various reasons.

DSAK-IAI believes that to promote the use of IFRS as the globally accepted financial reporting standards, IFRIC (and IASB) needs to resolve this kind of multi-interpretation issue. Specific guidance on how to treat the right over the land, both recognition and measurement (depreciation), on the specific pattern is highly desirable, to minimise the different practices currently present.

******* END OF ANALYSIS *******

Appendix C– Extract of an article from the Indonesian National Land Agency (translated into English by the submitter)

Indonesian National Land Agency Article

<http://kot-gorontalo.bpn.go.id/Propinsi/Sumatera-Barat/Kota-Padang/Artikel/TANAH-NEGARA-DAN-WEWENANG-PEMBERIAN-HAKNYA-%28Boedi-.aspx>

STATE LAND AND THE POWER OF RIGHT GRANTOR

In the context of Indonesian land law and regulation, land is defined as the space on the Earth surface, generally not including the space above and below the surface. The term State land indicates certain legal relation between the land as the object and the State as the subject. The legal relation generally suggests relation of control from the subject to the object. In the legal context, the term control (to control, to be controlled – possession) is not the same as ownership, and has different legal consequences. To be controlled does not necessarily mean to be owned, vice versa.

Looking back at the land law and regulation during the Dutch occupation in Indonesia, State land is owned by the State (King/Queen). Based on the following Dutch articles:

“behoudens opvolging van de tweede en derde bepaling der voormelde wet, blijft het beginsel gehandhaafd, dat alle grond, waarop niet door anderen regt van eigendom wordt bewezen, domein van de Staat is”.

“alle woeste gronden in de Gouvernementsladen op.... berhooren, voorzoover daarop door leden der inheemsche bevolking gene aan het ontginningsrecht ontleende rechten worden uitgeoefend, tot het Staatsdomein. Over dit tot het Staatsdomein behoorende gronden, berust behoudens het ontginningsrecht der bevolking, de beschikking iutluitend bij het Gouvernement”.

Unless claimed otherwise, vacant land is deemed as State land. The authority to grant right of ownership over a land is with the State (Governor General during the Dutch occupation, the related Ministry in present time), without diminishing the right that is already in the possession of individual citizen. The general concession is that every piece of land is owned by either individuals or entities. Should a land is vacant it is then

deemed as State land. This becomes the basis of early land laws and regulations in Indonesia.

In the development of the laws and regulations, it can be summarised that there are two types of State land:

1. Free State land – State land where no rights have ever been attached to the land.
2. State land with rights attached to the land in the past, and for particular reasons reverts back to the State.

More present development in the laws and regulations in Indonesia show that the State through its government is mandated with the authority to govern the use of land in Indonesia, which include the authority to administer the rights over the land. The authority governed to the State does not include the right of ownership over the land, where it falls with the individual Indonesian citizen, and where appropriate eligible entities. This is the opposite of what was happened in the past during the Dutch occupation.