



## **Improvements to HKFRSs 2009**

### **Amendments to HKAS 17 Leases – Classification of Leases of Land and Building**

The Question and Answer (Q&A) below should be read in conjunction with the Amendments to HKAS 17 Leases in the Improvements to HKFRSs 2009 issued in May 2009.

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#### **Question:**

**The Improvements to HKFRSs 2009 (issued in May 2009) included amendments to HKAS 17 Leases, which deleted paragraphs 14 and 15 and inserted a new paragraph 15A. To what extent do these amendments change the classification of interests in leasehold land situated in Hong Kong?**

#### **Answer:**

The amendments to HKAS 17 were made as a result of the amendments made to the equivalent IAS, IAS 17, by the IASB. In particular the amendments deleted the guidance in paragraph 15 which had stated that when land had an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term. In paragraph BC8D to the amendments it was noted that these amendments were a reversal of the decision the IASB had made in December 2003 i.e. prior to the date that HKAS 17 was originally issued as part of the HKICPA's programme to fully converge HKFRSs with IFRSs.

The new paragraph 15A is a form of replacement of paragraphs 14 and 15. Paragraph 15A repeats the requirement previously in paragraph 15, that the classification of land and buildings as being held under finance or operating lease should be separately assessed. However, the guidance on how to do this is limited to a cross reference to paragraphs 7 to 13, which apply to all leases, in addition to a reminder that an important consideration when classifying land leases is that land normally has an indefinite economic life.

Paragraph 7 states that the classification of leases is based on the extent to which the risks and rewards incidental to ownership of an asset lie with the lessor or the lessee. A lease is therefore classified as a finance lease if the lease transfers substantially all the risks and rewards incidental to ownership to the lessee. As stated in paragraph 10, whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.



Paragraphs 10 and 11 of HKAS 17 set out examples and indicators of situations which individually or in combination may lead to a classification of a lease as a finance lease. In particular, paragraph 10(d) refers to leases where at the inception of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset. In addition, paragraphs BC8B-BC8C of the Basis of Conclusions to the amendments indicate that the IASB's current view is that the present value of the residual value of a property in a lease with a term of several decades or more would be negligible and that in such circumstances classifying the lease as a finance lease would be consistent with the economic position of the lessee.

In the case of a transferable interest in land granted by the Hong Kong Government<sup>1</sup>, the lease premium on the initial lease term is paid in full at the outset, and is then effectively recovered from the buyer of that interest if the current holder sells that interest. In the secondary market therefore, the price paid by the buyer is in effect the minimum lease payments to acquire the remaining rights under the lease, even though that amount is not actually paid to the lessor (i.e. in this case the Government).

Establishing whether that amount paid either by the original lessee or the buyer in the secondary market equates to substantially all the fair value of the land is not immediately obvious, as there is no market for freehold land in Hong Kong to compare to. However, in practice, transaction values in the Hong Kong property market have typically demonstrated that the property market does not materially distinguish between Government land leases of varying duration unless there is no expectation of renewal.

This appears to indicate that either the market considers the reversionary interest to be small or the market believes that the lease term specified in the land lease will be capable of extension for a nominal amount, in accordance with the published land policy of the Hong Kong Government<sup>2</sup>. In other words, the indicator under paragraph 10(d) (i.e. at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset) is either satisfied in the manner expected in paragraph BC8C or is satisfied because the market is pricing the Government leases as if they contain the feature set out in paragraph 11(c) of HKAS 17 (i.e. that the lessee under such leases will in practice have the ability to continue to lease the land for a secondary lease term at a rent that is substantially lower than market rent).

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<sup>1</sup> In Hong Kong, transferable ownership interests in land and buildings generally take the legal form of a right granted by the Government of the Hong Kong Special Administrative Region to occupy a designated portion of land (solely or in common with others) for a specified period of time and for a specified purpose, together with outright ownership (solely or in common with others) of structures situated thereon. 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, with such change in ownership being registered in the Government's Land Registry.

<sup>2</sup> <http://www.landsd.gov.hk/en/service/landpolicy.htm>



If the market is in effect behaving as if the land interest were substantially the same as a freehold interest, then the lessee of such a lease is in effect exposed to substantially all the risks and rewards of ownership of the land. In such circumstances, classification of the interest as being held under a finance lease is consistent with the substance of the interest and the economic position of the lessee. Preparers of financial statements should, based on the circumstances of their transactions, assess to what extent the present value of the minimum lease payments (i.e. the transaction price of the leasehold land) amounts to substantially all of the fair value of the land as if it is freehold.

If the registered holder of the land interest is regarded as the lessee under a finance lease, then, unless the property is leased out by the registered holder to another party under a finance lease, the following HKFRSs would be applicable to accounting for that interest by the holder:

- HKAS 2, *Inventories*, if the property interest is held for sale in the ordinary course of business or is in the process of being developed for such a sale;
- HKAS 16, *Property, plant and equipment*, and HK Interpretation 4, *Leases – Determination of the length of lease term in respect of Hong Kong land leases*, if the property interest is held for own use; or
- HKAS 40, *Investment property*, if the property is held to earn rentals and/or for capital appreciation. (Note: In this case, HKAS 17 would also be applicable to the registered holder in the role as a lessor, if the property were rented out to others under a lease. Typically these sub-leases would be short term tenancies (e.g. of 2 to 5 years' duration) and would therefore be classified as operating leases from which the registered holder earned rental income).

Any change in classification of the interest in land which arises as a result of these amendments to HKAS 17 should be dealt with in accordance with the transitional provisions set out in paragraph 68A of HKAS 17. This paragraph requires retrospective adoption unless the entity does not have the information necessary to apply the amendments retrospectively. In such cases, the entity is required to recognise the asset (and any unpaid lease premium liability) at fair value on the date it adopts the amendments, with a corresponding adjustment to retained earnings and this amount should be considered as deemed cost going forward. The effective date of the amendments is annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.