



The
Treasury

February 2011

tpp
11-01

**Accounting Policy:
Lessor classification of long-term land leases**

Office of Financial Management
Policy & Guidelines Paper

Preface

This policy is issued by NSW Treasury as a Policy and Guidelines Paper and clarifies how a lessor should apply Accounting Standard AASB 117 *Leases* (as amended in 2009) to classify a long-term lease of land.

The policy substantively revises and replaces NSW Treasury Policy & Guidelines Paper TPP 06-3 *Lessor Accounting for Prepaid Long-term Leases of Land* as a result of recent amendments to AASB 117.

Implementation of this policy will achieve consistent accounting for such leases by NSW public sector lessors.

The policy applies to all NSW public sector entities (including statutory State owned corporations) for financial years beginning on or after 1 July 2010.

Mark Ronsisvalle
for Secretary
NSW Treasury
February 2011

Treasury Ref: TPP11-01
ISBN: 978-0-7313-3486-5 [electronic]

General inquiries concerning this document should be initially directed to:
The accounting policy section of NSW Treasury, Tel: 9228 4095, or
Email: robert.williams@treasury.nsw.gov.au

This publication can be accessed from the Treasury's Office of Financial Management website (<http://www.treasury.nsw.gov.au>).

Contents

	Page
Preface	i
Executive summary	1
1 Introduction	2
1.1 Background	2
1.2 Issue	2
1.3 Application	2
2 Classifying the lease	3
3 Transitional requirements for 2010-11	4
4 Accounting impact on prepaid leases	4
5 Further information	5

Executive Summary

This policy is issued by NSW Treasury as a Policy and Guidelines Paper and clarifies how a lessor should apply Accounting Standard AASB 117 *Leases* (as amended in 2009) to classify a long-term lease of land.

It applies to all NSW public sector entities (including statutory State owned corporations) for financial years beginning on or after 1 July 2010.

A public sector agency may be a lessor in a long-term (eg 99-year) lease of land (or an interest in land). The long-term nature of such leases gives rise to questions about how they should be classified for accounting purposes.

Accounting Standard AASB 117 *Leases* gives guidance on classifying leases. This policy applies that guidance to long-term land leases.

This policy:

- requires a lessor to classify a long-term land lease as a finance lease if it transfers to the lessee substantially all the risks and rewards incidental to ownership of the land
- applies to financial years beginning on or after 1 July 2010
- requires a lessor with an unexpired long-term land lease as at 1 July 2010 to review the classification of the lease and, where appropriate, reclassify it as a finance lease and account for the change in accordance with the transitional provisions of AASB 117.

Implementation of this policy will achieve consistent accounting for such leases by NSW public sector lessors.

1. Introduction

1.1 Background

A public sector agency may be a lessor in a long-term (eg 99-year) lease of land (or an interest in land). The long-term nature of such leases gives rise to questions about how they should be classified for accounting purposes.

Accounting Standard AASB 117 *Leases* gives guidance on classifying leases. This policy applies that guidance to long-term land leases.

The specific guidance on land leases in AASB 117 was amended in 2009 by AASB 2009-5 *Further Amendments to Australian Accounting Standards arising from the Annual Improvements Project*. The amendment removes the assertion that a land lease will normally be classified as an operating lease and requires instead that the lease be classified on the basis of whether it transfers substantially all the risks and rewards incidental to ownership of the land. The amendment effectively requires a long-term land lease to be classified as a finance lease instead of an operating lease.

In amending IAS 17 (on which AASB 117 is based), the International Accounting Standards Board acknowledged that it had reconsidered and reversed its previous decision in relation to its guidance on classifying land leases [IAS 17, paragraphs BC8A and BC8D].

The amending of AASB 117 necessitates the amending of Treasury Policy & Guidelines Paper TPP 06-3 *Lessor Accounting for Prepaid Long-Term Leases of Land*.

1.2 Issue

A fundamental issue for a lessor in a long-term land lease is whether the lease should be classified as a finance lease or an operating lease. The classification determines the appropriate accounting.

1.3 Application

This policy applies to any NSW public sector agency that is a lessor in a long-term lease of land (or an interest in land) where the lease payments represent substantially all of the fair value of the land and the lessor retains title to the land. Long-term leases typically run for 50 years or more. Relevant legislation usually sets a maximum permissible term (including renewal options) of 99 or 100 years.

The policy is issued as a Treasurer's Direction under sections 9 and 45E of the *Public Finance and Audit Act 1983* and therefore applies to entities required to prepare general purpose financial reports under that Act. It is also mandatory for statutory State owned corporations. A specific reference to it will be included in those entities' Statements of Corporate Intent.

This policy applies to financial years beginning on or after 1 July 2010.

However, if a lessor's financial year does not begin in July, it applies this policy from the start of its first financial year beginning on or after 1 January 2010.

This policy substantively revises and replaces TPP 06-3 *Lessor Accounting for Prepaid Long-term Leases of Land* of June 2006, which is hereby withdrawn.

2. Classifying the lease

AASB 117 *Leases* distinguishes between finance leases and operating leases and requires a different accounting treatment for each type. It is therefore important to determine at the inception of the lease whether a long-term land lease is classified as a finance lease or an operating lease.

A **finance lease** transfers, from the lessor to the lessee, substantially all the risks and rewards incidental to ownership of the leased asset. Title may or may not eventually transfer. An **operating lease** does not transfer those risks and rewards [paragraph 3].

AASB 117 provides indicators that would normally lead to a lease being classified as a finance lease [paragraphs 10 and 11]. These include:

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 [paragraph 10(d)].

Further, the Basis for Conclusions on IAS 17 *Leases* (on which AASB 117 is based), in discussing the land element of long-term leases, states:

The [International Accounting Standards] Board noted that the lessee in leases of this type will typically be in a position economically similar to an entity that purchased the land and buildings. The present value of the residual value of the property in a lease with a term of several decades would be negligible. The Board concluded that accounting for the land element as a finance lease in such circumstances would be consistent with the economic position of the lessee [paragraph BC8C].

The indefinite economic life of land may suggest that the lessor retains significant risks and rewards incidental to its ownership after the expiry of the lease term. However, at lease inception when the lease is required to be classified, the present value of such risks and rewards in a long-term lease will be insignificant.

Therefore, this policy requires a lessor to classify a long-term land lease as a finance lease, if it transfers to the lessee substantially all the risks and rewards incidental to ownership of the land.

A lease will transfer substantially all of those risks and rewards to the lessee if, 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 land, and
- the lessor's residual risks and rewards after the end of the lease term is not significant.

This will typically be the case where the lease term is 50 years or more.

3. Transitional requirements for 2010-11

AASB 117 *Leases* was amended by AASB 2009-5 *Further Amendments to Australian Accounting Standards arising from the Annual Improvements Project*. The amendments took effect for annual reporting periods beginning on or after 1 January 2010. Therefore, for most NSW public sector agencies the effective date was 1 July 2010. If a lessor's financial year does not begin in July, it applies this policy from the start of its first financial year beginning on or after 1 January 2010.

The amendments effectively change the classification of long-term land leases. Most now qualify as finance leases whereas prior to the amendments they normally qualified as operating leases.

The amended transitional provisions of AASB 117 require a lessor or lessee to reassess the classification of all unexpired land leases at the effective date of the amendment, based on information existing at the inception of those leases, and to adjust any reclassified land lease, retrospectively if possible [paragraph 68A].

This policy requires a lessor with an unexpired long-term land lease as at 1 July 2010 to review the classification of the lease in accordance with AASB 117 as clarified by this policy. Where appropriate, the lessor should reclassify the lease as a finance lease and account for the change in accordance with the transitional provisions of AASB 117.

A reclassification should be disclosed as a change in accounting policy in accordance with paragraph 28 of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

4. Accounting impact on prepaid leases

At the inception of a long-term land lease, the lessee often prepays all of the lease payments.

A prepaid lease classified as a finance lease under this policy will effectively be accounted for as a sale. At the inception of the lease, the lessor will derecognise the land and recognise the associated gain or loss on disposal. This contrasts with the superseded policy which required the lessor to initially recognise the prepayment as deferred revenue, to amortise it to revenue progressively over the term of the lease and to initially revalue the land downwards to its nominal fair value.

Reclassifying an existing prepaid long-term land lease as a finance lease in accordance with the transitional requirements of AASB 117 would normally require the lessor to:

- derecognise the deferred revenue liability by transferring it to retained earnings as at the beginning of the comparative year (2009-10)
- cease amortising the deferred revenue liability, and
- adjust the comparative year's revenue accordingly.

5. Further information

General inquiries concerning this document should be initially directed to NSW Treasury's Accounting Policy Section, Tel: 9228 4095.