



MALAYSIAN INSTITUTE OF ACCOUNTANTS
FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE
("FRSIC")

FRSIC Issue No. 6 [2007]

Split of the Minimum Lease Payments between the Land and the Building Element

The issue:

IAS 17.15 states that "The land and buildings elements of a lease of land and building are considered separately for the purposes of lease classification..."

In situations where the land is classified as an operating lease and the building as a finance lease, then there is a need to split the minimum lease payment or the upfront payment between the two elements.

IAS 17.16 requires that "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."

It also goes further to say that "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".

Under BC10, it states that "The Board noted that an allocation of the minimum lease payments by reference to the relative fair values of the land and buildings would not reflect the fact that land often has an indefinite economic life, and therefore would be expected to maintain its value beyond the lease term. In contrast, the future economic benefits of a building are likely to be used up, at the least to some extent, over the lease term. Therefore, it would be reasonable to expect that the lease payments relating to the building would be set at a level that enabled the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. In the case of land, the lessor would not normally need compensation for using up the land."

BC 11 further elaborates "Therefore, the Board decided to clarify in the Standard that the allocation of the minimum lease payments is weighted to reflect their role in compensating the lessor, and not by reference to the relative fair values of the land and buildings. In other words, the weighting should reflect the lessee's leasehold interest in the land and the buildings. In the extreme case that a building is fully depreciated over the lease term, the minimum lease payments would need to be weighted to provide a return plus the full depreciation of the building's value at the inception of the lease. The leasehold interest in the land would, assuming a residual value that equals its value at the inception of the lease, have a weighting that reflects only a return on the

initial investment".

It would be extremely useful if MIA could provide members as to how to apply the above provision as to:

- (a) How to split the land and the building elements based on the requirements of IAS 17; and
- (b) Under what situation is it considered that the land and the building elements cannot be allocated reliably between the two elements?

Current accounting practice as observed by the Submitter:

Have not seen any life examples but many companies will be affected very soon because many Malaysian companies do have leasehold land and buildings as their "fixed asset" and accordingly, a split will have to be done [in most cases]. There are not many literatures on this subject.

Our checks with Hong Kong for example reveal that:

- (a) some uses the route of impracticability to split between land and building element;
- (b) some uses the formulae: Building element = Land element & Building element – market value of the Land (i.e. the building fair value is the balancing amount); or
- (c) some uses the formulae: Land = Land element & Building element – net replacement cost of building.

In Philippines, one accountant suggested the following: obtain the PV of the lease payments of a comparable land lease [on a standalone basis], then obtain the PV the lease payments on a comparable building lease [on a standalone basis]. Then apply the allocation based on these two PVs.

Reasons for the FRSIC to address the issue:

FRS 117 is effective for financial period beginning on or after 1 October 2006. For some companies, this FRS 117 is already effective. However, there is insufficient guidance currently as to how to apply the above requirements of FRS 117. To ensure consistency in application by all our affected Malaysian companies, guidance would be appreciated by members.

Submitter's proposal or recommendation to address the issue:

None suggested. However, my view is that none of the methods used in Hong Kong and Philippines as described above are acceptable under IAS 17.

Submitted on:

2 February 2007

Corresponding FRSIC Consensus:

FRSIC Consensus 5 - Split of the Minimum Lease Payments between the Land and the Building Element [To view, click on the Consensus title]