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Guidance paper – Accounting for leased property as lessor

Objective of this guidance

Many State entities have leased properties to other entities under peppercorn lease arrangements or other long term lease arrangements. In some cases, the underlying assets have been derecognised on the basis that the lessor has transferred substantially all the risks and rewards incidental to ownership of the leased asset. This may not be the correct treatment under AASB 16. The purpose of this guidance paper is to provide clarity and interpretation of how the relevant accounting standards apply to a lessor when classifying different types of leases at inception.

This guidance paper does not provide details on how to account for operating and finance leases, it only discusses the determination of the classification of such at inception of a lease.

Relevant Accounting Standard

AASB 16 - Lessor - Classification of leases

<u>Para 61:</u> A lessor shall classify each of its leases as either an operating lease or a finance lease.

<u>Para 62:</u> A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

<u>Para 63:</u> 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. Examples of situations that **individually or in combination** would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term

(b) the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised

(c) the lease term is for the major part of the economic life of the underlying asset even if title is not transferred

(d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset

(e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

Para B55: When a lease includes both land and buildings elements, a lessor shall assess the classification of each element as a finance lease or an operating lease separately applying paragraphs 62–66 and B53–B54. In determining whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life.

Para B56: Whenever necessary in order to classify and account for a lease of land and buildings, a lessor shall allocate lease payments (including any lump-sum upfront payments) 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 date. 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.

Para B57: For a lease of land and buildings in which the amount for the land element is immaterial to the lease, a lessor may treat the land and buildings as a single unit for the purpose of lease classification and classify it as a finance lease or an operating lease applying paragraphs 62–66 and B53–B54. In such a case, a lessor shall regard the economic life of the buildings as the economic life of the entire underlying asset.

Application of Accounting Standard

Long term lease of land

Where land that is owned by the entity (the lessor) is leased out to a lessee under a long-term contract, the lessor is required to classify the lease at inception in accordance with AASB 16.62.

At lease inception the lessor shall classify the lease as a finance lease, if it transfers to the lessee substantially all the risks and rewards incidental to ownership of the land. The criteria would be considered met if:

- the present value of the 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 with a long-term lease.

In evaluating the above criteria, it's essential to consider the economic substance of the lease transaction rather than solely relying on the form of the contract. Where a lease is structured as a peppercorn lease, if the substance of the agreement indicates that the lessee has assumed most of the risks and rewards associated with ownership, it would be classified as a finance lease.

In instances where the lessee constructs a building on the leased land (or has already constructed the building on inception of the land), the lessor shall consider the same key principles above in determining whether the lease of land is to be classified as a financing or operating lease at inception. Extra consideration should be given to the terms of the lease contract of the land to determine if the lessor transfers ownership of the land to the lessee by the end of the lease term in accordance with AASB 16.63.

Short-term lease of land and building

Where building and land that are both owned by the entity are leased out to a lessee under a contract, the lessor again shall classify the lease at inception in accordance with AASB 16.62. This assessment shall be performed separately for the building and land.

As with the previous example, the lessor shall classify the lease as a finance lease, if it transfers to the lessee substantially all the risks and rewards incidental to ownership of the assets, and the lessor's residual risks and rewards after the end of the lease term is not significant.

Where the lease is of a short term and does not consume a major portion of the buildings useful life, there is considered to be significant residual risk and reward after the end of the lease term, the lease would therefore considered to be an operating lease, it would be reasonable to apply the same treatment to the land in this lease given the shorter-term nature of the lease.