

HKAS 17 “LEASES”

Derek Wan [September 2006]

Hong Kong Accounting Standard (“HKAS”) 17 “Leases” issued by the Hong Kong Institute of Certified Public Accountants superseded Statement of Standard Accounting Practice (“SSAP”) 14 of same title and is effective for the accounting periods beginning on or after 1 January 2005. HKAS 17 has significant impact on entities with leasehold properties and minor impact on other lessor/lessee arrangements.

Previously, SSAP 14 allowed leasehold properties to be accounted for under SSAP 17 “Property, Plant and Equipment” under which the leasehold properties as a whole including both land and buildings were generally classified as property, plant and equipment.

With introduction of HKAS 17, the leasehold land and buildings have to be assessed separately and classified as operating or finance leases in the same way as leases of other assets. A lease is a finance lease if it transfers substantially all risks and rewards incidental to ownership whilst it is an operating lease if it does not transfer substantially such risks and rewards.

To separately classify and account for a lease of land and buildings, the minimum lease payments should be allocated between the land and the buildings elements in proportion to their relative fair values at the inception of the lease. In general the leasehold land element in Hong Kong is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. The buildings element may be finance or operating lease based on the classification criteria in HKAS 17. If it is classified as a finance lease, it is included in property, plant and equipment and accounted for in accordance with HKAS 16 “Property, Plant and Equipment”.

However, separate measurement on the land and buildings elements is not required when:

- the lease payments cannot be allocated reliably between land and buildings elements in which case the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases; or
- the lessee’s interest in the land and buildings is classified as an investment property in accordance with HKAS 40 “Investment Property” and the fair value model is adopted.

The land and buildings in Hong Kong are often acquired/leased together rather than separately. Practically, it may be difficult to determine their separate relative fair values at the inception date and an external professional valuation may be sought to measure these two elements in order to satisfy the requirements of HKAS 17.

In addition to the above major changes, HKAS 17 brings about other key change that it no longer allows the choice available to the lessors as to how to account for the initial direct costs. Under HKAS 17 they are now defined as the incremental costs directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer

lessors. They include commissions, legal fees and other internal costs that are incremental and directly attributable to negotiating and arranging the lease but exclude general overheads such as those incurred by a sales and marketing team.

Under SSAP 14, the lessors could either expense such costs immediately when incurred or amortise them over the lease term. HKAS 17 now prohibits the immediate expensing and the accounting treatment will depend on the type of leasing arrangement entering into. For finance lease other than those involving manufacturer or dealer lessors, initial direct costs should be included in the initial measurement of the finance lease receivable. This will impact the calculation of the interest rate implicit in the lease and therefore reduce the amount of income recognized over the lease term.

Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease and are recognized as an expense when the selling profit is recognized, which for a finance lease is normally at the commencement of lease term.

Initial direct costs incurred by operating lessors should be added to the carrying amount of the leased asset and recognized as expense over the lease term on the same basis as lease income.

If you encounter any problems in applying HKAS 17, please don't hesitate to consult your auditors for technical advices.