

## **TECHNICAL NOTE 03/2006 - LEASES OF LAND AND BUILDINGS IN HONG KONG**

Paul Yeung [October 2006]

The vast majority of properties in Hong Kong comprise high-rise buildings, be they residential, offices or factories. Developers of these properties usually lease lots of land from the Government and develop the land according to the lease conditions, such as to construct buildings on the land according to the specifications within a specified period. Individual units of these lots of land and buildings are usually sold as undivided shares in the lots. Interests of all parties, including future buyers of the units, are governed by the deeds of mutual covenant.

In substance and in form, "owners" of these units are a lessee of a lease of land and buildings. According to the Hong Kong financial reporting standards, the land and buildings elements of these leases should be considered separately for the purposes of lease classification.

### **The term of land leases in Hong Kong**

In general, Hong Kong has the following types of land leases:

- i) leases of land granted after 1 July 1997, which are usually for a term of 50 years from the date of grant (except for some leases for special purposes);
- ii) leases granted from 27 May 1985 (the date of entry into the Joint Declaration) to 30 June 1997, which are normally for terms expiring not later than 30 June 2047;
- iii) leases granted before 27 May 1985 and expiring before 30 June 1997 with no right of renewal. These leases have usually been extended to terms expiring not later than 30 June 2047 without payment of an additional premium but subject to payment of an annual rent from 1 July 1997; and
- iv) leases granted before 27 May 1985 and expiring after 30 June 1997. A variety of leases fall under this category. For example, it may be:
  - a. a lease for 999 years from 26 June 1843 or a later date;
  - b. a lease with an original term of 75 years expiring after 30 June 1997 with a right of renewal for one further term of 75 years;
  - c. a lease with original term of 99 years or 150 years with no right of renewal; or
  - d. a renewed lease expiring after 30 June 1997.

### **Allocation of the interests in leases of land and building**

For the purpose of lease classification under HKAS 17 "Leases", the land and buildings elements of a lease of land and buildings should be considered separately.

A characteristic of land is that it normally has an indefinite economic life. If title of land is not expected to pass to the lessee by the end of the lease term, the lease of land will be an

operating lease. All government leases for land in Hong Kong, and the land element in a lease of land and buildings, are therefore an operating lease.

When the payments for an interest in a lease of land and buildings can be allocated reliably between these two elements, the buildings element should be classified as a finance or operating lease as appropriate.

However, if the payments cannot be allocated reliably between these two elements and if it is clear that both elements are operating leases, the entire lease should be classified as an operating lease. For example, a short term lease of land and buildings for 3 years should be classified as an operating lease in its entirety.

If the lease payments cannot be allocated reliably between these two elements and both elements are not clearly operating leases, the entire lease should be classified as a finance lease. This may be the case when a qualified surveyor certified that the information necessary for a reliable allocation of the lease payments between the elements of land and buildings is not available.

### **Classification of an operating lease as an investment property**

The issue is complicated when the separate elements of the land and buildings are further classified in accordance with HKAS 16 “Property, Plant and Equipment” and HKAS 40 “Investment Properties”

An investment property is a property held by the owner (or by the lessee under a finance lease) to earn rentals or for capital appreciation or both.

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if (and only if) the property would otherwise meet the definition of an investment property.

This classification alternative is available on a property-by-property basis. That is, if an entity has classified some operating leases as an investment property, it has no obligation to classify all other similar operating leases as an investment property.

However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model.

### **Example 1**

ABC Company Limited holds two properties, Property A and Property B in Hong Kong. Both Property A and Property B are rented to a third party. The acquisition costs of the two properties can be allocated reliably between the two elements of land and buildings.

ABC Company Limited must classify the buildings element of the two properties as an investment property since they are held for rental income.

However, ABC Company Limited has the following alternatives in accounting for the land elements in the properties:

Alternative 1:

ABC Company Limited may choose to classify the land element of the two properties as payments for an operating lease.

In such a case, ABC Company still have a choice to use the cost model or the fair value model to measure the buildings element of the two properties.

Alternative 2:

ABC Company Limited may choose to classify the land element of Property A and Property B as an investment property.

In such a case, ABC Company Limited must use the fair value model to measure both the land element and the buildings element of the two properties, and separate measurement for the land element and the buildings element of the two properties is not required.

Alternative 3:

ABC Company Limited may choose to classify the land element of the Property A as an investment property and the land element of Property B as payments for an operating lease.

In such a case, ABC Company Limited must use the fair value model to measure both the land element and the buildings element of Property A. Separate measurement for the two elements of Property A is not required.

As a result of classifying an operating lease as an investment property, ABC Company Limited must use the fair value model to measure all its investment properties, including the buildings element of Property B.

**Example 2**

ABC Company Limited holds a property (Office C) for own use in Hong Kong. The acquisition cost of Office C can be allocated reliably between the two elements of land and buildings.

ABC Company Limited must classify the land element of the Office C as payments for an operating lease, and must separately classify the buildings element of Office C as an property, plant and equipment held under a finance lease, since Office C is held for own use.

ABC Company Limited may use the cost model or the fair value model to the buildings element of Office C according to its accounting policy for property, plant and equipment.

### **Example 3**

ABC Company Limited holds a property (Property D) under a 75 year lease. Property D is rented to a third party. The acquisition cost of Property D cannot be allocated reliably between the two elements of land and buildings.

ABC Company Limited must classify Property D as a property held under a finance lease, since the buildings element of the lease is not clearly an operating lease.

Property D is an investment property since it is held for rental income. ABC Company Limited may use the cost model or the fair value model to measure Property D according to its accounting policy for investment property.

### **Example 4**

ABC Company Limited holds a property (Factory E), which has a lease term of 50 years and is held for own use. The acquisition cost of Factory E cannot be allocated reliably between the two elements of land and buildings.

ABC Company Limited must classify Factory E as a property held under a finance lease, since the buildings element of the lease is not clearly an operating lease.

Factory E is a property, plant and equipment since it is held for own use. ABC Company Limited may use the cost model or the fair value model to measure for Factory E according to its accounting policy for property, plant and equipment.

### **Implications on Auditor' s Report**

#### Clients has properly allocated lease payments between the two elements

In general, if the auditor has obtained sufficient appropriate evidence regarding the allocation of lease payments to the land element and the buildings element of a lease of land and buildings, for example a report from a qualified surveyor, and if the auditor has satisfied that the lease has been properly accounted for in accordance with the relevant financial reporting standards, the auditor need not consider modify his/her opinion.

#### Clients has not allocated lease payments between the two elements

There are cases that the client asserts in the financial statements that the lease payments cannot be allocated reliably between the land element and the buildings element of the lease, and therefore has not allocated the lease payments.

Provided that the auditor has obtained sufficient appropriate evidence that there is no reliable allocation between the two elements, for example a confirmation from a qualified surveyor, and provided that the auditor has satisfied that the lease has been properly accounted for in accordance with the relevant financial reporting standards, the auditor need not consider modify his/her opinion.

However, if the auditor is of the opinion that reliable allocation is available, but the client has not made the allocation or refused to allow the auditor to engage experts to make the allocation, the auditor's scope of work would be limited and the auditor would consider modifying his/her opinion accordingly.

If the auditor has obtained sufficient appropriate evidence that reliable allocation between the two elements is available, for example a report from a qualified surveyor, not allocating the lease payments may not comply with the relevant financial reporting standards. In such cases, the auditor may disagree with the accounting treatment, and would consider modifying his/her opinion accordingly.

#### Clients has arbitrary allocated lease payments between the two elements

In some cases, the client arbitrarily allocates the lease payments to the two elements, and the allocation is not supported by a report from a qualified surveyor.

If the auditor is of the opinion that the client made the arbitrary allocation because reliable allocation may not be available, but the client refuses to allow the auditor to engage experts to confirm that a reliable allocation is not available, the auditor's scope of work would be limited and the auditor would consider modifying his/her opinion accordingly.

If the auditor has obtained sufficient appropriate evidence that there is no reliable allocation between the two elements, for example a confirmation from a qualified surveyor, the arbitrary allocation may not comply with the relevant financial reporting standards. In such cases, the auditor may disagree with the accounting treatment, and would consider modifying his/her opinion accordingly.

In rare cases, the auditor may have obtained sufficient appropriate evidence, for example a report from a qualified surveyor, that a reliable allocation between the two elements would be materially different from the arbitrary allocation. In such cases, the auditor may disagree with the accounting treatment, and would consider modifying his/her opinion accordingly.