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FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE

FRSIC Consensus 5

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

Introduction

FRSIC Consensus 5 “Split of the Minimum Lease Payments between the Land and the Building Elements” was developed by the Financial Reporting Standards Implementation Committee (“FRSIC”) and issued by the Malaysian Institute of Accountants (“MIA” or “Institute”) on 27 March 2008.

The Consensus contained herein is issued as part of the Institute’s initiatives to promote best practices in compliance with the highest standards in financial accounting.

FRSIC CONSENSUS 5**SPLIT OF THE MINIMUM LEASE PAYMENTS BETWEEN THE LAND AND THE BUILDING ELEMENTS**

FRSIC Consensus is guidance issued by MIA and shall be regarded as best practice. It should be read in conjunction with the respective applicable accounting standards.

Members of MIA are expected to observe compliance to the consensus issued. In exceptional circumstances where departure is necessary, members shall be prepared to justify the departure.

FRSIC Consensus need not be applied to immaterial items. Nothing in the FRSIC Consensus is to be construed as amending or overriding the accounting standards or other statements adopted or issued by the MASB and other relevant laws.

The Issue

1. Paragraph 15 of FRS 117 (Leases) states that "The land and buildings elements of a lease of land and building are considered separately for the purposes of lease classification." In situation where the land is classified as an operating lease and the building as a finance lease pursuant to FRS 117, an allocation of the minimum lease payments or the upfront payment between these two elements is inevitable.
2. Paragraph 16 of FRS 117 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 further provides 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".
3. In the absence of specific guidance in the accounting standards, different methods are being applied in allocating the minimum lease payments between the land and the building element.

4. Guidance is therefore needed to address the following questions:-
 - (a) What is the acceptable method(s) to allocate the minimum lease payments between the land and the building elements based on the requirements of FRS 117; and
 - (b) When are the minimum lease payments considered as “cannot be allocated reliably between the land and the building elements”?

Consensus and Basis of Consensus

5. The Committee recognised the requirements in FRS 117.16 to allocate the minimum lease payments between the land and the building elements in proportion to the relative fair values of the leasehold interests in the land element and the buildings element of the lease at the inception of the lease.
6. It is therefore essential to establish if various methods adopted by the professional valuers or internal experts of a reporting entity in the allocation of the minimum lease payments to the land element and the buildings element is in accordance with the provisions of FRS 117.16.
7. The Committee noted the basis of conclusion in BC 11 of FRS 117 which states that the allocation of the minimum lease payments between land and buildings 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 interest in the land and buildings.
8. Representatives from selected independent valuers were invited to deliberate on the issue. It is acknowledged that various methods could be adopted to allocate the minimum lease payments between the land element and the buildings element. The professional valuers explained that the selection of methods is dependent on the specific terms of the lease arrangement which often differs from one lease to another in different jurisdictions. Whichever methods are adopted, the valuer profession representatives confirmed that the leasehold interest of the leasehold land and buildings and not the fair value of the leasehold land and buildings are taken into consideration in the allocation process as guided by the standards and guidelines governing the valuers’ profession.

9. After seeking views from the professional valuers, the Committee is of the view that the valuers profession or internal expert of a reporting entity, being accredited with the requisite expertise, would be able to advise companies on the selection of an appropriate method to allocate the minimum lease payments between the land and the building elements taking into consideration that the allocation shall be weighted to reflect the lessee's interest in the land and buildings. However, as management is responsible for the preparation of the financial statements, they should ensure that the bases and assumptions used by these experts in arriving at the valuation are appropriate for such purpose.
10. In circumstances where the minimum lease payments cannot be allocated reliably between the land and the building 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.
11. Based on the above, the Committee concluded that it is acceptable to have a number of methods to allocate the minimum lease payments to the land and building elements. Reliance on professional valuer or internal expert is acceptable if the methodologies used are permissible and endorsed by the Institution of Surveyors, Malaysia. Whilst reliance could be placed on these experts to present a fair allocation of the minimum lease payments between the land and the building elements pursuant to FRS 117, the Committee emphasised that an entity shall disclose in the notes to the financial statements, judgements applied in the allocation of the minimum lease payments between the land and the building elements in accordance with FRS 101.113, Presentation of Financial Statements.
12. FRS 101.113 requires an entity to disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. For best practice, disclosure on the methods and key assumptions applied in estimating the allocated amounts is encouraged.

Issuance Date of this Consensus

13. This Consensus is issued on March 27, 2008.

References

FRS 117 "Leases"

FRS 101 "Presentation of Financial Statements"