ZAMBIA INSTITUTE OF CHARTERED ACCOUNTANTS

ACCOUNTING FOR LAND BASED ON INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) 16 LEASES

GUIDANCE NOTE #01/22

A. OBJECTIVE

The objective of this paper is to provide guidance on the accounting treatment for Leasehold Land in Zambia in accordance with the requirement of the International Financial Reporting Standards (IFRS).

IFRS 16 Leases (IFRS 16) specifies the recognition, measurement, presentation and disclosure of leasehold land as there is no conceptual basis for differentiating long-term leases of land from other leases. The IASB considered, but decided against a scope exclusions for long-term leases of land.

B. BACKGROUND

On 13th January 2016, the International Accounting Standards Board (IASB) released IFRS 16; Leases (IFRS 16) which provide a single accounting model requiring lessees to recognize assets and liabilities for all leases except for those leases that are 12 months or less or the leases have low value. The guidance now include a new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) that are recognized on the balance sheet for all operating leases.

In Zambia, ownership of land is vested in the Zambian people, but administered by the Republican President. Therefore, land in Zambia is held on leasehold basis. Accordingly, on acquisition of land from the Government, one is given either a 99 years or 14 years period as tenant or lessee from the Ministry of Lands. There is no freehold land ownership in Zambia.

The following broad scenario is applicable in the case of leasehold land ownership in Zambia as partially excerpted from the IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets and IAS 17 Leases, Staff Interpretation paper of September 2012:

- An entity or individual purchases the right over the land from the individual owner of the land in a sale and purchase agreement. The entity or individual pays an agreed amount to the land owner, and nominal administration fee and related taxes to the government. The government provides the approval for the new utilisation of the land, from right of ownership (that the individual owner has) to right to use – cultivate or build over the land (the entity will have).

- The land reverts to the government (not to the individual owner), if an entity decides not to extend or renew the right to use the land, as opposed to the transaction under 'entities' right over the owners' where the land reverts to the individual owner. The land will be a Government land—it will be under the government's administration until new applications are received from individuals or entities to use the land. If an individual or entity applies for the land, it shall pay certain administrative fees and related taxes to the government, which does not represent the fair value of the land.

C. EXTRACTS FROM AUTHORITATIVE GUIDANCE / STANDARDS / LEGISLATION / REGULATION

1. *Split between the land and buildings*

IFRS 16, B55 requires that 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.

IFRS 16, B57 requires that 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.

2. *Right to extend the lease*

IFRS 16 B37 specifies that at the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. Examples of factors to consider include, but are not limited to:

a) contractual terms and conditions for the optional periods compared with market rates, such as:

i. the amount of payments for the lease in any optional period;

ii. the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and

iii. the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

3. *Requirement to depreciate a right of use asset*

IFRS 16 provides an entity with the option of applying a cost model as per paragraph 30, where a lessee shall measure the right-of-use asset at cost:
(a) less any accumulated depreciation and any accumulated impairment losses; and
(b) adjusted for any re-measurement of the lease liability.

Furthermore paragraph 31 requires a lessee to apply the depreciation requirements in IAS 16 Property, Plant and Equipment in depreciating the right-of-use asset, subject to the requirements in paragraph 32, which states that If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right of-use asset from the commencement date to the end of the useful life of the underlying asset.

4. *Lease Payments*

IFRS 16.27 guides that at the commencement date, the lease payments included in the measurement of the lease liability comprise among others, the payments for the right to use the underlying asset during the lease term that are not paid at the commencement date, such as fixed payment less any lease incentives receivable, variable lease payments that depend on an index or a rate initially measured using the index or rate as at the commencement date, amounts expected to be payable by the lessee under residual value guarantees etc.

IFRS 16.28 further describes Variable lease payments as those that depend on an index or a rate such as payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates.

5. *Guidance under previous lease standard - IAS 17, Leases (IAS 17)*

Previously, under IAS 17 in a rule introduced in December 2003, when deciding on the accounting treatment for land, an important consideration was to determine whether land was an operating or a finance lease, and because land would normally have an indefinite economic life, most of the land elements were considered operating leases before an amendment in 2010. Subsequent to the amendment, a lease of land became subject to the general lease classification criteria of IAS 17 which required that, if a lease of land transfers substantially all of the risks and rewards incidental to ownership of the land to the lessee, then the lease was considered a finance lease; otherwise it was an operating lease.

Therefore a land lease with a term of several years could be classified as a finance lease, even if at the end of the lease term title would not pass to the lessee, because in such arrangements substantially all risks and rewards were transferred to the lessee and the present value of the residual value of the leased asset was considered negligible.

6. *Extract of Guidance under IAS 16, Property, Plant and Equipment (IAS 16)*

Under IAS 16.58, land is considered to have an unlimited useful life and is not depreciated. For other depreciable assets, the depreciable amount (cost less residual value) is allocated on a systematic basis over the asset's useful life [IAS 16.50].

If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

7. *Extract of Guidance under IAS 40, Investment Property (IAS 40)*

Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business and land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.), is investment property.

Investment properties are initially measured at cost and, with some exceptions and may be subsequently measured using a cost model or fair value model, with changes in the fair value under the fair value model being recognised in profit or loss.

D. DISCUSSION TO SUPPORT THE ACCOUNTING GUIDANCE

To address why land use is in fact a lease, it is important to address the fact patterns of land use in Zambia.

In Zambia, the current subsisting laws do not provide for freehold land tenures and vests all statutory land in the President of Zambia. As such, law relating to land in Zambia provides for leasehold of either 14 years (for individuals wanting to convert their customary land into leaseholds) or 99 years. The rights to the lessee are conferred by both the Lands and Deeds Registry Act Cap 185 and the Property Transfer Tax Act Cap 340 of the Laws of Zambia.

Section 4(1) of Cap 185 cited above provides that any document or any interest in land for a longer term than one year must be registered, Further, the interpretations section 2(i) of Cap 340 provides that any lease above five years is to be treated as a transfer of rights and attracts property transfer tax (PTT).

The fact patterns in Zambia are similar to those articulated in the IFRS Committee's interpretation of September 2012 in that payment is made directly to the individual owner to purchase the right to use land generally based on the fair value of the land. Once an individual or entity purchases the right, any rights over the land transfers to the new entity, with only the government having the right to revoke the entity's right, but only on the ground of public interest or if the entity fails to meet the administrative requirements which includes the payment of annual land rates.

Further, the right to use land can be extended and renewed indefinitely at only an insignificant cost (administrative fees and related taxes) to be paid to the government and the entity has a legally protected right to obtain the extension/renewal, provided that all the legal and administrative requirements are met and that the land is not claimed by the government to be used for public interest purposes. No compensation is provided for the land if the government revokes the entity's right when the period of the right has ended/expired or if the application to extend or renew the right is declined by the government.

To the extent an entity decides not to extend or renew the right to use the land at the end of the leasehold, as opposed to the transaction under 'entities' right over the owners' where the land reverts to the individual owner, the land reverts to the government until new applications are received from individuals or entities to use the land. If an individual or entity applies for the land, it then pays certain administrative fees and related taxes to the government. In other words, the amount of payment does not represent the fair value of the land, however the land rates would given that the land reverts to the government, not to the individual owner, if an entity does not make an extension or renewal of the land tenure, the government is identified as a lessor. Thus entities do not substantially own the land because the government has a right to reject the renewal. In addition, compensation for land would not be provided if the government revokes the entity's right when the period of the right has ended.

This is the fact pattern the IASB IFRS Interpretation Committee used to determine that there was characteristics of a lease based on the definition of a lease, which is "A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time" are satisfied. Such characteristics identified in this submission included:

a) Right to use an asset: a right to use land is a right to use an asset.
b) Existence of lessor and lessee: the government is identified as a lessor, and the entity/individual is a lessee.
c) A payment or series of payments: payment to purchase the right is made directly from the entity to the individual owner who surrenders the land to the government, and the annual land rates paid to government
d) Agreed period of time: there is an agreed period of time between the government and the entity including renewal options.

Further in the basis of conclusion, 'IFRS 16 BC78A' the IASB guided that the "*long term lease of land*" is sometimes regarded as being economically similar to the purchase of land, which prompted some stakeholders to suggest that long term leases of land should be excluded from the scope of IFRS 16. The IASB however decided not to specifically exclude such leases from the scope of IFRS 16 because:

a) There is no conceptual basis for differentiating long term leases of land from other leases, because if the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as such.

b) For a long term lease of land (for example, a 99 year lease) the present value of the lease payments is likely to represent substantially all of the fair value of the land. In this case the accounting applied by the lessee will be similar to accounting for the purchase of the land.

The board decided not exclude the lease of land from IFRS 16 for the reasons given in a and b above, and because the lease title is not transferred at the end of the lease, this gives the lessee the right to use the asset in line with the scope of IFRS 16. An entity under IFRS 16 is also required to compute the residual value of the asset and determine the present value of the 'Right of use' (ROU). This value can be applied in the determination of the depreciable amount. However, because it meets the criteria of a lease as the title is not transferred at the end of the lease, it is accounted for under the IFRS 16 rules.

Further considerations are as follows:

1. IFRS 16 BC 55 and 57 states that where there is a land buildings element in a contract, the entity is required to split the land element from the building element even if they have been joint acquired, giving credence to the different accounting treatment accorded to them.

2. IFRS 16 BC 37 requires that an entity considers if the lessee is reasonably certain to exercise an option to extend the lease. In the case of the 99-year leases in Zambia, the option rests with the Government of Zambia and not the lessee. The government has the authority to arrange and conduct the allocation of use of the land, and to determine legal relationships between land holders and the land. The government obtains the residual interest of the land by way of administration and thus ownership of the land substantially transfers to the government who is the lessor in this transaction.

   In the leases in Zambia, Government does not give any extension options in the lease agreement to the lessee.

3. IFRS 16 does require the right of use asset as defined as an asset that represents a lessee's right to use an underlying asset for the lease term to be depreciated. Should lease transfer the asset at the end of the asset then it requires the ROU to be depreciated.

   The key determinant is whether this land transaction must be treated as PPE or as a lease in accordance with IFRS 16. The key issue to be considered is whether an underlying asset can be determined in the arrangement. In the case of land leases, there is a lease agreement between the Government of Zambia and the lessee. The land in this case can be identified as the underlying asset. **NOTE:** <u>The standard does not exempt the depreciation of the right of use asset, unless if it fell in the scope of the provisions of IAS 16.</u>

E. PERTINENT QUESTIONS AND POSSIBLE RESPONSES TO BE CONSIDERED WHEN AMORTIZATION OF LAND

POSSIBLE QUESTION	RESPONSE
When there is a 14- or 99-year lease should we amortise that land over the lease period?	What is being amortised is a right to use the land and NOT the land. Such type of lease represents the right to use the asset. We amortise the amount paid in accordance with paragraph 30.
What if there is a possibility that the lease will be renewed after the 14- or 99-year period?	• We need to consider if a new fee will be paid for the extension and thereafter; • An entity has to determine a portion which relates to obtaining the initial deed/lease and a portion which will be replaced by the nominal fee.
Are infinite life intangible assets subject to amortization?	Infinite life intangible assets are NOT subject to amortization.
Does substance over form apply on amortization of leasehold land?	Yes, it does apply. What we need to determine would be, is the right of use of the asset infinite or finite. In this case the right of use asset has a defined period of 14 years or 99 years, depending

POSSIBLE QUESTION	RESPONSE
	on the remaining period of the lease term.
When does the right to use the asset expire?	The right to use the asset expires when the lease ends after 14 or 99 years, thereafter you will be required to pay an extension fee for the right to be extended beyond the 14- or 99-year period. This extension is at the discretion of the Government and not the lessee.
On what basis can we extend the amortization period beyond the lease term?	You can only extend the amortisation period beyond that if the entity has an unconditional unilateral right to renew the lease.
Does the entity have an unconditional unilateral right to renew the lease? If yes is this clearly indicated in the lease agreement?	No. In Zambia there is no unconditional unilateral right to renew the lease. The ultimate decision rests with the Government of Zambia. The lease agreements do not give the lessee the unconditional right to renew.
What if precedence reflects that the leases are likely to be renewed at the end of the lease term?	• Practice is usually that governments reserve the right to renew the lease, even if in practice they would renew the lease. • An entity also needs to consider the impact of potential changes in laws and regulations relating to the lease of land. • However, the entities with such leases will need to consider the impact of IFRS 16 adoption and that should be disclosed in the financials.
If the Government of the Republic of Zambia (GRZ) will likely renew the lease after 14 or 99 years, does this constitute an infinite asset?	If the renewal is highly likely this does not necessarily mean the asset has an infinite life, as the GRZ retains the final decision on whether to renew or cancel a lease. At the moment there seems to be no case where we may draw to definitive conclusions on whether the GRZ has cancelled leases.
Is there reasonable certainty that the lessee will obtain ownership at the end of the lease term?	No. There is no reasonable certainty that the lessee will obtain ownership at the end of the lease term. In Zambia the law states that all land belongs to the President. The GRZ also retains the right to renew the lease at its expiration.

F. CONCLUSION

Based on the authoritative guidance above; the following is the conclusion:

- There is no conceptual basis for differentiating long term leases of land from other leases, as such if the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term., it meets the lease definition of the IFRS 16.
- In Zambia, the current subsisting laws only provide for leasehold land and does not provide for freehold land tenures, and vests all statutory land in the President of Zambia. Accordingly, all land in Zambia must be treated under the provisions of IFRS 16, as it meets the definition of a lease.
- Land must be separated from the building components in accordance with IFRS 16, subject to the practical expedients.
- All land in Zambia is treated as a lease and must be accounted for as a right of use asset in accordance with IFRS 16.
- The ROU must be depreciated in accordance with IFRS 16.
- The payments (annual land rates) made to Government must be computed as fixed lease payments and added to the ROU asset and lease liability in accordance with IFRS 16, representing the obligation to pay annual land rates to government for the duration of the lease on the balance sheet.
- The transaction cost for the purchase of the land will continue to be capitalized and depreciated in line with the tenure of the land as the first part,
- Present assets held under a finance lease as property at an amount equal to the net investment in the lease.

Retrospective restatement will be required, either by applying the full retrospective approach (third balance sheet) or the modified retrospective approach (opening retained earning adjustment) to the financial statements.

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