DRAFT INTERPRETATION

HKAS-INT – 15
Operating Leases - Incentives

Paragraph 14 of HKAS 1 Presentation of Financial Statements, requires that financial statements should not be described as complying with Hong Kong Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable Interpretation. Interpretations are not intended to apply to immaterial items.

Reference: HKAS 17 *Leases*

ISSUE

1. In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. Examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

2. The issue is how incentives in an operating lease should be recognised in the financial statements of both the lessee and the lessor.

CONSENSUS

3. All incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or form or the timing of payments.

4. The lessor should recognise the aggregate cost of incentives as a reduction of rental income over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished.

5. The lessee should recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.

6. Costs incurred by the lessee, including costs in connection with a pre-existing lease (for example costs for termination, relocation or leasehold improvements), should be accounted for by the lessee in accordance with the Hong Kong Accounting Standards applicable to those costs, including costs which are effectively reimbursed through an incentive arrangement.

BASIS FOR CONCLUSIONS

7. Paragraph 35 of the Framework explains that if information is to represent faithfully the transactions and events that it purports to represent, it is necessary that transactions and events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. HKAS 8.10(b)(ii) also requires the application of accounting policies which reflect economic substance.

8. Paragraph 22 of the Framework and HKAS 1.25 require the preparation of financial statements under the accrual basis of accounting. HKAS 17.33 and HKAS 17.50 specify the basis on which lessees and lessors respectively should recognise amounts payable or receivable under operating leases.

9. The underlying substance of operating lease arrangements is that the lessor and lessee exchange the use of an asset for a specified period for the consideration of a net amount of money. The accounting periods in which this net amount is recognised by either the lessor or the lessee is not affected by the form of the agreement or the timing of payments. Payments made by a lessor to or on behalf of a lessee, or allowances in rental cost made by a lessor, as incentives for the agreement of a new or renewed lease are an inseparable part of the net amount receivable or payable under the operating lease.

10. Costs incurred by the lessor as incentives for the agreement of new or renewed operating leases are not considered to be part of those initial costs which are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income in accordance with HKAS 17.52. Initial costs, such as direct costs for administration, advertising and consulting or legal fees, are incurred by a lessor to arrange a contract, whereas incentives in an operating lease are, in substance, related to the consideration for the use of the leased asset.

11. Costs incurred by the lessee on its own behalf are accounted for using the applicable recognition requirements. For example, relocation costs are recognised as an expense in the income statement in the period in which they are incurred. The accounting for such costs does not depend on whether or not they are effectively reimbursed through an incentive arrangement as they are not related to the consideration for the use of the leased asset.

Date of Issue : [ ] 2004

Effective Date: This Interpretation becomes effective for lease terms beginning on or after 1 January 2005.

Appendix

This appendix is illustrative only and does not form part of the Interpretation. The purpose of the appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

EXAMPLE APPLICATION OF HKAS-INT-15

Example 1

An enterprise agrees to enter into a new lease arrangement with a new lessor. The lessor agrees to pay the lessee's relocation costs as an incentive to the lessee for entering into the new lease. The lessee's moving costs are 1,000. The new lease has a term of 10 years, at a fixed rate of 2,000 per year.

The accounting is:

The lessee recognises relocation costs of 1,000 as an expense in Year 1. Net consideration of 19,000 consists of 2,000 for each of the 10 years in the lease term, less a 1,000 incentive for relocation costs. Both the lessor and lessee would recognise the net rental consideration of 19,000 over the 10-year lease term using a single amortisation method in accordance with paragraphs 4 and 5 of this Interpretation.

Example 2

An enterprise agrees to enter into a new lease arrangement with a new lessor. The lessor agrees to a rent-free period for the first three years as incentive to the lessee for entering into the new lease. The new lease has a term of 20 years, at a fixed rate of 5,000 per annum for years 4 through 20.

The accounting is:

Net consideration of 85,000 consists of 5,000 for each of 17 years in the lease term. Both the lessor and lessee would recognise the net consideration of 85,000 over the 20-year lease term using a single amortisation method in accordance with paragraphs 4 and 5 of this Interpretation.