Resource Management Guide No. 117

Classifying leases with a land component for accounting purposes
Use of the Coat of Arms

The terms under which the Coat of Arms can be used are detailed on the following website: www.itsanhonour.gov.au/coat-arms.

Contact us

Questions or comments about this guide should be directed to:

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This guide contains material that has been prepared to assist Commonwealth entities and companies to apply the principles and requirements of the Public Governance, Performance and Accountability Act 2013 and associated rules, and any applicable policies. In this guide the: mandatory principles or requirements are set out as things entities and officials ‘must’ do; and actions, or practices, that entities and officials are expected to take into account to give effect to those and principles and/or requirements are set out as things entities and officials ‘should consider’ doing.
**Audience**

This Guide applies to: CFOs and CFO Units in all Commonwealth entities that have a lease agreement which includes a land component.

*This guide is designed to be read in conjunction with the relevant Australian Accounting Standard.*

**Key points**

- **Purpose:** To provide guidance on lease classification for both lessors and lessees in accordance with AASB 117 where the lease includes a land component.
- **Scope:** Applies irrespective of whether the entity is the lessee or the lessor whenever the lease includes a land component.
- **Aim:** To provide non-mandatory explanation and examples relating to the interpretation and application of Australian Accounting Standards to the above entities.
- **Reference previous guidance:** This guide replaces Accounting Guidance Note No. 2011/2.

**Resources**


**Applicable accounting pronouncements**

- AASB 117 *Leases*

**Contact information**

For further information or clarification, please email Budget Estimates and Accounting (BEA) at accountingpolicy@finance.gov.au.

**Guidance**

1. AASB 117 requires leases to be classified as either “operating” or “finance” leases (see ‘Definitions used’ below) at the inception of the lease irrespective of whether the entity is the lessee or the lessor. Where a lease contains both land and buildings each component must be assessed separately.

2. The land component of a lease can be considered a finance lease if substantially all of the risks and rewards are transferred to the lessee, even if title to the land does not transfer to the lessee at the end of the lease term.

**General principles in classifying leases**

3. As AASB 117 specifically considers land to normally have an indefinite economic life, the following principles should assist entities in classifying leases:

   - Leases with a lease term < 50 years conducted on an arm’s length basis are unlikely to transfer substantially all of the risks and rewards of land ownership to the lessee.
• Where the present value of the lease residual is > 5% of the land fair value it is unlikely that substantially all of the rewards of ownership have transferred.

4. When classifying leases, entities must also take into account any specific circumstances affecting the risks and rewards. These include, but are not limited to:

• lease terms imposing unusual obligations or restrictions on the lessee or lessor;
• lease terms providing unusual rights to the lessee or lessor;
• non-commercial arrangements; and/or
• options for title transfer or bargain purchase.

See also AASB 117 paragraphs 7-13

Specific issues in identifying and classifying the land component

5. There may be specific issues involved with identifying and classifying the land component of a lease, including:

<table>
<thead>
<tr>
<th>Identifying the land component</th>
<th>Generally, leases of premises will contain a land component, even where the premises are above or below the ground (excluding community land).</th>
</tr>
</thead>
<tbody>
<tr>
<td>The land is immaterial</td>
<td>Where the land component is immaterial, entities should refer to AASB 117 paragraph 17 and are allowed to treat the land and buildings as a single unit for the purpose of lease classification.</td>
</tr>
<tr>
<td>Cannot reliably allocate lease payments</td>
<td>Where lease payments cannot be allocated reliably between the land and building elements, AASB 117 paragraph 16 allows the entire lease to be 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.</td>
</tr>
<tr>
<td>The building is an operating lease</td>
<td>Where a lease has both land and building components and the building is classified as an operating lease, it is highly unlikely the land lease could be a finance lease.</td>
</tr>
</tbody>
</table>

Disclosure requirements

6. Entities should consider the disclosure requirements of AASB 117 and PRIMA Forms when accounting for leases.

Definitions used

• A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred (AASB 117.4).
• An operating lease is a lease other than a finance lease (AASB 117.4).