

# Lessee accounting: Farewell to Hong Kong Interpretation 4

On 1 January 2019, the Institute will withdraw its home-grown interpretation, HK-Interpretation 4 *Leases – Determination of the Length of Lease Term in respect of Hong Kong Land Leases* (HK-Int 4). The withdrawal coincides with the effective date of Hong Kong Financial Reporting Standard 16 *Leases* (HKFRS 16).

## Why was HK-Int 4 developed?

Hong Kong Accounting Standard (HKAS) 17 *Leases* requires land and buildings held under leases be amortized over the lease term, unless it is an investment property carried at fair value. The lease term includes any option to continue to lease the asset, with or without further payment, when, at the inception of the lease, it is reasonably certain that the lessee will exercise the option (HKAS 17.4).

When Hong Kong fully converged its standards with International Financial Reporting Standards in 2005, HK-Int 4 was developed to explain how to apply the lease term concept to land leases in Hong Kong, in the context of the specific land policy of the government of the Hong Kong Special Administrative Region. It was also released to address concerns regarding potential diversity in practice when accounting for land lease terms in Hong Kong.

On handover in July 1997, the land policy statement announced by the new government of the Special Administrative Region stated that non-renewable leases, may, upon expiry, be extended for a term of 50 years without payment of an additional premium at the sole discretion of the government, with the exception of short term tenancies and leases for special purposes.

A commonly asked question was whether, under HKAS 17, the government's general expression of intent was sufficient for a lessee to include an extended period, beyond the non-cancellable lease period, in their lease term calculation.

At the time, the Institute's Financial Reporting Standards Committee (FRSC), as the accounting standard setter for Hong Kong, considered that:

- HKAS 17 is clear that any future lease extension that is not reasonably certain to

be exercised at inception of the lease shall not be taken into account when calculating the lease term; and

- By Hong Kong law, the decision to extend a Hong Kong land lease is at the sole discretion of the government, not the discretion of the lessee, despite the government's expression of intent. In other words, a lessee does not have an option to continue to lease an asset at the inception of the lease.

Accordingly, the FRSC concluded that HKAS 17 requires entities to determine the land lease term by reference to the legal form and status of the lease. Specifically,

- Lessees shall not assume that the lease term of a Hong Kong land lease will be extended for a further 50 years, or any other period;
- In respect of leases in the New Territories area that will expire shortly before 30 June 2047, lessees shall assume that the legal limit in these leases to be the maximum lease term; and
- For leases that extend beyond 30 June 2047 (e.g. those with an original lease term of 999 years), lessees shall assume that any legal rights under the leases that extend the lease term to beyond 30 June 2047 will be protected for the full duration of the lease in the absence of any indication to the contrary.

HK-Int 4 did not introduce new requirements or guidance on the topic, but was issued to capture the discussion above and reinforce the application of the requirements in HKAS 17 – while preventing diverse or unacceptable practices.

## Why withdraw HK-Int 4?

HKFRS 16 will supersede HKAS 17 on 1 January 2019.

Similar to HKAS 17, HKFRS 16 requires a lessee to include, in the lease term, optional periods for which the lessee is reasonably certain to exercise. Furthermore, when determining the length of a Hong Kong land lease term, the FRSC noted that HKFRS 16 emphasizes the importance of assessing the enforceability of lease extension

options (paragraphs B34 and BC127 of HKFRS 16). As the government retains the sole discretion as to whether to renew the Hong Kong land leases upon expiry, a lessee does not have an enforceable right to extend the lease without the agreement of the government. Similar to today's practice under HKAS 17, a lessee will determine the term of a Hong Kong land lease based on the legal form and status of the lease under HKFRS 16.

The FRSC also noted that there is now a common understanding of the requirements to determine the term of a Hong Kong land lease under HKAS 17.

On this basis, in May 2016, the FRSC concluded that the requirements to determine the term of a Hong Kong land lease are unchanged from HKAS 17, and therefore decided to withdraw HK-Int 4.

## Other considerations

Entities are reminded that determining the lease term requires judgment and is a critical accounting estimate management makes. Entities are recommended to consider the additional guidance included in HKFRS 16:

- Lessor termination option (HKFRS 16.B35);
- Assessment of lessee extension and termination options (HKFRS 16.B37 to B40);
- Reassessment of extension and termination options (HKFRS 16.20 and B41); and
- Revision of lease term (HKFRS 16.21).

Finally, preparers should ensure that information which helps users of financial statements understand the judgments that management makes about the future and the sources of estimation uncertainty is disclosed in accordance with paragraph 125 of HKAS 1 *Presentation of Financial Statements*.



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