Institute of
Certified Public Accountants
of Kenya

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Guidance on Application of IAS 17 & IAS 40 with respect to Leasehold Land

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Preamble

Many enterprises in Kenya have in their possession land which is held under lease agreements with the Government. Such land has in the past been accounted for as Investment Properties or Property, Plant & Equipment (and in some cases revalued in line with the company's policy on revaluation). ***However IAS 17 paragraph 11 states that the cost of such leases should be accounted for as prepayments under non- current assets and amortised/expensed over the lease period.***

A number of enterprises that have put up buildings on the leasehold land may be inclined to feel that this justifies carrying the leasehold land under Property, Plant & Equipment or Investment Properties. ***However, paragraph 45 of IAS 16 states that: 'Land and buildings are separable assets and are dealt with separately for accounting purposes, even when they are acquired together.*** Land normally has an unlimited life and, therefore, is not depreciated. Buildings have a limited life and, therefore, are depreciable assets. ***An increase in the value of the land on which a building stands does not affect the determination of the useful life of the building.'***

Some enterprises may argue that in Kenya, long leasehold land is tantamount to ownership because such land is held under long-term leases of up to 999 years and this position is supported by the assumption that the Kenya Government will automatically renew leases for land. However, Appendix B to IAS 40 provides further guidance on the issue, and reiterates that a lessee is not permitted to treat its interest in property held under an operating lease as investment property, even if the lessee acquired its interest in exchange for a large up-front payment or the lease has a very long term.

In view of the foregoing, the following guidance has been prepared to assist members in dealing with the consequences of complying with this Standard. This guidance clarifies the treatment of leasehold land and is in line with the IASB position which clarifies that when classifying a lease of land and building, the lease should be split into two elements, a lease of land and a lease of building. The land element would be classified as an operating lease under paragraph 11 of IAS 17. The buildings element would be classified as an operating or finance lease by applying the normal conditions in IAS 17.

Council continues to provide guidance on complex issues relating to the implementation of Professional Standards with a view to enhancing compliance with the Standards. Such guidance is meant to assist in dealing with various issues and does not in anyway replace the Standards or absolve members from complying with the Standard(s) in question.

Advisory to Members.

Where a company has not complied with the Standard, the extent of non-compliance should be established in order to report the effect of misstatement in the financial statements.

Where the company does not quantify the financial impact of the departure on the enterprises' operating results, assets, liabilities, equity and cash flows for each period presented, then the auditor should quantify the effect if possible and incorporate it in the audit report unless the management does not agree with the figures involved in which case the qualification will be based on disagreement. If it is not possible to quantify the effect due to lack of adequate information then the qualification will be based on limitation of scope.

In May 2002, the IASB issued an exposure draft on proposed improvement to IASs and IAS 17 and IAS 40 are among those standards being reviewed in the improvement project. The objective of the draft is to eliminate alternatives, redundancies and conflicts in these Standards. Whilst it is appreciated that the Standards are under review, the current provisions of the Standards apply until amended.

For your guidance, a suggested note to the financial statements and audit report is included.

The following are examples of the audit reports that may be issued depending of the circumstances:

Auditors' Report
To the members of
ABC Company Limited

1. We have audited……………………….

Respective Responsibilities of the Directors and the Independent auditors

2. As described on page X, the directors are responsible………………..

Basis of Opinion

3. We conducted our audit in accordance…………………………….

Qualification

4 (a) (For leasehold land carried under Investment Property)

As discussed in Note XX to the financial statements, leasehold land has been presented in the financial statements under Investment Property at …………………… (Cost/cost less depreciation/fair value). This is not in accordance with International Accounting Standard Number 17 (IAS 17), which provides that a payment made to secure a lease for land should be presented as ***prepaid operating lease rentals*** under non current assets and, expensed/amortised over the period of the lease.

The non-compliance with IAS 17 has resulted in understatement/overstatement of expenses/amortisation costs by KShs …………….... and hence the profit and policyholders' funds (statutory funds) for the year are overstated/understated by KShs………………….. .and KShs……………. respectively.

In respect of the balance sheet, the effect of non-compliance is that the investments and revenue reserves under General Insurance business are overstated/understated by Kshs ……………. In addition, investments and policyholders funds under long term insurance business are overstated/understated by Kshs …………….

4 (b) (Leasehold land carried under Property, Plant and Equipment)

As discussed in Note XX to the financial statements, leasehold land has been presented in the financial statements under Property, Plant and Equipment at ……………………(fair value / depreciated cost /cost).This is not in accordance with International Accounting Standard Number 17 (IAS 17), which provides that a payment made to secure a lease for land should be presented as prepaid operating lease rentals under non current assets and expensed/amortised over the period of the lease.

4(b) (i) (leasehold land previously revalued and depreciated)

The non-compliance with IAS 17 has resulted in understatement/overstatement of expenses/amortisation costs by Kshs …………….. and hence the profit/loss for the year is overstated/understated by Kshs………………….The profit and policyholders' funds (statutory funds) are also overstated/understated by Kshs……………..

In respect of the balance sheet, the effect of non-compliance is that Property, Plant and Equipment, reserves and policyholders' funds (statutory funds) are overstated/understated by the same amount.

The retained earnings are overstated/understated by 20x1--- and 20x2-----

(Where leasehold land has neither been revalued nor depreciated)

The departure from IAS 17 has resulted in understatement/overstatement of expenses/amortisation costs by Kshs …………….. and hence the profit/loss and policyholders funds (statutory funds) for the year are overstated/understated by the same amount.

In respect of the balance sheet, the effect of non-compliance is that Property, Plant and Equipment is overstated/understated by Kshs ……………………………… and the reserves and policy holders funds (statutory funds) are overstated/understated by the same amount.

(For leasehold land not previously revalued but depreciated based on the original cost)

a) **if the rate used for depreciation is equal to what would have been the applicable amortisation rate**

   The departure from IAS 17 has no effect on the operating results of the company.

   In respect to the balance sheet, the effect of non-compliance is that the Property, Plant and Equipment is overstated by Kshs ……………………………… and the prepaid operating lease rentals are understated by the same amount.

b) **Where the rate used for depreciation is different from what would have been the applicable amortisation rate**

   The departure from IAS 17 has resulted in understatement/overstatement of expenses/amortisation costs by Kshs …………….. and hence the profit/loss and policyholders' funds (statutory funds) for the year are overstated/understated by the same amount.

   In respect to the balance sheet, the effect of non-compliance is that the Property, Plant and Equipment is overstated by shs…………………………… and the prepaid operating lease rentals are understated by the same amount.

   The retained earnings are overstated/understated by 20x1--- and 20x2-----

5 (a) Opinion (qualified)

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, proper books of accounts have been kept and the financial statements give a true and fair view … (as normal audit opinion).

5 (b) Opinion (adverse)

In view of the significant effect of non-compliance with the above IAS as mentioned in paragraph 4, in our opinion, proper books of account have not been kept and the financial statements do not show a true and fair view……………………

Suggested note to the financial statements

Accounting for leasehold land

Included in Investment Properties and Property, Plant and Equipment is leasehold land at cost less depreciation/fair value. This is not in accordance with International Accounting Standard Number 17 (Leases), which provides that a payment made to secure a lease for land should be presented as prepaid operating lease rentals under non current assets and, expensed/amortised over the period of the lease.

In practice, leasehold land forms an integral part of Investment Properties and/or Property, Plant and Equipment. The leasehold land issued by the Government of Kenya is under long term leases of upto 999 years and therefore to achieve a fair presentation such leasehold land has been classified as Investment Property and included in these financial statements at its fair value.

Although the treatment described above is not in accordance with IAS 17, the directors are of the opinion that the financial statements as prepared, fairly present the company's financial position, financial performance and cash flows as at 31 December 2002.

The departure from IAS 17 has resulted in an understatement/overstatement of net profit by Shs.XXX (2001 Shs.XXX), and a cumulative understatement/overstatement in net assets by Shs.XXX (2001 Shs.XXX).

	2002 Shs'000	**2001 Shs'000**
Leasehold land at fair value (included in Investment Properties/Property, Plant and Equipment)	XXX	XXX
Cost of leasehold land net of expense/amortisation at the end of the year	(XXX)	(XXX)
Accumulated fair value adjustment of leasehold land	**XXX**	**XXX**
Expense/amortisation for the year	**XXX**	**XXX**