

Accounting for jointly controlled operations

- The investor accounts for the assets it controls, the liabilities and expenses it incurs, and its share of the income from the joint operation. [3.6.370.10]

CURRENTLY EFFECTIVE REQUIREMENTS

This publication reflects IFRS in issue at 1 August 2012. The currently effective requirements cover annual periods beginning on 1 January 2012. The requirements related to this topic are derived from IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*.

FORTHCOMING REQUIREMENTS AND FUTURE DEVELOPMENTS

When a currently effective requirement will be changed by a new requirement that is issued but is not yet effective, it is referred to as a **forthcoming requirement**. The forthcoming requirements related to this topic are derived from the following.

- IFRS 11 *Joint Arrangements*, which is effective for annual periods beginning on or after 1 January 2013. The standard replaces IAS 31 and SIC-13 with respect to the classification and accounting requirements for investments in joint arrangements (currently joint ventures). The requirements of IFRS 11 are discussed in chapter 3.6A.
- IAS 28 (2011) *Investments in Associates and Joint Ventures*, which is effective for annual periods beginning on or after 1 January 2013. When a currently effective requirement will be changed by IAS 28 (2011), it is marked with a # and the impact of the change is explained in the accompanying boxed text. A brief outline of the effect of the revised standard on this topic is given in 3.6.125, 135, 195, 265 and 285.

There are no **future developments** for this topic.

3.6.10 IDENTIFYING A JOINT VENTURE

3.6.10.10 In order to determine that an entity is not an associate or a subsidiary but a 'joint venture' the following conditions are required:

- a contractual arrangement whereby two or more parties undertake an economic activity (see 3.6.20); and
- that the economic activity is subject to joint control (see 3.6.30). [IAS 31.3]

3.6.20 Contractual arrangement

3.6.20.10 The existence of a *contractual* arrangement is a key aspect of the definition of a joint venture. An entity that has its shares split evenly among its shareholders – e.g. with two shareholders each having a 50 percent interest – is not a joint venture unless there is a contractual arrangement that establishes joint control. [IAS 31.9]

3.6.20.20 The contractual arrangement between the venturers can take many forms. It could be a contract signed by the venturers, minutes of discussions between the venturers, or the joint venture

arrangement could be incorporated into the articles or by-laws of a jointly controlled entity. The form of the contractual arrangement may also depend on the requirements of the local laws and regulations. However, if the agreement is not in writing, then it nonetheless should be a valid means of evidencing a contract in the relevant jurisdiction(s). [IAS 31.10]

3.6.20.30 In our experience, it is uncommon for an entity whose shares are publicly traded to be subject to contractually established joint control.

3.6.30 Joint control

3.6.30.10 'Joint control' is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions essential to the accomplishment of the goals of the joint venture require the unanimous consent of the venturers. However, this does not preclude a joint venture from existing when some decisions do not require the consent of all the venturers, provided that significant decisions require consent by all parties. [IAS 31.3]

3.6.30.20 Joint control does not require a 50:50 economic interest. Joint control has its origin in the contractual agreement and therefore can be created between more than two venturers and with various proportionate holdings. For example, three parties with holdings in the ratio of 40:30:30 may exercise joint control if there is a contractual agreement that requires unanimous consent for all key decisions.

3.6.30.25 However, in assessing whether joint control exists, caution should be taken if there is a significant disparity in holdings. For example, consider an arrangement in which one party holds 75 percent and another party holds 25 percent. The significant disparity in holdings may indicate that joint control does not exist, because it is unlikely that a party holding 75 percent of the arrangement would accept the sharing of control of the arrangement.

3.6.30.30 Joint control also exists between two or more venturers even when another entity has an interest that does not give that entity joint control – e.g. when the respective interests are 45:45:10; as long as the two venturers with a 45 percent holding share control contractually, joint control exists. The holder of the 10 percent interest would be considered an investor in the venture as opposed to a venturer. [IAS 31.3]

3.6.40 Assessing whether joint control exists


3.6.40.10 In our view, factors that may be relevant in assessing joint control include the following.

- *The rights of each of the parties.* To convey joint control, rights should be substantive rather than protective. Substantive rights over operating decisions include the ability to approve the annual business plans; to select, terminate and set the compensation of management responsible for implementing the investee's policies and procedures; or to establish operating and capital decisions of the investee, including budgets, in the ordinary course of business. The right to approve decisions to issue shares is an example of protective rights.
- *The terms of shareholder agreements.* If there are clauses in the shareholder agreements or financial arrangements that give additional rights to one of the parties, then this may indicate that joint control does not exist (see 2.5.20).

- **How disputes between the parties are resolved.** For joint control to exist, dispute resolution procedures should be neutral and not favour one of the parties – e.g. a mutually agreed on, independent arbitrator might be used.
- **The termination provisions.** If termination clauses give an advantage to one of the parties, then this may indicate that joint control does not exist.
- **Subsequent transactions.** Transactions that are contemplated when the joint venture is set up – e.g. a sell-off by one of the parties – might indicate that no joint control exists.
- **The governance structures.** It is unlikely that joint control exists when one party has the power to appoint or remove the majority of the governing body members. This power can be exercised through a shareholders' committee such as supervisory board, executive board and/or steering committees. See 2.5.40 for further guidance.
- **The terms of any profit-sharing arrangements.** The existence of uneven profit-sharing arrangements may indicate the existence of other factors that should be considered in assessing whether there is joint control.

3.6.40.20 As an intermediate step in a business combination, the acquirer and seller may appear to exercise joint control over an entity. In our view, in these cases it is necessary to consider the overall economic effect of all the transactions related to the business combination as a whole. If the facts and circumstances indicate that joint control is not substantive – e.g. because joint control is for too short a period to have any real economic effect – then the entity should not be treated as a joint venture. See chapter 2.6 for a discussion of the general accounting requirements for business combinations.

EXAMPLE 1 – CONTROL VS ACTING IN BEST INTERESTS



3.6.40.30 Company R and Company S enter into an arrangement to develop and market a new product.

- R and S each have a 50% interest in newly formed Company T.
- R knows the local market and therefore is responsible for the operation and management of T.
- R agrees to act in the best interests of both parties when determining the financial and operating policies to be adopted by T.
- Profits will be distributed equally to both parties after deducting a fee paid to R for the operational management work.

3.6.40.35 Unless S has other rights that enable it to block policy decisions made by R, R has sole governance over the financial and operating policies of T. Therefore, T is a subsidiary of R and not a joint venture. T will be a joint venture only if the strategic financial and operating decisions require the unanimous consent of R and S; agreeing to act in the best interests of another party does not in itself establish joint control.

3.6.40.40 In our view, a special purpose entity (SPE) as defined by SIC-12 will generally not be a jointly controlled entity. When the financial and operating policies of an entity are largely predetermined, no ongoing decisions can be taken by unanimous consent of the venturers after set-up.

Therefore, the factors described in 3.6.40.10 to assess joint control are not relevant. If it is concluded that an entity does not have control over an SPE, then we believe that the entity would generally account for its interest in the SPE as a financial asset in accordance with IAS 39.

Management control

3.6.50 Joint control is assessed in terms of the ability to control the key financial and operating policies. One party may be the operator or manager of a joint venture, as long as all parties agree on key operating and financial policies collectively and the non-managing parties have the power to ensure that these are followed. [IAS 31.12]

ASSESSING THE TYPE OF JOINT VENTURE

3.6.60 There are three types of joint ventures. [IAS 31.13–14, 18–19, 24]

| TYPE | DEFINITION | EXAMPLES |
|--|--|---|
| Jointly controlled entity (see 3.6.30) | The joint activity is carried on through a separate entity. In our experience, this is the most common form of joint venture. | <ul style="list-style-type: none"> • Corporation • Partnership |
| Jointly controlled asset (see 3.6.360) | The joint activity is carried on with assets that are controlled jointly, whether or not owned jointly, but not through a separate entity. | <ul style="list-style-type: none"> • Two oil producers sharing the use of a pipeline to transport oil; both parties bear an agreed proportion of the operating expenses. • Four parties entering into an arrangement to jointly control an investment portfolio; the joint venture is evidenced by a contract, but no separate entity is formed. |
| Jointly controlled operation (see 3.6.370) | The joint activity is carried on by each venturer using its own assets in pursuit of the joint operation. | <ul style="list-style-type: none"> • Three aircraft charter entities agree to operate a charter route jointly, using their own aircraft and sharing sales revenue. • Four construction entities agree to act as a consortium to construct a hotel for a customer. One contract is signed between the customer and the members of the consortium. All four entities are party to the contract as the consortium is not a legal entity. |

3.6.70 **APPLICABILITY OF THE COMMON CONTROL EXEMPTION**

3.6.70.10 In our view, the common control exemption in accounting for business combinations also applies to the transfer of investments in jointly controlled entities between investors under common control. Although IAS 31 does not include an explicit exemption for common control transactions, proportionate consolidation follows the methodology of acquisition accounting. Therefore, we believe that it is appropriate to extend the application of the common control exemption. See chapter 5.13 for a discussion of the accounting for common control transactions. [IAS 31.33]

3.6.80 **ACCOUNTING FOR JOINTLY CONTROLLED ENTITIES**

3.6.90 **Proportionate consolidation vs the equity method**

3.6.90.10 Either the equity method or proportionate consolidation is used to account for jointly controlled entities. [IAS 31.30, 38]

3.6.90.20 The key difference between full consolidation and proportionate consolidation is that under proportionate consolidation only the investor's share of the assets and liabilities is accounted for and therefore there are no non-controlling interests (NCI) recognised. However, when a jointly controlled entity has a controlling interest in a non-wholly owned subsidiary (thereby resulting in NCI in the jointly controlled entity's consolidated financial statements) the venturer would reflect its proportionate share of that NCI if it elects to proportionately consolidate under the gross method (see 3.6.160).

3.6.90.30 In performing proportionate consolidation, the usual consolidation procedures apply. For example, inter-entity eliminations are made in proportion to the investor's interest, adjustments are made for significant events and transactions that occur when reporting periods end on different dates, and consistent accounting policies are used. See chapter 2.5 for guidance on the application of consolidation principles. Only specific issues that arise in the application of these principles to jointly controlled entities are addressed in this chapter. [IAS 31.33]

3.6.90.40 When jointly controlled entities are accounted for under the equity method, the guidance provided in 3.5.170–500 for accounting for associates applies.

3.6.100 **Consistency and change in accounting method**

3.6.100.10 The chosen accounting policy – i.e. proportionate consolidation or the equity method – is applied consistently to all jointly controlled entities from period to period. [IAS 8.13]

EXAMPLE 2 – JOINTLY CONTROLLED ENTITIES WITH DIFFERENT NATURES



3.6.100.20 Company W has investments in jointly controlled entities in Country B, which it has proportionately consolidated. During the reporting period, W invests in a jointly controlled entity in Country C. W believes that the nature of the jointly

controlled entity in Country C is different in substance from those in Country B and wishes to use the equity method to account for the jointly controlled entity in Country C.

3.6.100.25 IFRS does not permit this approach. If a policy of proportionate consolidation is adopted, then it is applied consistently to all jointly controlled entities, regardless of the nature of the jointly controlled entities.

3.6.100.30 As with other voluntary changes in accounting policy, a change in accounting policy with respect to jointly controlled entities is justified only if the change results in reliable and more relevant information (see 2.8.30).

3.6.110 **Exceptions from IAS 31**

3.6.110.10 In the investor's consolidated financial statements – or, if the investor has no subsidiaries, in its individual financial statements – use of either the equity method or proportionate consolidation for jointly controlled entities is mandatory unless the investment is held by a venture capital organisation (see 3.6.120) or is held for sale (see 3.6.130). [IAS 31.1–2]

3.6.120 **Venture capital organisations#**

3.6.120.10 IFRS contains an exemption from the requirement to apply equity accounting or proportionate consolidation for investments in jointly controlled entities held by venture capital organisations, investment funds or mutual funds, unit trusts and similar entities, including investment-linked insurance funds. The exemption is applied by designating the investments on initial recognition as at fair value through profit or loss (see 7.4.40). [IAS 31.1]

3.6.120.20 In our view, since fair value through profit or loss is a designation, it is appropriate to conclude that the choice need not be applied to all qualifying investments. However, we believe that a venture capital organisation that decided to apply IAS 31 to some investments, and IAS 39 to other investments, would need to articulate an appropriate rationale, and perhaps consider disclosure, for measuring the investments differently. See 3.5.110–140 for further information on whether an entity qualifies as a venture capital organisation.

3.6.120.30 In our experience, it is not common for venture capital organisations to be a venturer – i.e. a party that has joint control over a joint venture.

3.6.125 **FORTHCOMING REQUIREMENTS**

3.6.125.10 The exception for venture capital organisations, and certain similar entities, has been retained in IAS 28 (2011). However, it is now characterised as a measurement exemption that is an accounting policy choice rather than an investment-by-investment designation.

3.6.130 **Jointly controlled entities classified as held-for-sale#**

3.6.130.10 Jointly controlled entities that meet the criteria to be classified as held-for-sale (see 5.4.20 and 260) are measured at the lower of their existing carrying amount and fair value less costs to sell. Proportionate consolidation ceases at the time of reclassification. If the classification of a jointly controlled entity as held-for-sale ceases, then the investor reverts to proportionately consolidating the investment. See 7.3.640 for a discussion of distributions of investments in jointly controlled entities under IFRIC 17. [IAS 31.2, 43]

3.6.135 **FORTHCOMING REQUIREMENTS**

3.6.135.10 IAS 28 (2011) contains more specific guidance in respect of the application of IFRS 5 to investments in joint ventures (currently jointly controlled entities). IFRS 5 applies to an investment, or a portion of an investment, in a joint venture that meets the criteria to be classified as held-for-sale. For any retained portion of the investment that has not been classified as held-for-sale, the entity applies the equity method – since proportionate consolidation is no longer permitted as an accounting policy choice – until disposal of the portion classified as held-for-sale. After disposal, any retained interest in the investment is accounted for in accordance with IAS 39, or by using the equity method if the retained interest continues to be an associate or a joint venture.

3.6.140 **Proportionate consolidation**3.6.145 **Obligation or potential obligation to purchase equity instruments**

3.6.145.10 It could be questioned whether, by analogy to put options in an existing subsidiary, the exercise of a put option to purchase a jointly controlled entity's equity instruments should be anticipated. See 3.5.280 for further details.

3.6.150 **Applying proportionate consolidation**

3.6.150.10 Proportionate consolidation may be applied by:

- including the investor's share of each line item in the jointly controlled entity's financial statements with each relevant line item of the investor, in the same way as a normal consolidation; or
- presenting separate line items for the investor's share of each of the investee's assets, liabilities, income and expenses. [IAS 31.34]

EXAMPLE 3 – PRESENTATION OF PROPORTIONATE CONSOLIDATION

3.6.150.20 This example illustrates the different approaches permitted for presentation of the statement of comprehensive income by presenting either a combined statement of comprehensive income, with additional disclosure in the notes to the financial statements, or by presenting the jointly controlled entity's amounts separately in the statement of comprehensive income. Other items in the financial statements would be dealt with in the same way.

Approach 1: Combined presentation – Extract from the statement of comprehensive income

| | |
|-------------------------|----------|
| Revenue | 100,000 |
| Cost of sales | (60,000) |
| Gross profit | 40,000 |
| Other income | 2,000 |
| Distribution costs | (18,000) |
| Administrative expenses | (15,000) |
| Other expenses etc. | (3,000) |

Note: Included in the primary financial statements are the following amounts related to jointly controlled entities.

| | |
|-------------------------|---------|
| Revenue | 12,000 |
| Cost of sales | (7,000) |
| Gross profit | 5,000 |
| Other income | - |
| Distribution costs | (1,000) |
| Administrative expenses | (2,000) |
| Other expenses etc. | (500) |

Approach 2: Separate presentation – Extract from the statement of comprehensive income

| | GROUP | JOINT VENTURE | TOTAL CONSOLIDATED |
|-------------------------|----------|---------------|--------------------|
| Revenue | 88,000 | 12,000 | 100,000 |
| Cost of sales | (53,000) | (7,000) | (60,000) |
| Gross profit | 35,000 | 5,000 | 40,000 |
| Other income | 2,000 | - | 2,000 |
| Distribution costs | (17,000) | (1,000) | (18,000) |
| Administrative expenses | (13,000) | (2,000) | (15,000) |
| Other expenses etc. | (2,500) | (500) | (3,000) |

3.6.150.30 Approach 2 significantly increases the information contained in the primary financial statements and, depending on the nature or significance of jointly controlled entities, may be considered helpful for an understanding of the financial statements.

3.6.160 **Jointly controlled entity is a group**

3.6.160.10 A jointly controlled entity may have a controlling interest in a subsidiary in which there are NCI. An issue arises of how to proportionately consolidate the jointly controlled entity's subsidiary in the consolidated financial statements of the venturers.

- In determining whether the lease of land is a finance lease or an operating lease, an important consideration is that land normally has an indefinite economic life. [5.1.230.20]
- Immediate gain recognition from the sale and leaseback of an asset depends on whether the leaseback is classified as a finance or as an operating lease and, if the leaseback is an operating lease, whether the sale takes place at fair value. [5.1.480–490]
- A series of linked transactions in the legal form of a lease is accounted for based on the substance of the arrangement; the substance may be that the series of transactions is not a lease. [5.1.500]
- Special requirements for revenue recognition apply to manufacturer or dealer lessors granting finance leases. [5.1.340]

CURRENTLY EFFECTIVE REQUIREMENTS

This publication reflects IFRS in issue at 1 August 2012. The currently effective requirements cover annual periods beginning on 1 January 2012. The requirements related to this topic are derived from IAS 17 *Leases*, IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

FORTHCOMING REQUIREMENTS AND FUTURE DEVELOPMENTS

When a currently effective requirement will be changed by a new requirement that is issued but is not yet effective, it is marked with a # as a **forthcoming requirement** and the impact of the change is explained in the accompanying boxed text. The forthcoming requirements related to this topic are derived from IFRS 10 *Consolidated Financial Statements*, which is effective for annual periods beginning on or after 1 January 2013. A brief outline of the impact of IFRS 10 on this topic is given in 5.1.225. The requirements of IFRS 10 are discussed in chapter 2.5A.

The currently effective or forthcoming requirements may be subject to **future developments** and a brief outline of the relevant project, which may affect several aspects of lease accounting, is given in 5.1.530.

5.1.10 INTRODUCTION

5.1.10.10 The accounting treatment of a lease does not depend on which party has legal ownership of the leased asset, but rather on which party bears the risks and rewards incidental to ownership of the leased asset. [IAS 17.7]

5.1.10.20 A lease is an agreement whereby the lessor conveys to the lessee the right to use an asset for an agreed period in return for a payment or series of payments. The definition of a lease includes contracts that are sometimes referred to as 'hire' or 'hire-purchase' contracts. Although legal definitions of a lease, hire or hire-purchase agreements may vary between different legal jurisdictions, IFRS

focuses on the economic substance of the agreement. Therefore, lease accounting applies to contracts that meet the definition of a lease under IFRS and that are not exempt from IAS 17 or IFRIC 4, regardless of their legal name or definition. [IAS 17.4, 6, IFRIC 4.4]

5.1.10.30 Under IFRS, each lease is classified as either a finance lease or an operating lease; the classification determines the accounting treatment to be followed by the lessor and the lessee (see 5.1.100).

5.1.10.40 A lease is a finance lease when substantially all of the risks and rewards incidental to ownership of the leased asset are transferred from the lessor to the lessee by the agreement. Typical indicators assessed to determine whether substantially all of the risks and rewards are transferred include:

- the present value of the minimum lease payments that the lessee is required to make in relation to the fair value of the leased asset at the inception of the lease;
- the duration of the lease in relation to the economic life of the leased asset; and
- whether the lessee will obtain ownership of the leased asset.

5.1.10.50 A lease that is not a finance lease is an operating lease. [IAS 17.4]

5.1.15 SCOPE

5.1.15.10 Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources and licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of IAS 17 (see 3.3.30.15). [IAS 17.2–3]

5.1.15.20 IAS 17 applies only to agreements or components of agreements that transfer the right to use assets. It does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. [IAS 17.3]

5.1.15.30 IAS 41 (see 3.9) applies to the measurement of biological assets held by lessees under finance leases and for biological assets provided by lessors under operating leases. However, the requirements of IAS 17 apply for all other aspects of lease accounting for those assets. [IAS 17.2]

5.1.15.40 IAS 40 (see 3.4) applies to the measurement of investment property provided by lessors under operating leases and for property held by lessees that is accounted for as investment property (see 5.1.250). However, the requirements of IAS 17 apply for all other aspects of lease accounting for those assets. For example, the accounting for lease incentives will be according to IAS 17 and SIC-15 requirements (see 5.1.310.30–40). However, when the investment property is measured at fair value, an entity should not double count assets or liabilities that are recognised as separate assets or liabilities (see 3.4.160.80–100). [IAS 17.2]

5.1.20 DEFINITIONS

5.1.20.10 The definitions in IAS 17 are important in determining classification as a finance lease or as an operating lease (see 5.1.100). This classification is the basis for subsequent accounting for the lease by both the lessee and the lessor.

5.1.30 Minimum lease payments

- 5.1.30.10 Minimum lease payments are those payments that the lessee is, or can be, required to make to the lessor over the lease term. See 5.1.50 for further discussion of lease term, 5.1.160 for minimum lease payments in the context of lease classification, and 5.1.300 and 330 for minimum lease payments in the context of accounting for leases. [IAS 17.4]
- 5.1.30.11 From the lessee's point of view, minimum lease payments also include any amount guaranteed by the lessee or a party related to the lessee (e.g. residual value guarantee). From the lessor's point of view, minimum lease payments also include residual value guarantees by any third party unrelated to the lessor provided that party is financially capable of fulfilling the obligations under the guarantee. See 5.1.70 for further discussion of residual values. [IAS 17.4]
- 5.1.30.13 Both a lessee and a lessor include in minimum lease payments the exercise price of a purchase option over the leased asset held by the lessee only if it is reasonably certain at inception of the lease that the purchase option will be exercised. In addition, if the lease includes a put option under which the lessor can require the lessee to buy the asset at the end of the lease, then the lessee and the lessor include the exercise price of the put option in the minimum lease payments. This is because the put option functions economically as a residual value guarantee and the exercise price of the option is an amount that the lessee can be required to pay to the lessor. See 5.1.140 for further discussion of purchase options in the context of lease classification. [IAS 17.4]
- 5.1.30.17 Minimum lease payments do not include contingent rent amounts. See 5.1.80 for further discussion of contingent rent. [IAS 17.4]
- 5.1.30.20 Minimum lease payments do not include costs for services and taxes to be paid by and reimbursed to the lessor. Amounts owed by a lessee to a lessor may include charges for repairs and maintenance or for other services. Similarly, payments due under a lease may include charges that are reimbursements for expenditure paid by the lessor on behalf of the lessee (e.g. taxes and insurance). When there are service elements or other reimbursements included in a single payment, these elements should be separated from the minimum lease payments that relate to the right of use of the leased asset. Accordingly, when calculating the present value of minimum lease payments to evaluate lease classification, such service charges and reimbursements are excluded. [IAS 17.4]
- 5.1.30.30 As described in 5.1.510.50, IFRIC 4 provides guidance on the allocation of payments between lease payments and payments related to other elements of the arrangement. In our view, because IFRIC 4 is an interpretation of IAS 17 and the most recent guidance on the allocation of lease payments, the allocation into the two components (right of use and other services/reimbursement) should be based on the guidance in IFRIC 4; therefore, it is based on the components' relative fair values. In some cases, the allocation will require the use of an estimation technique for the fair value of the components. For example:
- estimating the lease component with reference to a lease agreement for a comparable asset that contains no other components, and estimating the payments for the other components with reference to the cost of those components together with a reasonable profit; or
 - estimating the payments for the other components with reference to comparable agreements and then deducting such payments from the total lease payments. [IFRIC 4.12–15]

5.1.30.35 The costs of services and taxes that the lessee is responsible for paying directly under other leases with similar types of property in similar locations may be used as a basis for estimating corresponding fair values under lease agreements in which these costs are included in the rental payments. Estimates of fair values for services and taxes may also be based on experience with similar property bought outright by the lessee or from other sources – for example:

- real estate taxes paid on similar property;
- property tax rate structures obtained from appropriate taxing authorities;
- estimates of insurance costs from insurance brokers; and
- experience in repairing or maintaining similar property.

5.1.30.37 Estimates of fair values for services and taxes should consider the anticipated fluctuations in these items over the lease term. For example, tax valuation methods vary by taxing authority, and these methods should be taken into consideration in evaluating whether property taxes would be expected to increase or decrease. Experience with assets that the lessee owns may also provide a basis for estimating fluctuations in the fair values of services and taxes pertaining to leased assets.

5.1.30.40 In our view, the specific nature of the guidance in IFRIC 4 overrides the general revenue allocation criteria discussed in 4.2.60.20–60.

5.1.30.50 See 5.1.375 for further guidance on lease arrangements that include service elements.

5.1.40 Inception date and commencement date of a lease

5.1.40 A distinction is made between the inception and commencement of the lease.

5.1.40.20 The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal terms of the lease. At this date:

- a lease is classified as either an operating or a finance lease; and
- in the case of a finance lease, the amounts to be recognised at the commencement of the lease are determined. [IAS 17.4]

5.1.40.30 The commencement of the lease term (also referred to as 'the commencement date') is the date from which the lessee is entitled to exercise its right to use the leased asset. This is the date of initial recognition of the lease. In other words, recognition of the lease takes place at the commencement date based on the amounts determined at the inception date.

5.1.40.40 A significant amount of time may pass between the inception date and the commencement date – e.g. when parties commit to leasing an asset that has not yet been built. In such cases, a calculation of the present value of minimum lease payments prepared to help in determining the classification of the lease covers all lease payments made from the commencement of the lease term. In respect of the period between the inception date and the commencement date in such cases, an acceptable approach is to exclude the time-value effect of the period between the inception date and the commencement date from the calculation of minimum lease payments for both classification and measurement purposes – i.e. at the commencement date, the lease is recognised based on the present value of the minimum lease payments as at the commencement date, using the discount rate at the inception date. However, if the lease payments are adjusted for changes

in the construction or acquisition cost of the leased asset, general price levels or the lessor's costs of financing the lease between the inception and commencement dates, then the effect of such changes is deemed to have taken place at inception. [IAS 17.4-5]

EXAMPLE 1 – CHANGES BETWEEN INCEPTION AND COMMENCEMENT DATES

5.1.40.45 Company B entered into a binding agreement on 1 January 2010 to lease a building from Company C. B will have the right to occupy the building from 1 January 2013, once C has finished construction of the building. The estimated fair value of the building on 1 January 2010, assuming that construction was completed at that date, was 11,000. The lease agreement states that the annual lease payments will be 10% of the construction costs incurred by C. The expected construction cost of the building was 9,000, such that the expected annual lease rental was 900 (9,000 x 10%). B starts occupying the building on 1 January 2013 as planned. The actual fair value of the building on this date is 13,000 and C's actual construction costs were 10,000, such that the annual lease payment is 1,000 (10,000 x 10%).

5.1.40.47 In order to assess the classification of the lease at inception, an acceptable approach is for B to consider the fair value of the building at inception of 11,000 and calculate the minimum lease payments using the actual construction costs of 10,000 discounted back to commencement date only – i.e. 1 January 2013 – using the discount rate at inception date. The minimum lease payments need not be discounted back to the inception date of 1 January 2010. If B assesses that the lease is a finance lease, then B will recognise the building as an asset on 1 January 2013, measured at the lower of 11,000 and the present value of the annual lease payments of 1,000 at 1 January 2013 using the discount rate at inception date.

5.1.50 Lease term

5.1.50.10 The lease term commences when the lessee is entitled to start using the leased asset. This date may be earlier than when actual use begins. For example, the lease term for a retail property may commence on 1 May 2012, but the lessee needs to customise the interior of the property before opening and operating its retail store on 1 July 2012. Even if the tenant could not start customisation until 1 June 2012, the commencement date of the lease is 1 May 2012 because this is the date on which the lessee is *entitled* to use the leased asset. [IAS 17.4]

5.1.50.20 The lease term includes the *non-cancellable* period of the contract and any further periods for which the lessee has an option to continue to lease the asset and for which, at the time of inception of the lease, it is judged reasonably certain that the lessee will exercise that option. For example, if the lease term is nine years but the lessee can cancel the lease without penalty at the end of the third and sixth years, then the non-cancellable period of the contract would be three years, unless at the time of inception of the lease it is judged reasonably certain that the lessee will not cancel the lease at the end of three years. [IAS 17.4]

5.1.50.30 IFRS does not provide specific guidance on how to assess when it should be considered 'reasonably certain' that a lessee would exercise an option to renew the lease. The assessment of the degree of certainty should be based on facts and circumstances at the inception of the lease rather than on the lessee's intentions. Factors relevant to the assessment may include, for example:

- the amount of the rentals payable in the secondary lease period compared with expected market rates for a similar asset during that period;
- the significance of continued use of the asset to the lessee's business model; and
- the ability of the lessee to recover costs that it incurs improving the leased asset.

5.1.50.40 In our view, if it is believed that a lessee will be economically compelled to renew a lease, then this indicates that renewal is reasonably certain. Conversely, if the lessee benefits from a modest discount on market rents in the secondary lease period, then this may increase the likelihood that the lessee will renew but, in the absence of other factors, will rarely demonstrate that renewal is reasonably certain.

5.1.60 Economic life and useful life

5.1.60.10 A leased asset's *economic* life is the period over which the asset is expected to be usable (e.g. by the current lessee and any subsequent user). The economic life is used when comparing the lease term with the asset's life to evaluate whether the lease is an operating or a finance lease (see 5.1.100). A leased asset's *useful* life, which may be shorter than its remaining *economic* life, is the period over which the economic benefits of the asset are expected to be consumed by the lessee. A lessee depreciates an asset capitalised under a finance lease over the shorter of the *lease term* and the asset's *useful* life, unless it is reasonably certain that the lessee will obtain ownership by the end of the lease term, in which case the depreciation period is the useful life. [IAS 17.4, 28]

5.1.60.20 In our view, when an asset that was previously leased subsequently becomes the subject of a new lease, the economic life of the asset for the purpose of assessing the lease classification of the new lease is the *remaining* economic life of the asset measured from the *commencement date* of the new lease. When there is no modification to the original lease, basing the classification on the leased asset's existing condition more accurately reflects the substance of the lease economics. For example, a new asset with an economic life of 10 years was leased under a five-year lease with no option for renewal. At the end of the lease term, the remaining economic life of the asset is assessed as seven years. Following expiry of the initial lease, the lessor grants a new five-year lease over the asset. We believe that the *economic* life for the purpose of classifying the second lease is seven years and the *useful* life is five years. [IAS 17.4]

5.1.70 Residual values

5.1.70.10 There are two types of residual value to be considered by the parties to a lease contract: *guaranteed* residual value and *unguaranteed* residual value. A 'guaranteed residual value' is the fixed or determinable amount that is required to be paid to the lessor at the end of the lease term or on disposal of the leased asset. An 'unguaranteed residual value' is the amount that the lessor expects to recover from the leased asset following the end of the term; however, realisation of that amount is not assured by a party external to the lessor. [IAS 17.4]

5.1.70.20 The amount of the minimum lease payments reflects whether the residual value is guaranteed or unguaranteed. The lessor includes in the determination of the minimum lease payments any residual value guaranteed by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. The lessee includes a guaranteed residual value in the determination of the minimum lease payments only if the lessee or a party related to the lessee has guaranteed the residual value. For a lessee, the amount included in the minimum lease payments in respect of a residual value guarantee is the maximum amount that the lessee could, in any event, be required to pay. An unguaranteed residual value is always excluded from the determination of the minimum lease payments, but is nevertheless part of the lessor's gross investment in a finance lease (see 5.1.330.10). [IAS 17.4]

5.1.70.30 See 5.1.378 for further guidance on residual value guarantees and third-party guarantees.

5.1.80 Contingent rent

5.1.80.10 The guidance in this section on the application of contingent rentals in determining minimum lease payments applies equally to both operating and finance leases. 'Contingent rent' is the portion of lease payments that is not fixed in amount. This definition specifically refers to future amounts that are not fixed because they are potential incremental payments linked to future changes in indices, sales, use of equipment etc. The calculation of minimum lease payments includes the lease payments that are known at the lease inception date, based on the then-current variable market rate or current price level. [IAS 17.4]

5.1.80.20 This can be illustrated by considering an 'interest-only' lease, in which the periodic lease payments are calculated by multiplying an underlying monetary amount by a market interest rate and, in addition, there is a final lease payment of the underlying monetary amount. In such cases, the market interest rate is being used to set the periodic lease payments. The minimum lease payments therefore include the periodic lease payments based on the market interest rate at inception of the lease plus the final repayment of the underlying monetary amount. Differences between the actual lease payments and the minimum lease payments arising from future changes in the market interest rate after inception of the lease are contingent rents.

EXAMPLE 2A – CONTINGENT RENTALS – INTEREST-BASED

5.1.80.30 The annual rentals in a five-year lease are calculated as 1,000 x Euribor, with a 'bullet' repayment of 1,000 at the end of year 5. If Euribor is 5% on inception of the lease, then the minimum lease payments would be 50 each year (1,000 x 5%) plus the bullet repayment of 1,000 in year 5. If Euribor is actually 7% in year 1, then the contingent rent in year 1 would be 20 ((7% - 5%) x 1,000). If this lease were classified as an operating lease, then the lessee would recognise the total minimum lease payments on a straight-line basis over the term of the lease, giving an annual rental expense of (50 + 1,000 / 5) = 250, and would recognise the contingent rent as incurred.

5.1.80.40 Additional considerations may apply in more complex cases, such as indexed rental payments. One acceptable way of analysing such agreements is to consider whether the index at

inception of the agreement is already included in the starting lease payments. For example, the lease agreement may identify a 'base' or 'starting' rent that is increased each year by the increase in a specified price index during that year. The agreement may state that the starting rent is 1,000 and that the annual lease payment will be 1,000 increased by the change in the consumer price index (CPI) since lease inception. As CPI is the summary of past actual price levels, under this approach the price level on any given date will already include the CPI on that date – i.e. current prices are inclusive of the current level of CPI. Under this approach, any increases in lease payments after lease inception relate to future changes in CPI and therefore are contingent rents.

EXAMPLE 2B – CONTINGENT RENTALS – INDEXED RENTALS

5.1.80.50 Company Y entered into a five-year lease for a retail property. The inception and commencement date are 1 January 2008 and rentals are payable on 31 December each year. The lease agreement specifies a starting rent of 1,000 and requires the actual lease payment on 31 December of each year to be calculated as follows.

Lease payment on 31 December in year X = 1,000 x (CPI at the end of year X / CPI at 1 January 2008)

5.1.80.60 Therefore, following the logic in 5.1.80.40, Y's minimum lease payments are 1,000 for every year of the lease. The starting rent of 1,000 already reflects the CPI at lease inception. Assuming that CPI at 1 January 2008 is 165 and it continues to rise in accordance with the indices below, then the actual rentals payable would be as follows.

| DATE | BASE RENT (A) | CPI (B) | CUMULATIVE CPI INCREASE (C) | ANNUAL RENTAL WITH CPI VARIATION (D) | CONTINGENT RENTALS (D - A) |
|------------------|------------------|------------|--------------------------------------|--|----------------------------------|
| 31 December 2008 | 1,000 | 174 | 1.05 | 1,050 | 50 |
| 31 December 2009 | 1,000 | 186 | 1.13 | 1,130 | 130 |
| 31 December 2010 | 1,000 | 194 | 1.17 | 1,170 | 170 |
| 31 December 2011 | 1,000 | 198 | 1.20 | 1,200 | 200 |
| 31 December 2012 | 1,000 | 205 | 1.24 | 1,240 | 240 |

Notes
(C) Calculated as (B / 165)
(D) Calculated as (A x C)

5.1.80.70 Not all rental increases can be ignored when calculating the minimum lease payments for a lease agreement that includes an indexation feature. The substance of the agreement helps in distinguishing between minimum lease payments and contingent rents.