



ACCOUNTING STANDARDS BOARD

INTERPRETATION OF THE STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE

EVALUATING THE SUBSTANCE OF TRANSACTIONS INVOLVING THE LEGAL FORM OF A LEASE (IGRAP 14)

Acknowledgement

This Interpretation of the Standards of Generally Recognised Accounting Practice (IGRAP) is drawn primarily from the equivalent SIC Interpretation on *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (SIC 27) issued by the International Accounting Standards Board (IASB). The IASB has issued a comprehensive body of IFRS[®] Accounting Standards and IFRIC[®] Interpretations. Extracts of SIC 27 are reproduced in this Interpretation of the Standards of GRAP with the permission of the IASB.

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Introduction

This pronouncement is set out in paragraphs .01 to .14. All paragraphs in this pronouncement have equal authority. The status and authority of appendices are dealt with in the preamble to each appendix. This pronouncement should be read in the context of its objective, its basis for conclusions and/or the basis for conclusions of its international equivalent, if applicable, the *Preface to the Standards of GRAP* and the *Framework for the Preparation and Presentation of Financial Statements*¹.

Standards of GRAP and Interpretations of the Standards of GRAP should also be read in conjunction with any directives issued by the Board prescribing transitional provisions, as well as any regulations issued by the Minister of Finance regarding the effective dates of the Standards, published in the Government Gazette.

Directives should be read in conjunction with the applicable Standards of GRAP and Interpretations of the Standards of GRAP.

¹ In June 2017, the Board replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for General Purpose Financial Reporting*.

Interpretation of the Standards of GRAP on *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

References

- GRAP 3 *Accounting Policies, Changes in Accounting Estimates and Errors*
- GRAP 9 *Revenue from Exchange Transactions*
- GRAP 11 *Construction Contracts*
- GRAP 13 *Leases*
- GRAP 19 *Provisions, Contingent Liabilities and Contingent Assets*
- GRAP 104 *Financial Instruments*

Issue

- .01 An entity may enter into a transaction or a series of structured transactions (an arrangement) with an unrelated party or parties (an investor) that involves the legal form of a lease. For example, an entity may lease assets to an investor and lease the same assets back, or alternatively, legally sell assets and lease the same assets back. The form of each arrangement and its terms and conditions can vary significantly. In the lease and leaseback example, it may be that the arrangement is designed to achieve a tax advantage for the investor that is shared with the entity in the form of a fee, and not to convey the right to use an asset.
- .02 When an arrangement with an investor involves the legal form of a lease, the issues are:
- (a) how to determine whether a series of transactions is linked and should be accounted for as one transaction;
 - (b) whether the arrangement meets the definition of a lease under the Standard of GRAP on *Leases* (GRAP 13); and, if not:
 - (i) whether a separate investment account and lease payment obligations that might exist represent assets and liabilities of the entity (e.g. consider the example described in Appendix A paragraph A2(a));
 - (ii) how the entity should account for other obligations resulting from the arrangement; and
 - (iii) how the entity should account for a fee it might receive from an investor.

Consensus

- .03 A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and take place concurrently or in a continuous sequence. (Appendix A provides illustrative examples of application of this Interpretation.)
- .04 The accounting shall reflect the substance of the arrangement. All aspects and implications of an arrangement shall be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.
- .05 GRAP 13 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. Indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under GRAP 13 include:
- (a) an entity retains all the risks and rewards incident to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement;
 - (b) the primary reason for the arrangement is to achieve a particular tax result, where applicable, and not to convey the right to use an asset; and
 - (c) an option is included on terms that make its exercise almost certain (e.g. a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).
- (Appendix B provides illustrative examples of this Interpretation.)
- .06 The definitions and guidance in paragraphs .66 to .87 of the *Framework for the Preparation and Presentation of Financial Statements*² shall be applied in determining whether, in substance, a separate investment account and lease payment obligations represent assets and liabilities of the entity. Indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and shall not be recognised by the entity include:
- (a) the entity is not able to control the investment account in pursuit of its own objectives and is not obligated to pay the lease payments. This occurs when, for example, a prepaid amount is placed in a separate investment account to protect the investor and may only be used to pay the investor, the investor agrees that the lease payment obligations are to be paid from funds in the investment

² In June 2017, the Board replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for General Purpose Financial Reporting*.

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account, and the entity has no ability to withhold payments to the investor from the investment account;

- (b) the entity has only a remote risk of reimbursing the entire amount of any fee received from an investor and possibly paying some additional amount, or, when a fee has not been received, only a remote risk of paying an amount under other obligations (e.g. a guarantee). Only a remote risk of payment exists when, for example, the terms of the arrangement require that a prepaid amount is invested in risk-free assets that are expected to generate sufficient cash flows to satisfy the lease payment obligations; and
 - (c) other than the initial cash flows at inception of the arrangement, the only cash flows expected under the arrangement are the lease payments that are satisfied solely from funds withdrawn from the separate investment account established with the initial cash flows.
- .07 Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under the Standard of GRAP on *Provisions, Contingent Liabilities and Contingent Assets*, the Standard of GRAP on *Financial Instruments* or the IFRS Standard(s) on insurance, depending on the terms.
- .08 The criteria in paragraph .20 of the Standard of GRAP on *Revenue from Exchange Transactions* shall be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as revenue that an entity might receive. Factors such as whether there is continuing involvement in the form of significant future performance obligations necessary to earn the fee, whether there are retained risks, the terms of any guarantee arrangements, and the risk of repayment of the fee, shall be considered. Indicators that individually demonstrate that recognition of the entire fee as revenue when received, if received at the beginning of the arrangement, is inappropriate include:
- (a) obligations either to perform or to refrain from certain significant activities are conditions of earning the fee received, and therefore execution of a legally binding arrangement is not the most significant act required by the arrangement;
 - (b) limitations are put on the use of the underlying asset that have the practical effect of restricting and significantly changing the entity's ability to use (e.g. deplete, sell or pledge as collateral) the asset;
 - (c) the possibility of reimbursing any amount of the fee and possibly paying some additional amount is not remote. This occurs when, for example:
 - (i) the underlying asset is not a specialised asset that is required by the entity to conduct its operations, and therefore there is a possibility that the entity may pay an amount to terminate the arrangement early; or
 - (ii) the entity is required by the terms of the arrangement, or has some or total

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discretion, to invest a prepaid amount in assets carrying more than an insignificant amount of risk (e.g. currency, interest rate or credit risk). In this circumstance, the risk of the investment's value being insufficient to satisfy the lease payment obligations is not remote, and therefore there is a possibility that the entity may be required to pay some amount.

- .09 The fee shall be presented in the statement of financial performance based on its economic substance and nature.

Disclosure

- .10 All aspects of an arrangement that does not, in substance, involve a lease under GRAP 13 shall be considered in determining the appropriate disclosures that are necessary to understand the arrangement and the accounting treatment adopted. An entity shall disclose the following in each period that an arrangement exists:
- (a) a description of the arrangement including:
 - (i) the underlying asset and any restrictions on its use;
 - (ii) the life and other significant terms of the arrangement;
 - (iii) the transactions that are linked together, including any options; and
 - (b) the accounting treatment applied to any fee received, the amount recognised as revenue in the period, and the line item of the statement of financial performance in which it is included.
- .11 The disclosures required in accordance with paragraph .10 shall be provided individually for each arrangement or in aggregate for each class of arrangement. A class is a grouping of arrangements with underlying assets of a similar nature (e.g. power plants).

Transitional provisions

- .12 *All changes resulting from the application of this Interpretation shall be accounted for in accordance with the requirements of the Standard of GRAP on Accounting Policies, Changes in Accounting Estimates and Errors.*

Effective date

Initial adoption of the Standards of GRAP

- .13 *This Interpretation becomes effective with reference to the effective date of the applicable Standards of GRAP as determined by the Minister of Finance in a regulation to be published in accordance with section 91(1)(b) of the Public Finance Management Act, Act No. 1 of 1999, as amended.*



Entities already applying Standards of GRAP

- .14** *An entity shall apply this Interpretation for annual financial statements covering periods beginning on or after 1 April 2011.*

Appendix A

Linked transactions

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

- A1 This Interpretation requires consideration of whether a series of transactions that involve the legal form of a lease are linked to determine whether the transactions are accounted for as one transaction.
- A2 Extreme examples of transactions that are viewed as a whole and accounted for as single transactions, include:
- (a) An entity leases an asset to an investor (the headlease) and leases the same asset back for a shorter period of time (the sublease). At the end of the sublease period, the entity has the right to buy back the rights of the investor under a purchase option. If the entity does not exercise its purchase option, the investor has options available to it under each of which the investor receives a minimum return on its investment in the headlease - the investor may put the underlying asset back to the entity, or require the entity to provide a return on the investor's investment in the headlease.

The predominant purpose of the arrangement is to achieve a tax advantage for the investor, where applicable, which is shared with the entity in the form of a fee, and not to convey the right to use an asset. The investor pays the fee and prepays the lease payment obligations under the headlease. The agreement requires the amount prepaid to be invested in risk-free assets and, as a requirement of finalising the execution of the legally binding arrangement, placed into a separate investment account held by a trustee outside of the control of the entity. The fee is retained by the entity.

Over the term of the sublease, the sublease payment obligations are satisfied with funds of an equal amount withdrawn from the separate investment account. The entity guarantees the sublease payment obligations, and will be required to satisfy the guarantee should the separate investment account have insufficient funds. The entity, but not the investor, has the right to terminate the sublease early under certain circumstances (e.g. a change in local tax law causes the investor to lose part or all of the tax benefits, or the entity decides to dispose of (e.g. replace, sell or deplete) the underlying asset) and upon payment of a termination value to the investor. If the entity chooses early termination, then it would pay the termination value from funds withdrawn from the separate investment account, and if the amount remaining in the separate investment account is insufficient, the difference would be paid by the entity. The underlying asset is a specialised asset that the entity requires to conduct its business.



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- (b) An entity leases an asset to another entity for its entire economic life and leases the same asset back under the same terms and conditions as the original lease. The two entities have a legally enforceable right to set off the amounts owing to one another, and an intention to settle these amounts on a net basis.
- (c) An entity (Entity A) leases an asset to another entity (Entity B), and obtains a non-recourse loan from a financier (by using the lease rentals and the asset as collateral). Entity A sells the asset subject to the lease and the loan to a trustee, and leases the same asset back. Entity A also concurrently agrees to repurchase the asset at the end of the lease for an amount equal to the sale price. The financier legally releases Entity A from the primary responsibility for the loan, and Entity A guarantees repayment of the non-recourse loan if Entity B defaults on the payments under the original lease. Entity B's credit rating is assessed as AAA and the amounts of the payments under each of the leases are equal. Entity A has a legally enforceable right to set-off the amounts owing under each of the leases, and an intention to settle the rights and obligations under the leases on a net basis.
- (d) An entity (Entity A) legally sells an asset to another entity (Entity B) and leases the same asset back. Entity B is obligated to put the asset back to Entity A at the end of the lease period at an amount that has the overall practical effect, when also considering the lease payments to be received, of providing Entity B with a yield of JIBAR plus 2 per cent per year on the purchase price.

Appendix B

The substance of an arrangement

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

- B1 This Interpretation requires consideration of the substance of an arrangement to determine whether it includes the conveyance of the right to use an asset for an agreed period of time.
- B2 In each of the examples described in Appendix A, the arrangement does not, in substance, involve a lease under GRAP 13 for the following reasons:
- (a) in the example described in Appendix A paragraph A2(a), the arrangement is designed predominantly to generate tax benefits that are shared between the two entities. Even though the periods of the headlease and sublease are different, the options available to each of the entities at the end of the sublease period are structured such that the investor assumes only an insignificant amount of asset risk during the headlease period. The substance of the arrangement is that the entity receives a fee for executing the agreements, and retains the risks and rewards incident to ownership of the underlying asset.
 - (b) in the example described in Appendix A paragraph A2(b), the terms and conditions and period of each of the leases are the same. Therefore, the risks and rewards incident to ownership of the underlying asset are the same as before the arrangement. Further, the amounts owing are offset against one another, and so there is no retained credit risk. The substance of the arrangement is that no transaction has occurred.
 - (c) in the example described in Appendix A paragraph A2(c), Entity A retains the risks and rewards incident to ownership of the underlying asset, and the risk of payment under the guarantee is only remote (due to the AAA credit rating). The substance of the arrangement is that Entity A borrows cash, secured by the underlying asset.
 - (d) in the example described in Appendix A paragraph A2(d), Entity A's risks and rewards incident to owning the underlying asset do not substantively change. The substance of the arrangement is that Entity A borrows cash, secured by the underlying asset and repayable in instalments over the lease period and in a final lump sum at the end of the lease period. The terms of the option preclude recognition of a sale. Normally, in a sale and leaseback transaction, the risks and rewards incident to owning the underlying asset sold are retained by the seller only during the period of the lease.



Comparison with the SIC Interpretation on *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (December 2001)

This Interpretation is drawn primarily from the SIC Interpretation on *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (SIC 27). The main differences between this Interpretation and SIC 27 are as follows:

- This Interpretation uses different terminology, in certain instances, from SIC 27. The most significant examples are the use of the terms “revenue” and “operation”. The equivalent terms in SIC 27 are “income” and “business”.
- As the Standard of GRAP on *Presentation of Financial Statements* (GRAP 1) does not incorporate the International Accounting Standards Board improvements on the statement of comprehensive income, this Interpretation has been aligned with the principles in GRAP 1.