

ACCOUNTING FOR ARRANGEMENTS - PART I

INTRODUCTION

Accounting is governed by the principle of 'substance over form'. This means transactions are accounted for and presented in financial statements in accordance with their substance and economic reality, and not merely their legal form. IAS 17 (AC 105) defines a lease as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. Based on the substance over form principle, transactions that in substance transfer the right to use an asset for an agreed period of time, in return for a series of payments, are accounted for as a lease transaction in terms of IAS 17 (AC 105), irrespective of the legal form of the arrangement.

In some cases it is simple to determine whether, in substance, a transaction involves a lease transaction. This is, for example, the case where an entity intends to lease an asset, and this intention is also evident from a legal transaction in the form of a lease agreement. Based on the substance over form principle, however, a situation could arise where a transaction does not take the legal form of a lease, but in substance conveys the right to use an asset. On the other hand, a transaction might take the legal form of a lease, while in substance it does not convey the right to use the asset. For these types of transactions it is more difficult to determine whether the transaction should be accounted for in terms of IAS 17 (AC 105), because the substance of the arrangement and the legal form thereof do not agree.

The International Financial Reporting Interpretations Committee (IFRIC) and the body which preceded it, the Standards Interpretation Committee (SIC), have issued two documents that provide more guidance on the application of the substance over form principle in the case of leases, namely:

- (a) IFRIC 4 (AC 437), *Determining whether an Arrangement contains a Lease* (which is effective for annual periods beginning on or after 1 January 2006); and
- (b) SIC 27 (AC 427), *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (which has been effective since 31 December 2001).

IFRIC 4 (AC 437) deals with arrangements that do not take the legal form of a lease, but in substance may convey a right to use an asset in return for a payment or series of payments (these are also generally referred to as 'embedded leases'). On the other hand, SIC 27 (AC 427) deals with transactions that involve the legal form of a lease, but in substance may not convey the right to use an asset.

The purpose of these articles is to consider the application of IFRIC 4 (AC 437) and SIC 27 (AC 427) and the interaction of these two interpretations with IAS 17 (AC 105) and other accounting principles. In this article, the first of two, the implications of IFRIC 4 (AC 437) are considered.

IFRIC 4 (AC 437)

Some transactions may convey the right to use an asset for an agreed period of time in exchange for a payment or series of payments, even though these transactions may not take the legal form of a lease. Such transactions may include outsourcing arrangements (for example, the outsourcing of an entity's data processing functions), take-or-pay contracts (in which the purchaser must make specified payments regardless of whether the purchaser takes delivery of the contracted products or services), and so on. IFRIC 4 (AC 437) establishes the criteria that should be used to determine whether such arrangements are or contain, in substance, lease transactions that should be accounted for in terms of IAS 17 (AC 105).

IFRIC 4 (AC 437).06 determines that an arrangement that does not take the legal form of a lease contains or is a lease:

1. If the fulfilment of the arrangement is dependent on the use of a specific asset; and
2. If the arrangement conveys a right to use the asset.

Both criteria must be met before one can conclude that the arrangement, in substance, is or contains a lease transaction. These two criteria are considered further below.

The fulfilment of the arrangement is dependent on the use of a specific asset – IFRIC 4 (AC 437)§07-08

A specific asset needs to be identified, because the definition of a lease in IAS 17 (AC 105) states that a lease is an agreement that

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conveys the right to use an asset. In an arrangement that does not take the legal form of a lease, the asset may be identified either explicitly or implicitly.

Even though the arrangement may identify the asset explicitly, one still has to determine whether the fulfilment of the arrangement is dependent on the use of that explicitly identified asset. IFRIC 4 (AC 437)§07 stipulates that an asset explicitly identified in an agreement is only a 'specific asset' if the supplier does not have the *right and ability* to use any other asset (not specified in the arrangement) to supply the goods or services in terms of the arrangement. The supplier retains the *right* to use other assets to supply the goods or services if the supplier has other assets, not specified in the arrangement, which the supplier could use to deliver the goods or services, and the agreement does not preclude the use of these assets to supply these goods or services. Even if the supplier has the right to use other assets to supply the goods or services, one needs to determine whether the supplier has the ability to use these other assets. The supplier only has the *ability* to do so if it is economically feasible or practical for the supplier to perform his/her obligations by using other assets.

For example, a mining company may contract a five year electricity supply agreement with an electricity provider to supply one of its mines with electricity. The electricity is currently sourced from a power plant that is situated right next to the mine. The agreement between the two parties identifies the power plant next to the mine as the plant from which the electricity will be supplied. Even though the asset is explicitly identified in the agreement, it needs to be determined whether the electricity supplier can only meet its obligation in terms of the agreement with the power plant that is situated next to the mine. This depends on whether the electricity provider has the right and the ability to source power to the mine from other power plants. If the electricity supplier owns other power plants and the contract does not preclude the use of another plant to supply the electricity, the supplier may have the *right* to satisfy this obligation with other assets. However, given the location of the mine, the supplier might not have the *ability* to source power from other plants, as it might not be economically feasible or practical to do so. In such a case, the fulfilment of the arrangement is dependent on the use of a specific asset.

If an agreement does not explicitly identify an asset, the asset may still be implicitly identified. This may, for example, be the case:

- If it is not economically feasible or practical for the supplier to perform the given obligation by using alternative assets; or
- If the supplier only owns one suitable asset with which it can perform the obligation in terms of the agreement; or
- If the asset used to fulfil the contract needs to be at a particular location or is specialised to the purchaser's needs; or
- If the supplier is a special purpose entity formed for a limited purpose. ➡

If the agreement is not dependent on the use of a specific asset, the agreement does not involve a lease, and it is then not accounted for in terms of IAS 17 (AC 105)

If the application of the abovementioned tests results in the conclusion that the agreement is not dependent on the use of a specific asset, the agreement does not involve a lease, and it is then not accounted for in terms of IAS 17 (AC 105). If the conclusion is reached that the fulfilment of the agreement is dependent on the use of a specific asset, it needs to be determined whether the arrangement conveys a right to use the asset.

The arrangement conveys the right to use the asset - IFRIC 4 (AC 437)§09

According to IFRIC 4 (AC 437)§09, an arrangement conveys the right to use an asset if the arrangement conveys the right to the purchaser to control the use of the underlying asset.

Paragraph 9 of the Interpretation specifies that the right to control the use of the underlying asset can be conveyed if any of the following conditions are met:

- The purchaser has the ability or right to operate the asset while obtaining or controlling more than an insignificant amount of output or other utility of the asset. A purchaser's ability to operate the asset may be evidenced by the purchaser's ability to hire, fire or replace the operator of the asset or the ability to specify significant operating policies and procedures in arrangement with the supplier (as opposed to a right to monitor the supplier's activities) and the supplier has no ability to change such policies and procedures.
- The purchaser has the ability or right to control physical access to the asset while obtaining or controlling more than an insignificant amount of output or other utility of the asset. This means that the purchaser has the ability to physically control the use of the asset through access. In such cases, the purchaser would have the ability to restrict the access of others to the economic benefits of the underlying asset.
- The price that the purchaser pays for the output is neither contractually fixed per unit of output, nor equal to the current market price per unit of output, as of the time of the delivery of the output. The likelihood is also remote that other parties will take more than an insignificant amount of the output or other utility that will be produced by the asset during the term of the arrangement.

In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier, regardless of whether the purchaser uses the underlying asset or obtains the output from the asset. Payments are therefore made for the right to use the asset, rather than for its actual use or output.

Again, for example, if the mining company mentioned earlier has the ability or right to operate the asset or the ability or right to control physical access to the asset, the agreement conveys the right to use the asset. Similarly, if the price that the mining company pays for the electricity is a contractually fixed price, irrespective of the actual output of electricity actually used, and if it is remote that other parties will take more than an insignificant amount of the output of the power plant, the agreement conveys a right to use the asset to the mining company.

Accounting for arrangements that contain a lease


Once an entity has identified that an arrangement which does not take the legal form of a lease does in fact contain a lease, the accounting principles established by IAS 17 (AC 105) become applicable. This means that the entity must use IAS 17 (AC 105)§07-19 to classify the lease either as an operating lease or as a finance lease.

If an arrangement contains a lease and the lease is an operating lease, applying IFRIC 4 (AC 437) is likely to result in a situation where the same assets, liabilities and expenses are recognised as if no lease had been identified. It should, however, be noted that IAS 17 (AC 105) requires lessors and lessees to recognise operating lease payments on a straight-line basis over the lease term, and adjustments may therefore be required to the recognition profile of the lease payments.

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If an arrangement contains a lease, and the lease is a finance lease, applying IFRIC 4 (AC 437) could result in significant accounting implications for both the lessor and the lessee. This is so because, under finance lease accounting, the lessor derecognises the asset that is used to fulfil the arrangement from its balance sheet and recognises a finance lease debtor, while the lessee recognises the asset on its balance sheet, as well as a corresponding finance lease liability. Previously, entities might have accounted only for the cash transactions under take-or-pay and other similar arrangements. Application of IFRIC 4 (AC 437) together with the finance lease requirements of IAS 17 (AC 105) results in a very different accounting treatment, as the cash payments allocated to the lease element of the arrangement are then effectively allocated between a repayment of the finance lease obligation and finance costs (in the case of the lessee) or a settlement of the finance lease debtor and finance income (in the case of the lessor).

SUMMARY

IFRIC 4 (AC 437) poses the question whether all transactions that are in substance leases are accounted for in terms of IAS 17 (AC 105) (completeness of lease transactions). IFRIC 4 (AC 437) therefore requires those who prepare financial statements to consider all supply and service agreements that are legally not leases, in order to determine whether they are in substance lease arrangements. SIC 27 (AC 427), on the other hand, poses the question whether all transactions that take the legal form of a lease are actually, in substance, lease transactions that should be accounted for in terms of IAS 17 (AC 105) (existence or occurrence of lease transactions). In the second article of this series of two articles the implications of SIC 27 (AC 427) will be considered. 

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