

ACCOUNTING FOR ARRANGEMENTS – PART 2



INTRODUCTION

Accounting is governed by the principle of 'substance over form'. This means that transactions are accounted for and are presented in financial statements in accordance with their substance and economic reality and not merely in accordance with their legal form. In the first article of this series of two articles it was established that the substance over form principle could result in certain arrangements being accounted for in terms of IAS 17 (AC 105) – Leases, even though these arrangements do not take the legal form of a lease. IFRIC 4 (AC 437) – Determining whether an Arrangement contains a Lease (which is effective for annual periods beginning on or after 1 January 2006), establishes the principles to determine whether an arrangement, that does not take the legal form of a lease, is or contains a lease that must be accounted for in terms of IAS 17 (AC 105).

SIC 27 (AC 427) - *Evaluating the Substance of Transactions Involving the Legal form of a Lease* (which has been effective since 31 December 2001), continues the application of the substance over form principle to leases. This interpretation deals with transactions that take the legal form of a lease, but that in substance may not convey the right to use an asset. The purpose of this article is to consider the application of SIC 27 (AC 427) and the way this interpretation interacts with IAS 17 (AC 105) and other accounting principles.

SIC 27 (AC 427)

Structured deals often contain legal leases as part of the combined arrangements, but these leases may, in substance, not necessarily convey the right to use an asset. People may enter into structured deals for various reasons, for example, to obtain financing or to achieve a certain tax advantage. A legal lease is normally one component of a total structured package that contains various elements, for example, sale-and-leaseback transactions or lease-and-leaseback transactions. SIC 27 (AC 427) stipulates that a series of transactions that involve the legal form of lease is linked and accounted for as one transaction when the overall economic effect (that is the substance) cannot be understood without reference to the series of transactions as a whole. In other words, the accounting treatment of the lease component of a structured deal is not considered in isolation when the lease is negotiated as part of a series of transactions that attempt to achieve a specific economic effect.

SIC 27 (AC 427)§05 lists three indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under IAS 17 (AC 105):

1. The 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; or
2. The primary reason for the arrangement is to achieve a particular tax result, and not to convey the right to use an asset; or
3. An option is included on terms that make its exercise almost certain, for example, a put option that is exercisable at a price sufficiently higher than the expected fair value when the option becomes exercisable.

One transaction that would satisfy the first indicator is a sale-and-finance leaseback transaction that has the economic effect of raising financing for the lessee. As the lessee has the same right to use the asset before and after the sale-and-leaseback transaction, the transaction does not convey the right to use the asset and should be accounted for in accordance with its economic substance, namely as a financing arrangement with the asset as its security. Although these types of transactions are not subject to lease accounting in terms of IAS 17 (AC 105), the accounting implications of the substance of the transactions is addressed by IAS 17 (AC 105)§58-66. The purpose of SIC 27 (AC 427) is to address other structured transactions that are not specifically covered

by IAS 17 (AC 105).

Appendix A to SIC 27 (AC 427) deals with four series of transactions that involve the legal form of a lease but, in substance, do not convey the right to use an asset. These transactions are considered further below.


Lease-and-leaseback arrangements to achieve tax advantages

Example

An entity can lease (headlease) an asset to another entity (the investor) and lease back the same asset (sublease it) for a shorter period of time. The investor prepays the lease payment obligations under the headlease.

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The agreement requires the amount that is prepaid to be invested in risk-free assets and, as a requirement of finalising the execution of the legally binding agreement, it must be placed into a separate investment account held by a trustee outside the control of the entity. Over the term of the sublease, the sublease payment obligations are satisfied with funds of an equal amount that are withdrawn from the separate investment account. At the end of the sublease period, the entity has the right to buy back the rights



At the end of the sublease period, the entity has the right to buy back the rights from the investor under a purchase option. If the entity does not exercise its purchase option, there are several options available to the investor.

from the investor under a purchase option. If the entity does not exercise its purchase option, there are several options available to the investor, under each of which the investor receives a minimum return on the investment in the headlease.

Application of SIC 27 (AC 427)

As discussed earlier, the three indicators listed in SIC 27 (AC 427)§05 may individually demonstrate that an arrangement is, in substance, not a lease arrangement. In this scenario, however, at least two of the indicators are present, and are discussed below.

The first indicator set out in SIC 27 (AC 427)§05 applies to this series of transactions, because the entity retains all the risks and rewards incident to ownership of the underlying asset and enjoys substantially the same rights to its use as before the arrangement. This is as a result of the fact that the entity still retains the right to use the asset during and after the sublease period, and therefore, the arrangement has not conveyed the right to use the asset. The entity retains the right to use the asset during the sublease period as a result of the sublease agreement. The entity also retains the right to use the asset after the sublease period, as a result of the option held by the entity to repurchase the rights from the investor for the remaining period of the headlease and the options available to the investor if the option of the entity is not exercised. This has the economic effect that the right to use the asset also remains with the entity after the sublease has expired. The

lease component of this series of transactions may, therefore, not be accounted for in terms of IAS 17 (AC 105), as no right to use the asset is conveyed.

In terms of the second indicator set out in SIC 27 (AC 427)§05, the predominant purpose of such a transaction is normally to achieve a tax advantage for the investor, which is shared with the entity in the form of a fee, and not to convey the right to use an asset (it should be borne in mind that, in South Africa, such a transaction might fall foul of the anti-avoidance provisions of section 103 of the Income Tax Act).

As it is not appropriate to account for the lease component of the series of transactions in terms of IAS 17 (AC 105), more guidance is given in SIC 27 (AC 427)§06 on how to account for this transaction in accordance with its economic substance.

Lease-and-leaseback arrangements with no economic effect

Example

In lease-and-leaseback arrangements with no economic effect, 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 in 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.

Application of SIC 27 (AC 427)

As the terms and conditions and period of each of the leases are the same, the risks and

rewards incident to the ownership of the underlying asset are the same as before the arrangement (first indicator in paragraph 5 of SIC 27 (AC 427)). The lease component of this series of transactions may not be accounted for in terms of IAS 17 (AC 105), as no right to use the asset is conveyed. The substance of the arrangement is that no transaction has occurred, and consequently, no transactions are recorded.

Sale-and-leaseback transactions not entered into to obtain financing

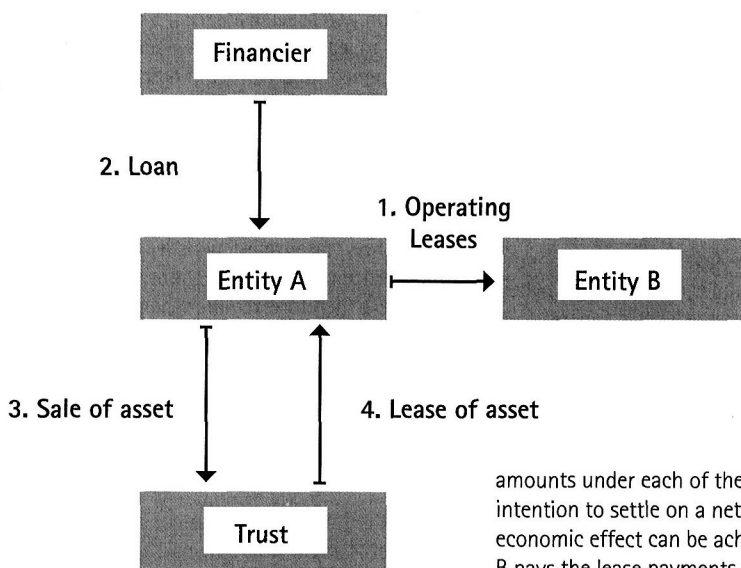
Example

Under such a scenario, Entity A might lease an asset under an operating lease to Entity B and obtain a loan from a financier (by using the asset as collateral). Subsequent to these two transactions (the lease and the financing), Entity A enters into a series of transactions which need to be considered in terms of SIC 27 (AC 427).

Entity A sells the asset (subject to the lease and the loan) to a trust, and in order to meet its obligations under the lease arrangement with Entity B, leases the same asset back from the trust. Entity A also concurrently

agrees to purchase the asset back from the trust 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. This means that the trust is legally obligated to repay the loan to the financier. Entity A guarantees repayment of the 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 offset the amounts owing under each of the leases (operating lease to Entity B and lease from the trust), and an intention to settle the rights and obligations under the leases on a net basis.

The transaction can be depicted as follows:



amounts under each of the leases and an intention to settle on a net basis, the same economic effect can be achieved if Entity B pays the lease payments directly to the trust in settlement of Entity A's obligation to the trust.

Application of SIC 27 (AC 427)

Because the overall economic effect of Transactions 3 and 4 cannot be understood without reference to the series of transactions as a whole, the two transactions are linked and must be accounted for as one transaction, in accordance with the economic substance of the combined transactions.

The economic substance may be determined as follows:

- Entity A will receive a cash inflow over the term of the lease from Entity B.
- As the amounts of payments under each lease are equal, Entity A will pass the cash flows received from Entity B to the trust in order to meet its lease obligations under the lease with the trust. As Entity A has a legally enforceable right to offset the

- The trust uses the cash inflows from the lease with Entity A to repay the loan to the financier.
- If Entity B defaults on the payment of the original lease, Entity A is liable in terms of the guarantee. However, based on Entity B's credit rating of AAA, the likelihood that this will happen is remote.
- Because Entity A agrees to repurchase the asset from the trust at the price that it has been originally sold to the trust, the risk of changes in the fair value of the asset remains with Entity A.
- Prior to Transactions 3 and 4, Entity A took all the risks and reaped all the rewards incident to the ownership of the asset (risks and rewards have not been passed to Entity B, as this is only an operating lease).

After Transactions 3 and 4, the situation is no different, as Entity A retains the risks

and rewards (changes in the fair value of the underlying asset, income from the asset, etc.) incident to the ownership of the asset, despite the sale-and-leaseback transaction entered into with the trust.

- It is not possible to argue that the sale-and-leaseback transaction is entered into to obtain financing, because Entity A has already obtained financing from the bank prior to Transactions 3 and 4.
- The transaction might have been entered into to obtain a tax advantage for Entity A. The transaction results in the repayments on the loan agreement with the financier being converted into lease payments that are paid to the trust. Provided that the transaction does not fall foul of section 103 of the Income Tax Act, this result in a situation where the capital component of the loan repayment is tax deductible for Entity B.
- SIC 27 (AC 427) therefore concludes that the net result of the arrangement (transactions 3 and 4) does not change the original position (transactions 1 and 2) prior to the series of transactions, namely that Entity A takes the risks and reaps

In lease-and-leaseback arrangements with no economic effect, 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 in the original lease.

Normally, in a sale and operating leaseback transaction, the seller only retains the risks and rewards incident to owning the underlying asset sold during the period of the lease.

the rewards incident to an asset which is leased to Entity B in an operating lease and the asset is used as security in a financing transaction with the financier. Transaction 4 is therefore not accounted for in terms of IAS 17 (AC 105), as it does not convey the right to use the asset.

Sale-and-leaseback transactions entered into to obtain financing

Example

Entity A legally sells an asset to Entity B and leases back the same asset. Entity B is obligated to put the asset back to Entity A at the end of the lease term at an amount that has the overall economic effect (when one also considers the lease payments to be received) of providing Entity B with a yield of the Johannesburg Interbank Agreed Rate (JIBAR) plus 2% per year on the purchase price (the price at which Entity B purchased the asset from Entity A).

Application of SIC 27 (AC 427)

Normally, in a sale and operating leaseback transaction, the seller only retains the risks and rewards incident to owning the underlying asset sold during the period of the lease. IAS 17 (AC 105) regards such a transaction as a normal sale transaction and any profit or loss on the sale of the transaction is recognised immediately in profit or loss (provided that the lease payments and sales price are at fair value).

In this example, however, Entity A's risks and rewards incident to owning the underlying asset do not change substantively, as the repurchase agreement has the overall economic effect that Entity A also retains the risks and rewards incident to owning the underlying asset after the lease term expires. IAS 17 (AC 105) regards a sale and finance leaseback as a transaction whereby the lessor provides finance to the lessee, with the asset as security. This principle is reinforced by SIC 27 (AC 427), which requires the series of transaction (sale and leaseback) to be accounted for as a single financing arrangement. It should be remembered that although a sale and finance leaseback are not subject to lease accounting in terms of IAS 17

(AC 105), the accounting treatment for the substance of the transaction is addressed by IAS 17 (AC 105)§58-66.

SUMMARY

SIC 27 (AC 427) and IFRIC 4 (AC 437) question two specific assertions with regard to lease transactions made by the management of an entity in preparing its financial statements, namely existence, occurrence and completeness. SIC 27 (AC 427) poses the question whether all transactions that have been accounted for in terms of IAS 17 (AC 105) are actually, in substance, lease transactions (existence or occurrence of lease transactions). SIC 27 (AC 427), therefore, requires the preparers of financial statements to consider arrangements where legal leases form part of a structured transaction to determine whether these arrangements, or part thereof, should be accounted for in terms of IAS 17 (AC 105).

IFRIC 4 (AC 437), which was considered in the first article of this two-part series, poses the question whether all transactions, which are legally not leases, but are in substance leases, are accounted for in terms of IAS 17 (AC 105) (completeness of lease transactions). IFRIC 4 (AC 437) therefore also requires those who prepare financial statements to consider all supply and service agreements that are, legally, not leases to determine whether they are lease arrangements in substance. ^{ASA}

Elmar Venter, MCom(Taxation) CA(SA), and Tania Tomes, CA(SA), are both Senior Lecturers, Department of Accounting, University of Pretoria