

Evaluating the Substance of Transactions Involving the Legal Form of a Lease

This version of INT SB-FRS 27 does **not** include amendments that are effective for annual periods beginning **after** 1 January 2016.

INT SB-FRS 27

Interpretation of Statutory Board Financial Reporting Standard 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (INT SB-FRS 27) is set out in paragraphs 3–11. INT SB-FRS 27 is accompanied by implementation guidance. The scope and authority of Interpretations are set out in the *Preface to Statutory Board Financial Reporting Standards*.

FOR THE IMPLEMENTATION GUIDANCE ACCOMPANYING INT SB-FRS 27, SEE SEPARATE DOCUMENT.

Interpretation of Statutory Board Financial Reporting Standard 27

Evaluating the Substance of Transactions Involving the Legal Form of a Lease

References

- SB-FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- SB-FRS 11 *Construction Contracts*
- SB-FRS 17 *Leases* (as revised in 2004)
- SB-FRS 18 *Revenue*
- SB-FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- SB-FRS 39 *Financial Instruments: Recognition and Measurement* (as revised in 2004)
- SB-FRS 104 *Insurance Contracts*

Issue

- 1 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.
- 2 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 SB-FRS 17; and, if not,
 - (i) whether a separate investment account and lease payment obligations that might exist represent assets and liabilities of the Entity (eg consider the example described in paragraph A2(a) of the guidance accompanying the Interpretation);
 - (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

- 3 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 takes place concurrently or in a continuous sequence. (Part A of the accompanying guidance provides illustrations of application of this Interpretation.)

- 4 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.
- 5 SB-FRS 17 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 SB-FRS 17 include (Part B of the accompanying guidance provides illustrations of application of this Interpretation):
- (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, and not to convey the right to use an asset; and
 - (c) an option is included on terms that make its exercise almost certain (eg a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).
- 6 The definitions and guidance in paragraphs 45–60 of the *Framework*¹ 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 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 (eg 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.
- 7 Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under SB-FRS 37, SB-FRS 39 or SB-FRS 104, depending on the terms.
- 8 The criteria in paragraph 20 of SB-FRS 18 shall be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income 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 income when received, if received at the beginning of the arrangement, is inappropriate include:

¹ In February 2011 the *Framework* was replaced with the *Conceptual Framework for Financial Reporting*. Paragraphs 45–60 are now paragraphs 4.4–4.19 of the *Conceptual Framework*.

- (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 (eg 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 business, 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 discretion, to invest a prepaid amount in assets carrying more than an insignificant amount of risk (eg 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.
- 9 The fee shall be presented in the statement of comprehensive income based on its economic substance and nature.

Disclosure

- 10 All aspects of an arrangement that does not, in substance, involve a lease under SB-FRS 17 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 income in the period, and the line item of the statement of comprehensive income in which it is included.
- 11 The disclosures required in accordance with paragraph 10 of this Interpretation 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 (eg power plants).

Effective date

This Interpretation becomes effective on 1 February 2003. Changes in accounting policies shall be accounted for in accordance with SB-FRS 8.