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IFRS for SMEs
Section 20 *Leases*

Presenter:
Anton van Wyk M. Com CA (SA)

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Presenter

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Anton van Wyk is a **chartered accountant** and independent consultant in International Financial Reporting Standards (IFRS and IFRS for SMEs). As former subject head of Financial Accounting at various higher education providers (including the University of Johannesburg and Monash University South Africa), he has gained valuable insights into and understanding of the important principles underlying the International Financial Reporting Standards (IFRS). Anton is a well-known and popular presenter who has presented numerous IFRS updates for several accounting bodies across South Africa. He is known for his ability to simplify and highlight the most important principles contained in IFRS, whilst keeping the learning process enjoyable for attendees.

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Welcome to the Webinar

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Welcome to this webinar dealing with **Section 20 *Leases*** in the **IFRS for SMEs**

Agenda – points to cover in the webinar

1. Introduction to Section 20 *Leases*
2. Determining whether an arrangement is/contains a lease
3. Lease classification
4. Accounting treatment of leases in the financial statements of lessees and lessors
5. Sale and leaseback transactions
6. Deferred tax on leases and sale and leaseback transactions
7. A glimpse into IFRS 16 *Leases*

IFRS for SMEs
Section 20 *Leases*
Introduction to Section 20 *Leases*

Section 20

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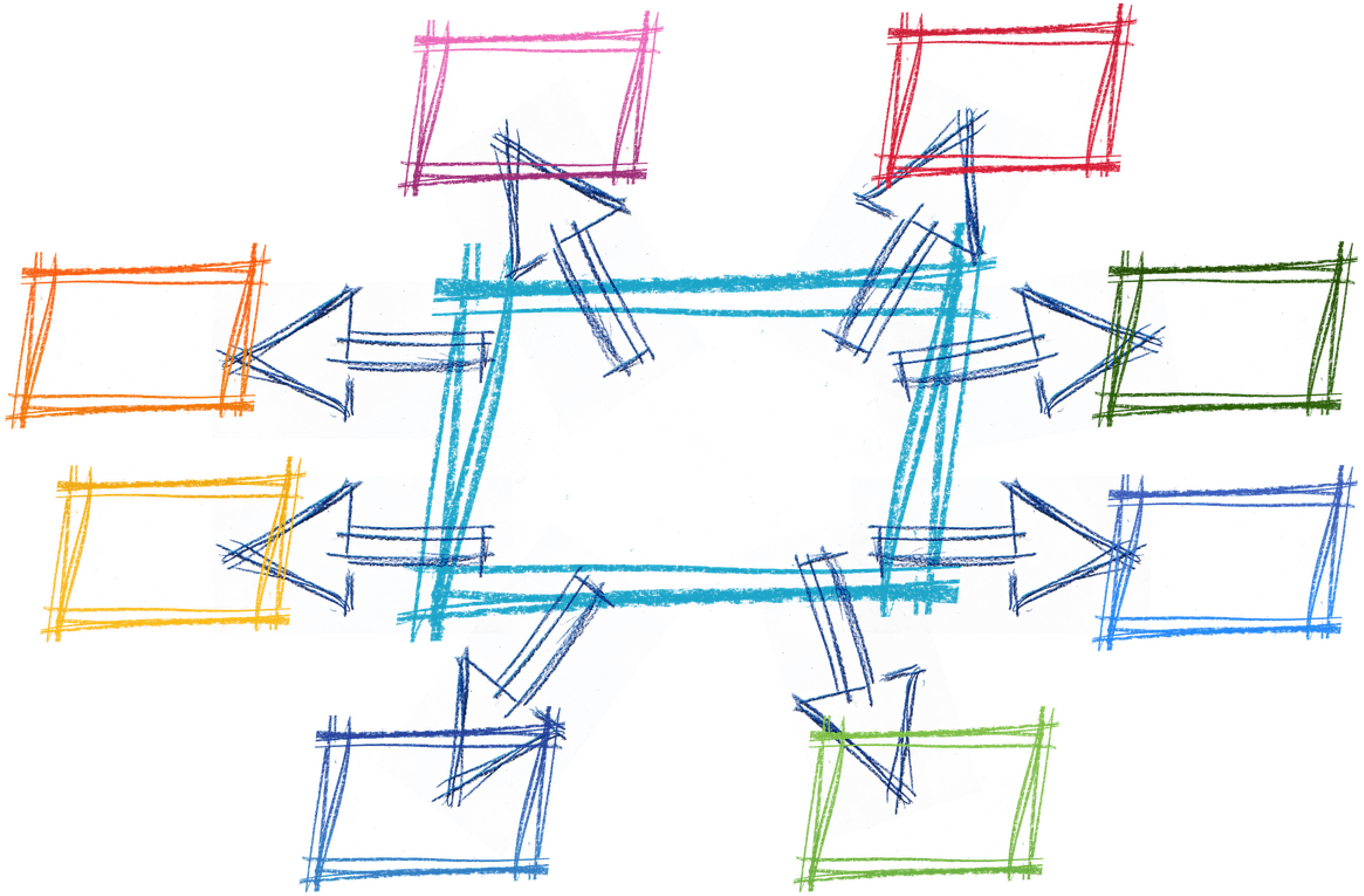
- Deals with **leases**

- Scope very important – what is a lease, and how is a lease identified?
- Classification of leases
  - Finance lease versus operating lease
  - Indicators of finance leases
- Lessees
  - Finance leases
  - Operating leases
- Lessors
  - Finance leases
  - Manufacturer/dealer lessors
  - Operating leases
- Sale-and-leaseback transactions
  - Resulting in finance leases
  - Resulting in operating leases



Leases <u>excluded</u> from scope

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- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
  - (s34 *Specialised Activities)*

- Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights
  - (s18 *Intangible Assets other than Goodwill)*

- <u>Measurement</u> of property held by lessees that is accounted for as investment property and <u>measurement</u> of investment property provided by lessors under operating leases
  - (s16 *Investment Property)*

- <u>Measurement</u> of biological assets held by lessees under finance leases and provided by lessors under operating leases
  - (s34 *Specialised activities*)

- Operating leases that are onerous
  - (s21 *Provisions and Contingencies)*

Important areas in section 20

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S20

- Definitions
- Identification
- Classification
- Lessees
- Lessors
- Sale and leaseback
- Tax

Important definitions in s20

- A **lease** is an agreement, whereby the lessor conveys to the lessee, in return for payment or a series of payments, the *right to use an asset* for an agreed period of time
- 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 provisions of the lease
- **Economic life** is either:
  - the period over which an asset is expected to be economically usable by one or more users; or
  - the number of production or similar units expected to be obtained from the asset by one or more users
- **Minimum lease payments** are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:
  - for a lessee: any amounts guaranteed by the lessee or by a party related to the lessee; or
  - for a lessor: any residual value guaranteed to the lessor by: (i) the lessee; (ii) a party related to the lessee; or (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised—the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Important definitions in s20

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- **Rate implicit in the lease** is the discount rate at which:
  - the sum of the present value of the lease payments (MLPs) and unguaranteed residual value equals
  - the sum of the fair value of the underlying asset and any initial direct costs of the lessor

- Example: Entities A (Pty) Ltd and B (Pty) Ltd enter into a rental agreement in terms of which A (Pty) Ltd rents a machine (with a fair value of R500 000 (ex VAT)) from B (Pty) Ltd at R10 000 per month (ex VAT) for a period of 60 months. B (Pty) Ltd arranged the contract and incurred legal costs of R25 000 (including VAT). At the end of the lease agreement, entity A (Pty) Ltd will either (this will be the choice of the lessee):
  - (a) Pay the final balloon payment of R50 000 (ex VAT) to obtain the legal ownership of the machine; or
  - (b) Return the machine to B (Pty) Ltd and pay no balloon payment.

  <u>The rate implicit in the lease is calculated as follows:</u>

  FV = R50 000 x 1,15 = (R57 500) (whether this residual value is guaranteed or unguaranteed, is irrelevant to this calculation)

  PV = fair value of the underlying asset = R500 000x 1,15 = R575 000 + lessor's direct costs of R25 000 = R600 000

  N = 12 months x 5 years = 60 months

  P/Yr = 12 (monthly instalments)

  Pmt = R10 000 instalment x 1,15 = (R11 500)

  Hence: the rate implicit in the lease = 8,4% p.a.

Minimum lease payments (MLP's)

- Important concept in lease accounting…

- **For the lessee**
  - Lease instalments i.t.o. the lease agreement
  - <u>Guaranteed</u> residual value (e.g. balloon payment) – this amount/value will have been guaranteed by the lessee, or by a party related to the lessee

- **For the lessor**
  - Lease instalments i.t.o. the lease agreement
  - <u>Guaranteed</u> residual value (e.g. balloon payment) – this amount will have been guaranteed by the lessee, a party related to the lessee or an independent 3rd party unrelated to the lessor that is financially capable to discharge the obligation under the guarantee

Relevance of MLP's

- **Lessees**
  - Must create a finance lease obligation only for the MLP, as this is what a <u>present obligation</u> exists for at inception of the lease
  - Therefore unguaranteed residual values not included in MLP (i.e. excluded from finance lease obligation as no unconditional present obligation exists)

- **Lessors**
  - Recognise 'gross investment in the lease' (effectively <u>a receivable</u>) in finance lease, which comprises:
    - MLP's (i.e. instalments over lease term <u>plus</u> guaranteed residual values)
    - *Plus:* <u>unguaranteed</u> residual values, as long as probable to be recovered

- The above emphasises again the difference between accounting for a liability (i.e. PRESENT obligation) versus an asset (i.e. probable FUTURE economic benefits)

Example: RIL & PV of MLPs

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The same information applies as in the example on the rate implicit in the lease…

Quick recap…
Rate implicit in the lease was 8,4% p.a.

A (Pty) Ltd has a CHOICE to either pay the balloon payment in cash (R57 500 including VAT) or to return the machine to B (Pty) Ltd. Seeing that this choice can be exercised by A (Pty) Ltd, the lessee, this is regarded an **unguaranteed residual value** as A (Pty) Ltd is not unconditionally obliged to pay the amount, and can return the machine instead.

A (Pty) Ltd is now required to calculate the PV of MLPs, as explained before:
Pmt = (R11 500)
I/Yr = 8,4%
N = 60
P/Yr = 12
FV = ZERO (as it is unguaranteed)
Thus: PV of MLPs = R562 124 (remember: the fair value of the asset was R575 000)

IFRS for SMEs
Section 20 *Leases*
Determining whether an arrangement is/contains a lease

Determining whether an arrangement contains a lease

- Based on the **substance** of the transaction (legal form could be an entirely different concept!)

- Assess whether:
  - Fulfilment of the arrangement is **dependent on the use of a specified asset**?
    - Substantive substitution rights?
  - Arrangement **conveys a right to use the asset**?
    - Purchaser has ability/right to operate the asset in a manner it determines while obtaining more than insignificant output OR
    - Purchaser has right/ability to control physical access to asset while obtaining more than insignificant output OR
    - Chances are remote that another party will take more than insignificant amount of output **AND** price that purchaser will pay is neither fixed per unit of output nor equal to current market price per unit

Example

A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
- The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- The supplier is responsible for repairs, maintenance, and capital expenditures.
- The supplier must stand ready to deliver a minimum quantity of gas each month.
- Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Application

The arrangement contains a lease within the scope of Section 20, because:

- An asset (the facility) is explicitly identified in the arrangement and **fulfilment of the arrangement is dependent** on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive.
- The purchaser has **obtained the right to use the facility** because, on the facts presented—
  - in particular, that the facility is designed to meet only the purchaser's needs and the supplier has no plans to expand or modify the facility—it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility's output **and**
  - the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output

- The lease will therefore now be treated in terms of section 20 of the IFRS for SMEs

IFRS for SMEs
Section 20 *Leases*
Lease classification

Lease classification

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- Quite an advanced concept, great care is needed to correctly classify
- Economic substance over legal form prevails
- Indicators exist, but may not be conclusive…
- Professional judgement required!
- Lessor and lessee may classify same lease differently

- **FINANCE LEASE:** a lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of the leased asset from the lessor to the lessee – legal title (ownership) may or may not eventually transfer to the lessee

- **OPERATING LEASE:** a lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of the leased asset from the lessor to the lessee

Lease classification

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- Depends primarily on the substance of the transaction rather than form of the contract – i.e. ownership (legal title) not a requirement for risks and rewards to transfer to the lessee…

- Classification is done at inception of lease agreement, and not at physical commencement of the lease term

Primary indicators that risks and rewards are transferred to the lessee

- Lease transfers ownership (legal title) by the end of the lease term
- Bargain purchase option for the lessee, significantly below fair value, therefore reasonably certain at inception to be exercised
- Lease term is for major part of economic life of asset (>= 75%)
- At inception, the PV of MLP amounts to at least substantially all of the fair value of the leased asset (>=90%)
- Leased assets are so specialised that only lessee can use without significant modification

Secondary indicators that risks and rewards are transferred to lessee

- If lessee cancels lease, lessor's losses associated with cancellation are borne by lessee
- Gains/losses from fluctuations in fair value of residual accrue to the lessee
- Lessee has the ability to continue the lease for a secondary period at a rent substantially below market-related rent

Important things to note

- Indicators not always conclusive
  - Stick to foundation: significant R&R <u>associated with</u> ownership effectively transferred to the lessee?
- If terms of lease are changed so that classification at inception would have been different = new lease
- Lease of <u>land and buildings</u>: classification to be assessed separately
  - Next slide…

Separate classification

- **Land** – normally has an indefinite economic life…
  - Therefore lease of land = *operating lease* unless legal title transfers
  - Professional judgement required

- **Buildings** – use primary and secondary indicators…

- MLP allocated between land and buildings in proportion to **relative fair values of the leasehold interests in the land and building elements** at inception (see next slide)
  - If not possible: whole lease = finance lease, unless clearly both elements are operating leases

- If land element = immaterial: land & buildings treated as a single unit for lease classification

Example: info

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- **Fair value of leasehold interests in:**
  - Land = R1 million (not immaterial)
  - Buildings = R4 million
- **Fair values of underlying:**
  - Land = R2 million (not immaterial)
  - Buildings = R6 million
- PV of MLP = R6 million
- Ignore VAT
- Lease of land = correctly classified as operating lease
- Lease of building = correctly classified as finance lease

Example: solution

- Dr Buildings (leased) R4.8m
- Cr Finance lease (F/P) R4.8m
- **(<u>R4m/R5m</u> x R6m MLP)**

For allocation purposes!

- Operating lease of land to be expensed as incurred

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IFRS for SMEs
Section 20 *Leases*
Accounting treatment of leases
in the financial statements of lessees and lessors

Finance leases: Lessees Initial recognition

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- At <u>commencement</u> of lease term, classification at inception!
- Recognise assets and liabilities
  - **Equal to the fair value of the leased property (R575 000)**
  - **or, if lower, at the PV of MLP (R562 124)**
  - as determined at inception of lease

Dr Machine	R487 124
Dr Input VAT	R75 000
Cr Finance lease obligation	R562 124

- The rate implicit in the lease to be used, if practicable, to determine PV of MLP
- Otherwise the lessee's incremental borrowing rate *(this option is not available to lessors)*
  - This is in case the RIL cannot be readily determined as lessor's direct costs are not known
- Direct costs to be capitalised to leased asset

Finance leases: Lessees Subsequent measurement

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- MLP's to be apportioned between:
  - Finance charge
  - Reduction of outstanding liability

Dr Interest expense (P/L)
Dr Finance lease obligation (SoFP)
Cr Bank

- Depreciation/amortisation shall be recognised on depreciable/amortisable leased assets i.t.o. relevant sections of the IFRS for SMEs (e.g. Section 17 PP&E)
  - If uncertain about ownership transfer to lessee: depreciate/amortise over shorter of lease term and useful life (conservative approach followed)

Finance leases: Lessors
Initial recognition

- Assets held in terms of finance leases are to be **presented as receivables** in the SOFP at an amount equal to the net investment in the lease

Net investment in the lease	**100**	
Gross investment in the lease	180	MLPs + ung. RV
Less: Unearned finance income	(80)	

- Direct costs part of investment in the lease
  - Impacts rate implicit in the lease (as per definition)
  - Except for manufacturer/dealer lessors: expensed when selling profit is recognised

Finance leases: Lessors Subsequent measurement

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- Finance income recognised based on pattern reflecting a **constant periodic rate of return** on the lessor's net investment in the finance lease
  - Rate implicit in the lease used again (only option!)
  - Amortised cost model *(effective interest method)*

Finance leases: Lessors Subsequent measurement

- Guidance for manufacturer/dealer lessors:
  - Artificially low interest rates (.22)
  - Two components of income
    - Gain on disposal of asset
    - Finance income earned
  - Cost of sale (.44)

    = cost (or CA) **LESS PV of unguaranteed residual**
  - Direct costs expensed at commencement when selling profit is recognised

This portion of the asset is effectively not sold…

Operating leases: Lessees

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- Lease payments recognised as expense on a **straight-line basis over the lease term**, unless another systematic basis is more representative of the time pattern of the user's benefit obtained
  - Even if the cash payments are not on that basis…

- <u>*Unique to IFRS for SME's*</u>
  - *If lease payments to lessor are structured to increase in line with general inflation (based on published indexes or statistics) to compensate for lessor's expected inflationary cost increases, operating lease payments are not straight-lined…*

Operating leases: Lessors

- Assets relating to operating leases to be presented according to their nature
  - Land & buildings = investment property
  - Machinery, equipment, vehicles, etc. = PP&E
  - Intangible assets etc.
- Lease income from operating leases to be recognised in profit or loss on a **straight-line basis over the lease term**, unless another systematic basis is more representative of the time pattern in which use-benefit derived from leased asset is diminished
- <u>*Unique to IFRS for SME's*</u>
  - *If lease payments to lessor are structured to increase in line with general inflation (based on published indexes or statistics) to compensate for lessor's expected inflationary cost increases, operating lease payments are not straight-lined*
- Initial direct costs = added to CA of the leased asset and recognised as expense <u>over the lease term</u> on same basis as lease income
- Depreciation/amortisation of leased asset to be calculated in accordance with relevant section

IFRS for SMEs
Section 20 *Leases*
Sale and leaseback transactions

Sale and leaseback: finance lease

- **Excess of sales proceeds over CA = deferred and amortised over lease term**
- Substance is a financing transaction where asset is provided as security
  - Thus no selling profit recognised…
- Deferred profit in SOFP is treated as a 'negative asset' (valuation allowance)
  - i.e. deducted against CA of leased asset when presented in AFS

Dr Bank	**R1 000 000**	
Cr Asset		R800 000
Cr Deferred profit (SoFP)		*R200 000*

Dr Machine (SoFP)	R1 000 000	
Cr Finance lease obligation (SoFP)		**R1 000 000**

Sale and leaseback: operating lease

- **Transaction is established at fair value**
  - Recognise gain/loss on disposal in P/L
- **If SP < fair value**
  - Recognise gain/loss on disposal in P/L
  - If loss arose, and loss is compensated for by lower lease instalments: defer loss and amortise over lease term
- **If SP > fair value**
  - Excess > fair value is deferred and amortised over lease term
  - Remainder recognised in profit or loss

Anti-manipulation measures…

Sale and leaseback: operating lease

- **If fair value (at sale and leaseback) < CA**
  - Recognise impairment loss first between CA and fair value, before dealing with any lease issue
  - Impairment losses may never be deferred

IFRS for SMEs
Section 20 *Leases*
Deferred tax in respect of leases and sale and leaseback transactions

Operating leases: income tax

- **IFRS for SMEs = operating lease**
  - Lease instalment evenly recognised in P/L, could be equalised if uneven, then deferred tax arises (no SARS equalisation)
- **Taxation = operating lease**
  - Actual lease instalment per agreement taxed/deducted, usually ex VAT
  - Never equalised, even if uneven instalments with even benefit
  - Lessor: wear-and-tear deductions on asset leased to lessee (depends on how used by lessee)

Operating leases: VAT

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- **IFRS for SMEs = operating lease**
  - Recognise VAT based on actual instalment paid/received (x15/115)
  - Do not equalise VAT when straight-lining lease instalments!!
- **Taxation = operating lease**
  - VAT claimed/paid per actual lease instalment paid/received, straight-lining irrelevant
  - Instalment x 15/115 = VAT claimed from/paid to SARS

Operating leases: take note

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- **Leasehold improvements**
  - **IFRS for SMEs:**
    - Lessee: capitalise debit to 'prepaid expenses' and amortise over lease term to P/L, credit bank/LTL/creditors etc. – no deferred tax arises
    - Lessor: capitalise debit to PP&E and credit 'income received in advance' and amortise over lease term to P/L – deferred tax arises
  - **Income tax:**
    - Lessee: deduct over lease term from when improvements are completed (excluding VAT) (S11g)
    - Lessor: include in gross income when accrues (when contract is signed (theory)/when improvements are complete (practice)), may have once-off relief i.t.o. S11h
  - **VAT:**
    - Accounting: capitalise VAT receivable/payable at commencement of lease term and claim back from/pay to SARS (depending on whether lessee/lessor)
    - Taxation: claim back from/pay to SARS earlier of invoiced or paid

Operating leases: take note

- **Lease premium (amount paid upfront to secure lease, e.g. deposit)**
  - **IFRS for SMEs:**
    - Lessee: capitalise debit to 'prepaid expenses' and amortise over lease term to P/L, credit bank etc. – no deferred tax arises
    - Lessor: capitalise debit to bank and credit 'income received in advance' and amortise over lease term to P/L – deferred tax arises
  - **Income tax:**
    - Lessee: deduct over lease term from when available for use (excluding VAT) (S11f)
    - Lessor: include in gross income when accrues (when contract is signed), may have once-off relief i.t.o. S11h
  - **VAT:**
    - Accounting: capitalise VAT receivable/payable at commencement of lease term and claim back from/pay to SARS (depending on whether lessee/lessor)
    - Taxation: claim back from/pay to SARS earlier of invoiced or paid

Finance leases: income tax

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- **IFRS for SMEs = "financed acquisition/sale"**
  - Lessee: expense interest & depreciation; amortised cost model
  - Lessor: recognise selling profit (if M/D lessor) and finance income earned (if not M/D lessor: only finance income earned recognised)
- **Taxation = operating lease**
  - Lessee: deduct lease instalments incurred, excl. VAT (see next slide how)
  - Lessor: taxed on lease instalments accrued, excl. VAT (see next slide how)
  - Lessor: wear-and-tear deductions claimed on cost price of leased asset, excluding input VAT when asset acquired
    - Residual value not considered i.r.o. wear-and-tear deductions

Finance leases: income tax

- Lessee/lessor: Instalment incurred/accrued deducted/included for taxation, **excluding** VAT (assuming VAT vendor, qualifying purpose etc.) **VAT Act**

"ICA"

"Operating lease"

- Remove VAT i.t.o. S23C
  (weight of instalments)

Remove VAT
(15/115 x instalment)

Note: most finance leases will qualify as ICA's in terms of the income tax act...

Finance leases: VAT

- **IFRS for SMEs = "financed acquisition/sale"**
  - If ICA (for tax): claim from/pay to SARS 100% VAT upfront
  - If rental agreement (for tax): claim/pay VAT per instalment
- **Taxation = could be ICA or rental agreement**
  - If ICA: claim from/pay to SARS 100% VAT upfront, instalments then adjusted per S23C for income tax
  - If rental agreement: claim/pay VAT per instalment, instalments then adjusted x 15/115 to remove VAT for income tax

Sale & leaseback: income tax

- **Seller-lessee**
  - Taxed at 28% on recoupment, if any
  - CGT at 80% on capital gain, if any
- **Lessor-buyer**
  - Wear-and-tear deductions (S23D & S23G)
    - Original cost price for seller-lessee, less allowances granted to seller-lessee
    - Plus: recoupment (for seller-lessee)
    - Plus: 80% of capital gain (of seller-lessee)

IFRS for SMEs
Section 20 *Leases*
A glimpse into IFRS 16 *Leases*
(full IFRS vs IFRS for SMEs)

A glimpse into IFRS 16 *Leases*

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- IFRS 16 *Leases* has different accounting treatments for lessees and lessors
- Lessors = in line with previous IAS 17 *Leases* and IFRS for SMEs Section 20 *Leases*
  - Lease classification still important; lessors classify leases between operating and finance leases
- Lessees are required to capitalise all leases, except
  - Leases of low value assets (=<$5 000)
  - Short-term leases (lease term =<12 months)
- Lessees are required to recognise a right-of-use (ROU) asset, and not the underlying asset
- Rights are distinguished according to the amendments to the 2018 Conceptual Framework
  - Right of ownership
  - Right of use etc.
- Lessees treat all leases using the amortised cost (effective interest) model
  - Recognise ROU asset
  - Recognise lease liability
  - Amortise the ROU asset over the lease term
  - Use amortised cost model to account for the lease liability
- Lessees present ROU assets either in a separate line item, or include the ROU asset as part of the line-item relating to the underlying asset (e.g. PP&E, Intangible assets etc.)
- Disclosure entails reconciling the asset from opening balance to closing balance
  - Could be part of the PP&E note disclosure etc.

Q&A

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If you would like to e-mail a question, please use:

technicalquestions@accountingacademy.co.za

Thank you for your participation

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