ACCOUNTING GUIDELINE

# GRAP 13

## Leases

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

## Contents



***Added additional illustrative example**

# 1. Introduction

This document provides guidance on how an entity should classify lease agreements and the accounting and disclosure thereof in its financial statements. The contents should be read in conjunction with GRAP 13. For purposes of this guide, "entities" refer to the following bodies to which the standard of GRAP relate to, unless specifically stated otherwise:

- Public entities
- Constitutional institutions
- Municipalities and all other entities under their control
- Trading entities and government components applying the standards of GRAP
- Parliament and the provincial legislatures
- TVET and CET colleges

Explanation of images used in manual:

| | |
|---|---|
|  | Definition |
|  | Take note |
|  | Management process and decision making |
|  | Example |

## 2. Scope

GRAP 13 is applicable to all entities who prepare financial statements based on the accrual basis in accounting. The Standard does not apply to:

- Leases for the purpose of exploring for or use of minerals, oil, natural gas, and other similar non-regenerative resources;
- Licensing agreements for items like films, recordings, script, patents and copyrights; and
- The initial recognition of assets and liabilities in a lease agreement acquired in a transfer of functions between entities and mergers.

The standard cannot be used as measurement basis for:

- Property held by lessees that are accounted for as investment property;
- Investment property provided by lessors under operation leases; and
- Biological assets held lessees under finance leases or provided by lessors under operating leases.

GRAP 16 on *Investment Property* and GRAP 27 on *Biological Assets* should be followed for the measurement of such assets.

Under specific situations, legislation may prevent an entity from entering into certain types of agreements. Although legislation may have been contravened, the requirements of this standard should still be applied. Accordingly, the application of a Standard of GRAP is not justification for non-compliance with legislation

## 3. Definition and Identification

A lease is 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.

The definition of a lease includes other arrangements, such as hire purchase contracts (contracts for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions).

As apparent from the definition above, leases are agreements whereby an entity can gain the use of an asset for a specified period of time. A typical example would be a straightforward rental agreement; however, entities also use a lease to finance an asset without having to purchase the asset outright.

It is important to note that, in most cases, legal ownership of the leased asset will rest with the lessor, while the possession and use of the leased asset will vest in the lessee.

Most leases are written contracts which set out the terms and conditions of the lease and therefore the lease should be easily identifiable. However, in some instances entities may enter into arrangements that do not take the legal form of a lease, but that conveys the right to use an asset in return for a series of payments. These arrangements may comprise of one transaction, or a series of transactions, which may be or might contain, in substance, a lease element.

Upon entering into such a type of arrangement, an entity has to determine whether or not the arrangement is, or contains, a lease. The lease component will then be accounted for in accordance with GRAP 13.

### 3.1 Determining whether an arrangement contains a lease

The determination of whether an arrangement contains a lease should be based on the substance of the arrangement, rather than its legal form, which in turn requires an assessment of whether the following two conditions were met:

Fulfilment depends on the use of a **specific** asset

AND

Arrangement conveys a **right to control** the use of that asset*

Asset is **explicitly identified** in the arrangement and the supplier does not have the right and ability to fulfil the obligation using **other assets not specified** in the arrangement

If yes, then the condition is met

Supplier owns or leases **only one asset** with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets

If yes, then the condition is met

Purchaser has the ability or right to **operate the asset** in a manner it determines*

If yes, then the condition is met

Purchaser has the ability or right to **control physical access** to the asset

If yes, then the condition is met

It is unlikely that other parties will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement; and

The price that will be paid 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 delivery of

If yes, then the condition is met

*The purchaser needs to obtain or control more than an insignificant amount of the output or other utility of the asset.

If the answer is 'yes' to any of the points above, then the condition will have been met. Note, however, that both conditions have to be met before an arrangement is deemed to be, or deemed to contain, a lease.

If the arrangement contains a lease, the requirements of GRAP 13 will be applied to the lease element and therefore the lease will need to be classified as either a finance lease or an operating lease, based on the classification criteria as indicated in the section below.

**Example: Right to use an asset**

Entity B requires substantial power to operate its mining operations. Entity B therefore enters into an arrangement with Entity E to erect a power station next to Entity B's mine.

In terms of the arrangement, Entity B will be the sole user of the power station for the next 20 years and will pay Entity E for the electricity consumed.

Assume that the expected economic life of the power station is 25 years.

Entity B and E will have to determine whether or not the arrangement is or contains a lease.

Condition 1: Does the fulfilment depend on the use of a specified asset?

Yes, the power station.

Condition 2: Does the arrangement convey the right to control the use of the asset?

Yes, Entity B will obtain more than an insignificant amount of the output as it is using the power station exclusively for the major part of its economic life, i.e. 20 out of the 25 years.

Therefore both conditions have been met and the arrangement contains a lease.

## 4. Classification of a lease

Once it has been determined that an arrangement is (or contains) a lease, it should be established whether the lease should be classified as either a finance or an operating lease. This classification results in substantially different accounting treatments, as the leased asset (and corresponding liability) is capitalised in the case of a finance lease, whereas this is not the case in respect of an operating lease.

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An operating lease is a lease other than a finance lease.

## 4.1 Classification at inception

As the classification of a lease agreement depends on the definitions in the standard, the circumstances surrounding the lease agreement may be different for the parties to the agreement; as a result the classification of the same lease may be different in the accounting records of the lessee and lessor.

The classification of the lease is made at inception of the lease and is not changed, unless both parties agree to change the provisions of the initial lease (other than by renewing it), and these changes would have resulted in a different classification of the lease at its inception. This amended lease is considered a new lease agreement.

Note the difference between **commencement date** and **inception date**:

The **commencement date** is the date from which the lessee is entitled to exercise its right to use the asset and therefore when the lease will be initially recognised in the accounting records and when depreciation commences. The **inception date** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principle provisions of the lease. This is also when the lease should be classified as either a finance lease or an operating lease. Furthermore this is when the amounts to be recognised at commencement of a finance lease are determined.

As such, the commencement date of the lease is typically when the lessee takes possession of the leased asset. The inception date is typically the date on which the lease agreement is signed by both parties and becomes legally binding.

In the case of a renewal or extension of the lease, where the lease arrangement was reassessed, the accounting for the lease should be applied from the inception of the renewal or extension period.

If there are changes in estimates (such as economic life or residual value) or changes in circumstances (for instance default by the lessee), this would not result in a reclassification of the lease.

A contract may be concluded only consisting of an agreement to lease an asset. However, an agreement may also be concluded where the lease is one part of an agreement which includes other elements, such as the construction or servicing of the asset. The lease component of the agreement should be treated in accordance with GRAP 13.

Various types of agreements may be also entered into for the provision of goods and/or services, which involves the use of a designated asset. In some circumstances it may not always be clear whether a lease has arisen or not. Professional judgment is then required from management to determine whether the arrangement constitutes a lease that should be accounted in accordance with GRAP 13. Refer to previous section for discussion and guidance thereon.

## 4.2 Risks and rewards of ownership

The classification of a lease under GRAP 13 does not depend on where the legal ownership of the leased asset lies, but rather on the extent to which the risk and rewards incidental to ownership of the asset has been transferred from the lessor to the lessee. If substantially all of the risks and rewards have been transferred to the lessee, it is a finance lease; otherwise it is an operating lease.

The risks and rewards that are considered to be incidental to ownership include (but are not limited to) the following:

| Risks | Rewards |
|---|---|
| • Which party carries the risk of possible losses as a result of **idle capacity**, **technological obsolescence** and fluctuation of **asset value** as a result of change in economic conditions;<br>• Which party carries the risk of repairs and maintenance of the asset;<br>• Which party carries the risk of insurance cost / losses? | • Deriving revenue or service potential from the use of the asset over its economic life;<br>• Profitable operation of an asset over its economic life; and<br>• Gain from the increase in value or the realisation of the residual value upon disposal. |

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with legal form. Thus legal title of a leased asset may not necessary transfer to a lessee, but the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life, therefore such asset should be included in the lessee's financial statements in accordance with GRAP 13.

Difference between economic life and useful life

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.

Useful life is either:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

Economic life is therefore the total expected life of an asset and useful life is the expected life of the asset over which the entity will use it. The useful life will therefore never be more than the economic life but can be the same.

## 4.3 Classification indicators

An entity should consider the terms of the agreement or contract and should classify the lease depending on the substance of the transaction rather than the form of the contract. This requires an entity to carefully assess the classification of a lease.

The following are examples of situations that would normally result in a lease being classified as a finance lease (the primary indicators listed in GRAP 13):

These indicators are intended to assist as a guide in the decision-making process, but may not be conclusive. An entity should therefore not follow the guidance blindly, but it is important that it considers the overall substance of the lease agreement for each of its leases. The classification should be based on an overall assessment of whether substantially all of the risks and rewards of ownership of the leased asset have been transferred to the lessee.

- Ownership of the asset is transferred to the lessee when the lease term ends;
- The lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair value of the asset at the date the option becomes exercisable and at the time of entering the lease, it is expected that the lessee will exercise the option;

The exercise of the option is based on the expectation of the entity. Therefore, if the entity does not expect to exercise the option (for example, if the entity has a policy of returning all leased assets at the end of the lease term, regardless of the price), this indicator will not be present - even if the price at the date that the option is expected to be exercised is significantly lower than the fair value

- The lease term is for a major part of the economic life of the asset even though title is not transferred;

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

If the lease agreement contains a cancellation clause with no penalty to the lessee, the lease term will be from commencement date to the earliest point at which the cancellation clause is exercisable by the lessee.

If the lease agreement contains a cancellation clause which states that the lessee would have to compensate the lessor with an amount equal to what would have been paid if the lease was not cancelled, then the cancellation clause is ignored in determining the lease term. This is because 100% of the lease payments would still be made.

**Example: Classification of leases**

Entity B leases a vehicle, with a total economic life of 5 years, from VASA bank, for a period of 4 years. 4 out of 5 years is a major part of the economic life of the vehicle, therefore the lease could be classified as a finance lease at the inception of the agreement.

There is no clear cut threshold as to what will be considered to be 'a major part of the economic life of the asset', although approximately 75% is considered reasonable in terms of common practice.

An entity should follow its own process to determine the acceptable threshold that it will use in making the assessment. This threshold should be documented in its own operational policies. It should be noted, however, that this threshold should not represent an automatic cut-off point - an entity should consider all relevant factors when assessing the classification of a lease to decide whether substantially all of the risks and rewards have been transferred.

It should be noted that an entity will need to determine the economic life and the useful life of the leased asset, in order to determine whether the asset qualifies as a finance lease or not.

- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;

The 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.

For a lessor – any residual value guaranteed by the lessee, a party related to the lessee or a third party unrelated to the lessor who is financially capable of discharging its obligations under the guarantee.

**Example: Calculating the present value of minimum lease payments due**

Entity A entered into a lease agreement on 1 April 20X0 to lease a machine for a period of three years. The monthly lease payment is R5,000 payable in arrears beginning 30 April 20X0 and the rate implicit in the lease is 5%.

The present value of the minimum lease payments will be calculated as follows:

| | |
|---|---|
| PMT | 5,000 |
| i | 0.00416667% (5% / 12) |
| n | 36 (3 x 12) |
| PV? | 166,828 |

Note the lease is payable on a monthly basis, therefore the interest rate and period also needs to be monthly

This calculation can be done on a financial calculator or in MS Excel.

There is no clear cut threshold to what amounts to 'at least substantially all of the fair value' of the asset when comparing this value to the present value of the minimum lease payments, although approximately 90% is considered reasonable in terms of common practice.

An entity should follow its own process to determine the acceptable threshold that it will use in making the assessment. This threshold should be documented in its own operational policies. It should be noted, however, that this threshold should not represent an automatic cut-off point - an entity should consider **all** relevant factors when assessing the classification of a lease to decide whether substantially all of the risks and rewards have been transferred.

It should be noted that an entity will need to determine the present value of the minimum lease payments and the fair value of the leased asset, in order to determine whether the leased asset qualifies as a finance lease or not.

- The leased asset is of such a specialised nature that only the lessee can use it without major modifications; or
- The leased asset is not easily replaceable by another asset.

The following are other indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease (the secondary indicators listed in GRAP 13):

- If the lessee can cancel the lease, the lessee will carry any loss that will be incurred by the lessor as a result of the cancellation;
- Gains or losses due to changes in the fair value of the residual value are credited to the lessee; and
- At the end of the initial lease, the lessee has an option to extend the lease at a rent that is substantially lower than the market rent.

**Example: Classification of leases**

Entity B leases a vehicle, with a total economic life of 5 years, from VASA bank, for a period of 4 years. Entity B has the option to continue with the lease for another year, without payment during this period. It is reasonably certain that Entity B will exercise this option.

There are two indicators that this lease agreement is a finance lease:

- Entity B has the ability to continue with lease for another year at a rent lower than market rent; and

- The lease term will be five years in total, which is equivalent to the economic life of the vehicle

The lease is therefore classified as a finance lease at the inception of the agreement.

For a lease to be classified as a finance lease it is not necessary to have all the above indicators present, it could be one or a mixture of the above indicators.

It is important to note that the indicators mentioned under this section are not always conclusive. A lease can be classified as an operating lease even if one or more of these indicators are present, if it is clear from other factors that the risks and rewards of ownership are not transferred to the lessee.

The deciding factor is the extent to which risks and rewards incidental to ownership of an asset lie with either the lessor or lessee.

**Example: Right to use an asset (continued)**

It has been concluded that the arrangement contains a lease as both conditions have been met. The next step will be to determine whether the lease should be classified as a finance lease or an operating lease, based on the classification criteria in GRAP 13.

As Entity B is leasing the power station exclusively for the major part of its economic life (4 out of 5 years), and the rights of use have therefore effectively been conveyed to Entity B, the lease meets the definition of a finance lease. The lease should be accounted for as a finance lease.

Entity B will consequently recognise the power station as an asset and a raise a corresponding finance lease obligation in the statement of financial position.

In contrast, Entity E will derecognise the power station as an asset, and recognise a finance lease asset equal to the net investment in the lease in the statement of financial position.

Also refer to ***Example 1: Classifying a Lease***

## 4.4 Land and buildings

When a lease contains land and a building, the two components should be assessed individually. Land usually has an indefinite economic life (except in cases such as for landfill sites and quarries which have limited economic lives); therefore it is possible that the building may be classified as a finance lease and the land as an operating lease.

On initial recognition, the lease payments should be allocated between the land and the building based on the fair values of each. If payments cannot be allocated, the entire lease is classified as finance lease, unless the lease contract is clearly an operating lease, e.g. where the building is leased for a significant shorter period than its economic life.

In instances where the lease payment amount that would be allocated to land is immaterial, both land and building can be treated as single asset for classification purposes and the economic life of the asset would be based on the economic life of the building.

Where lessee's interest in the property is classified as an investment property in terms of GRAP 16 on *Investment Property*, separate measurement of land and buildings is not required and it is accounted for under the fair value model.

In such a situation, the lease is accounted for as if it was a finance lease. Where subsequent events change the nature of the lessee's property interest, the lessee should carry on accounting for the property interest as a finance lease, even though it is no longer classified as an investment property.

**Example: Classification of property interest held under operating lease as an investment property**

Entity B acquires a 50-year ground lease that otherwise meets the definition of an investment property. In order to classify this leasehold interest as an investment property, the entity is required to use the fair value model when accounting for all of its investment property (this is the accounting policy for the entity with regards to investment property).

If a subsequent event changes the nature of Entity B's interest so that the property is no longer is classified as investment property, Entity B will continue to account for the lease as a finance lease.

## 4.5 Cell phones and 3G modems

In practice, a cell phone (or 3G modem) contract usually results in the contract holder obtaining ownership of the phone and receiving the right to use the network for the duration of the contract.

The indicators of the transfer of risks and rewards which are most relevant to cell phone contracts are as follows:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

Due to the fact that cell phone contracts usually transfer ownership at the end of the contract and the phone usually only has a short economic life, these contracts will generally result in finance leases.

The specific terms of the agreements should however be considered when classifying these agreements. Also take into consideration the concept of materiality in considering the accounting and disclosure of cell phones and 3G modems contracts.

Also refer to **Example *2*: Initial Measurement of Cell Phone Contracts**

## 5. Recognition and Measurement

### 5.1 Finance lease in the financial statements of a lessee

At the beginning of the lease term, i.e. commencement date, the lessee should recognise the leased asset as an asset and the lease commitment as a liability in the statement of financial position.

The leased asset should be recognised at lower of:

- the fair value of the leased property; and
- the present value of the future minimum lease payments.

The present value of the future minimum lease payments is discounted at the interest rate implicit in the lease, which can usually be calculated from the information provided in the contract. If it is not possible to calculate the rate implicit in the lease, then the entity uses its incremental borrowing rate (i.e. entity / government lending rate).

The interest **rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of:

- the minimum lease payments; and
- the unguaranteed residual value;

to be equal to the sum of:

- the fair value of the leased asset; and
- any initial direct costs of the lessor.

The **lessee's incremental borrowing rate** of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

When an entity has borrowings that are guaranteed by the government, the incremental borrowing rate of interest should reflect the government's guarantee and any fees, which will normally result in a lower incremental borrowing rate of interest.

## Example: Calculating the present value of minimum lease payments due

Entity A entered into a lease agreement on 1 April 20X0 to lease a machine for a period of three years. The monthly lease payment is R5,000 payable in arrears beginning 30 April 20X0 and the rate implicit in the lease is 5%. In addition, Entity A has to pay a contingent rental based on 2% of its turnover.

The present value of the minimum lease payments will be calculated as follows:

| | |
|---|---|
| PMT | 5,000 |
| i | 0.00416667% (5% / 12) |
| n | 36 (3 x 12) |
| PV? | 166,828 |

Note the lease is payable on a monthly basis, therefore the interest rate and period also needs to be monthly

This calculation can be done on a financial calculator or in MS Excel.

The journal entry at commencement of the lease will be as follows:

| | Debit | Credit |
|---|---|---|
| | **R** | **R** |
| Finance lease asset (machine) | 166,828 | |
| Finance lease liability | | 166,828 |

Note that the contingent rent is ignored for the purposes of calculating the present value of minimum lease payments due.

The initial direct costs that the lessee incurs to negotiate and arrange a lease should be added to the amount recognised as an asset.

The leased asset and finance lease liability should not be offset against each other in the financial statements. Where an entity distinguishes between current and non-current liabilities, lease liabilities should also be distinguished.

An entity should apportion the minimum lease payments between finance charge and settlement of the outstanding liability, i.e. capital portion. The finance charge should be allocated to each period during the lease term, so that a constant periodic rate of interest on the balance of the liability can be produced. To allocate the finance charge to periods during the lease term, approximations may be used by the lessee to simplify the calculation.

Contingent rents expected, i.e. payments linked to a variable that is not known until payment is due, for example, payment linked to future price indices, percentage of future sales or amount of copies made by machine, etc., will be charged as an expense in the periods when it is actually incurred. As such, these portions of the lease payments are excluded from the minimum lease payments.

Depreciable leased assets under finance leases recognised will give rise to a depreciation / amortisation expense. The depreciation / amortisation policy should be established in accordance with GRAP 17 on *Property, Plant and Equipment* and GRAP 31 on *Intangible Assets*.

Where it is reasonably certain that the lessee will obtain ownership at the end of the lease term, the asset will be depreciated / amortised over the same period, i.e. useful life, as for similar assets that are owned, as per the entity's depreciation / amortisation policy. In all other instances, the asset will be depreciated / amortised over the shorter of the lease term or its useful life.

The subsequent measurement of the leased asset should be consistent with the applicable standard of GRAP. Where applicable, the entity should assess whether the asset has become impaired, by applying the relevant impairment tests in accordance with the standards of GRAP on impairment of assets.

Also refer to **Example *3*: Subsequent Measurement – Finance Lease in the Financial Statements of a Lessee**

## 5.2 Finance lease in the financial statements of a lessor

Lease payments receivable under a finance lease should be recognised as an asset in the statement of financial position. The receivable would be equal to the net investment in the lease.

The net investment is the gross investment in the lease discounted at the interest rate implicit in the lease.

The gross investment is the aggregate of:

- The minimum lease payments receivable; and
- Any unguaranteed residual value accruing to the lessor.

Therefore the net investment is the capital portion and the gross investment is the capital plus unearned interest portions.

Where initial direct costs to negotiate and arrange the lease are incurred by lessor (other than a manufacturer or trader lessor), these are included in the initial measurement of the finance lease receivable and therefore reduce the lease revenue recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included in the finance lease receivable automatically and it is not required to add them separately.

Costs incurred by manufacturer or trader lessors in connection with negotiating and arranging the lease are not initial direct costs as defined and are expensed when the gain or loss on the lease is recognised, which is normally at the commencement of the lease term.

Interest receivable should be recognised over each period based on a pattern that reflects a constant periodic rate of return on the lessor's net investment in the finance lease. The recognition should be on a systematic and rational basis. The lease payment received reduces the gross investment in the lease and is allocated to the principal debt (capital) and accrued finance revenue.

The lessor needs to review the estimated unguaranteed residual value used to calculate the gross investment. If the estimated unguaranteed residual decreases, the revenue allocation over the lease term should be revised and the amount reduced in respect of revenue already accrued, should be recognised immediately.

When a manufacturer or trade lessor enters into a finance lease agreement, the asset is transferred from inventory, thus the sales revenue would be recognised in the period of the sale and finance revenue will be earned over the term of the finance lease.

The sales revenue would be the same as the asset's value recognised by the lessee, (excluding the initial cost incurred by the lessee), which is the lower of the fair value of the asset or the minimum lease payments accruing to the lessor, discounted at a market rate of interest. The cost of sale would be the cost, or carrying amount of the leased property, less the present value of unguaranteed residual value. The difference between sales revenue and cost of sale will be the gain or loss on the sale, which should be calculated in accordance with the policy followed by the entity for outright sales. This should be recognised at the commencement of lease.

Where the manufacturer or trader incurred cost in connection with negotiating and arranging a lease, it is expensed when the gain or loss on sale is recognised. If the manufacturer or trade lessor offered the lessee an artificially low rate of interest, the gain or loss on sale of the asset will be limited to the gain or loss that would have been earned if a market rate of interest was used.

Manufacturer or trade lessor in GRAP 13 refers to all entities that manufacture or trade assets and also act as lessors of those assets, regardless of the scale of their leasing, trading and manufacturing activities.

Also refer to **Example *4*: Subsequent Measurement – Finance Lease in the Financial Statements of a Lessor**

## 5.3 Operating lease in the financial statements of a lessee

A lease asset is not recognised in respect of an operating lease, as the risks and rewards incidental to ownership is not transferred to the lessee. Consequently, the lease payments under an operating lease should be recognised as an expense in the statement of financial performance on a straight-line basis over the lease term.

Payments for services such as insurance and maintenance should, however, be separately recognised and disclosed in the period they occur.

Where the lease payments in respect of an operating lease is escalated by a fixed rate (e.g. 3% per annum), the total cost is calculated for the whole lease (over the whole lease term) and is then equalised over the lease term.

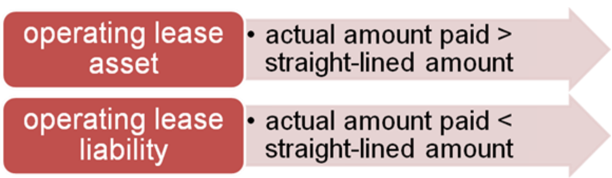
Where the cost of an operating lease is escalated with reference to a future amount of a factor that changes other than by passage of time (such as a price index or CPIX), this factor amounts to a contingent rental and is therefore disregarded when calculating the straight-lining.

Instances where straight-lining will not be required:

- Rental agreement is for an indefinite period;
- Rental agreement is on a month-to-month basis; and
- There is no escalation of the lease payments.

Another systematic basis can be used to recognise the expense if it is more representative of the time pattern of the user's benefit, e.g. machine hours. Another systematic basis may be relevant where the lease payments are based on usage.

Any difference between the actual lease payments and the straight-lined amounts will be recognised as operating lease assets or liabilities in the statement of financial position.



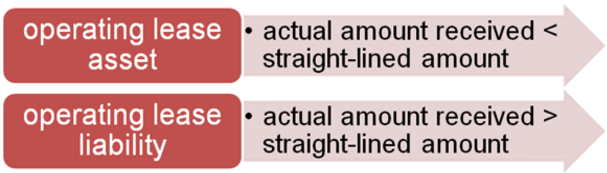
If there is an operating lease incentive provided, it should be recognised as an integral part of the lease transaction irrespective of the incentive's nature or form or the timing of payments. The lessee would recognise the incentives as a reduction of rental expense on the same basis as the expense (i.e. straight-lined unless another systematic basis is adopted).

Also refer to **Example 5: Calculating the straight-lined amounts for an operating lease**

## 5.4 Operating lease in the financial statements of a lessor

The lease revenue under an operating lease should be recognised in the statement of financial performance.

For straight-lining, the same principles apply as indicated under the previous section. The only difference will be the recognition of operating lease assets or liabilities in the statement of financial position as this is from the lessor's perspective




Cost incurred to earn lease revenue is recognised as an expense on the same basis of the revenue recognised.

When the lessor incurred cost in negotiating and arranging the operating lease, these costs should be added to the carrying amount of the leased asset and recognised as expenses over the lease term on the same basis as the lease revenue.

The depreciation / amortisation policy on the leased asset should be consistent with the normal depreciation / amortisation policy for similar assets in accordance with GRAP 17 on *Property, Plant and Equipment* and GRAP 31 on *Intangible Assets*.

The standards of GRAP on impairment of assets should be applied to determine whether the leased asset has become impaired.

## 6. Sale and Leaseback

Sometimes an entity would enter into a transaction involving selling an asset and then the leasing back of the same asset from the purchaser. The sales price and lease payments are inter-linked as they are usually negotiated at the same time.

If such a transaction results in a finance lease, this will, in essence, amount to a finance transaction, as the seller retains the risk and rewards of ownership of the asset. It is essentially "refinanced". A sale and leaseback transaction is therefore a way for the lessee to obtain finance from the lessor, with the asset as security. Therefore, any excess of the sales proceeds over the carrying amount should not be recognised as revenue immediately, instead it should be deferred and amortised over the lease term.

When a sale and lease back results in an operating lease, the accounting treatment will be determined by the following:

- if sales price is equal to the fair value; the gain or loss should be recognised immediately;
- if sales price is below fair value; the loss is recognised immediately, with the exception of a loss that will be compensated by future lease payment that are below market price which should be deferred over lease term;
- if sales price is above fair value; the gain is deferred over the lease term; and
- if the lease payments and the sale price are at fair value (a normal sales transaction), then the gain or loss is recognised immediately.

The tables below show the requirements in the various circumstances.

| Sale price at fair value | Carrying amount equal to fair value | Carrying amount less than fair value | Carrying amount above fair value |
|---|---|---|---|
| Gain | no gain | recognise gain immediately | not applicable |
| Loss | no loss | not applicable | recognise loss immediately |

| Sale price below fair value | Carrying amount equal to fair value | Carrying amount less than fair value | Carrying amount above fair value |
|---|---|---|---|
| Gain | no gain | recognise gain immediately | no gain (note 1) |
| Loss not compensated for by future lease payments at below market price | recognise loss immediately | recognise loss immediately | (note 1) |
| Loss compensated for by future lease payments at below market price | defer and amortise loss | defer and amortise loss | (note 1) |

| Sale price above fair value | Carrying amount equal to fair value | Carrying amount less than fair value | Carrying amount above fair value |
|---|---|---|---|
| Gain | defer and amortise gain | defer and amortise excess gain (note 3) | defer and amortise gain (note 2) |
| Loss | no loss | no loss | (note 1) |

- **Note 1:** This represent circumstances where the fair value is less than the carrying amount of the asset. The difference between the carrying amount of an asset and the fair value should be recognised as a loss immediately where it is subject to a sale and leaseback.
- **Note 2:** The gain is the difference between fair value and sale price, because the carrying amount would have been written down to fair value.
- **Note 3:** The excess gain (the excess of sale price over fair value) is deferred and amortised over the period for which the asset is expected to be used. Any excess of fair value over carrying amount is recognised immediately.

**Example: Sale and leaseback transaction – operating lease**

| **1. Sale price above fair value** | |
|---|---|
| | **R** |
| Book value (BV) | 100 |
| Fair value (FV) | 110 |
| Sale price (SP) | 125 |
| Gain to be recognised (FV - BV) | 10 |
| Gain to be deferred (SP - FV) | 15 |

| 2. Sale price below fair value | | |
|---|---|---|
| | Asset A | Asset B |
| | **R** | **R** |
| Book value (BV) | 100 | 100 |
| Fair value (FV) | 125 | 110 |
| Sale price (SP) | 110 | 95 |
| Gain to be recognised (SP - BV) | 10 | - |
| Apparent loss deferred if compensated by below market rentals (SP - BV) | - | (5) |

## 7. Illustrative Examples

### Example 1: Classifying a Lease

An entity has entered into a four year rental agreement for a photocopier. In terms of the agreement, the entity will have the right to use a specified photocopier that will not be charged for the rental period, thereafter the photocopier must be returned to the lessor.

The following are the main provisions of the agreement:

- The rental payment is R2,500 per month over a period of 48 months.
- The rental payments will fluctuate in accordance with changes in the prime lending rate.
- The entity is responsible for the insurance of the asset.
- The agreement states that ownership remains with the lessor, and at no time will ownership pass to the entity.
- At the end of the lease term, the lease can continue on a month-to-month basis (based on the final rental amount), until notified by either party.
- If the entity cancels the agreement during the term, it has to immediately pay all outstanding payments for the remainder of the rental period to the lessor.

If the entity was to purchase the photocopier outright, a cash payment of R95,000 would be required. The entity's incremental borrowing rate is 12%. The economic life of a photocopier is considered to be five years.

The entity applies the indicators as listed in GRAP 13 to the provisions in the lease agreement to determine whether it should be classified as an operating or a finance lease:

| GRAP example of situations that normally indicate finance leases | Application to rental agreement | Met (Y/N) |
|---|---|---|
| The lease transfers ownership of the asset to the lessee by the end of the lease term | No such provision in agreement | N |
| The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the 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 | No such provision in agreement | N |
| The lease term is for the major part of the economic life of the asset even if title is not transferred | Lease contract is for 4 years and the economic life of the photocopier is 5 years<br>4/5 = 80%<br>This is considered to be a major part of the life of the asset | Y |
| At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset | Using a financial calculator or MS Excel:<br>PV = (rate,nper,pmt)<br>PV = (12/12,48,-2,500)<br>PV = 94,935<br>Therefore the present value equals substantially all of the fair value of R95,000 | Y |

| GRAP example of situations that normally indicate finance leases | Application to rental agreement | Met (Y/N) |
|---|---|---|
| The leased assets are of a such a specialised nature that only the lessee can use them without major modifications | The photocopier is not specialised and can be used by other entities | N |
| The leased assets cannot easily be replaced by another asset | Photocopier can easily be replaced by another | N |
| If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee | Entity has to pay all outstanding rentals if it cancels the lease | Y |
| Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease) | Not applicable to agreement | N |
| The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent | Not applicable, as the entity can continue renting the photocopier at the final rental amount | N |

It is not necessary that all criteria are met for an agreement to constitute a finance lease. If substantially all the risks and rewards of ownership have been transferred to the entity, it should account for the agreement as a finance lease. The transfer of risks and rewards is demonstrated by the fact that the present value of the minimum lease payments equals substantially all of the fair value of the photocopier, that the lease is for the major part of the economic life of the asset and that the entity is responsible for insuring the asset.

The entity should therefore classify the lease as a finance lease and account for it accordingly.

## Example 2: Initial Measurement of Cell Phone Contracts

***Discussion on the measurement of cell phone and 3G modem contracts***

In order to determine the value attributable to the handset/modem, the components of the transaction needs to be identified and the consideration payable needs to be allocated to these components. The following is an example of components that may exist in a generic cell phone / 3G modem contract:

- Sale of a cell phone/modem;
- Finance cost relating to the sale of the cell phone/modem;
- Use of the network; and
- Free minutes/data bundles.

The following methods can be used to allocate the consideration to the relevant components:

- • Relative fair values method;
- • Residual value method; or
- • Cost-plus-margin method.

In terms of the relative fair value method, the total consideration is allocated to the different components based on the ratio of the fair values of the components relative to each other. In order to apply this method, the fair values of the components need to be ascertained.

The residual value method requires the undelivered components (e.g., network access/free minutes) to be measured at fair value and the remainder is to be allocated to the delivered component (e.g., cell phone/modem).

The cost-plus-margin method allocates the consideration based on the expected cost of each component plus a reasonable margin. This method should be applied only when it is difficult to apply the relative fair values or residual value method.

The best evidence of fair value is the price charged for an identical item sold on a standalone basis.

***Example on the measurement of cell phone and 3G modem contracts***

Entity A signed a two year cell phone contract with Network1. The entity pays R430 per month (excluding VAT) for 24 months and it gets 200 anytime minutes for free plus a free cell phone. Should the contract be cancelled, Entity A will be liable for all outstanding monthly payments.

The phone becomes the property of Entity A at the end of the contract. The cash price (at inception date of the contract) for the cell phone provided with the contract is R7,199. The incremental borrowing rate of Entity A is 15% (this is the rate that Entity A would have paid had it borrowed the money to buy the cell phone for R7,199).

**Step 1:** Determine if the contract is a finance or operating lease

This contract is finance lease due to Entity A carrying all the risk and rewards of ownership, this is demonstrated by:

- Ownership is transferred to Entity A at the end of the period;
- Entity A will carry all the cost involved in cancelling the contract; and

- Entity A is responsible for paying insurance and thus carries all the risk should the phone be lost, stolen or broken.

**Step 2:** Determine the amount to be recognised as the cost of the asset and liability which is the lowest of fair value (R7,199) or the present value of future payments. The present value of the minimum lease payments will be calculated as follows:

| | |
|---|---|
| PMT | 430 |
| i | 0.0125% (15% / 12) |
| n | 24 |
| PV? | 8,868 |

The average rate per peak minute is R1. The present value of 200 minutes for 24 months will be calculated as follows:

| | |
|---|---|
| PMT | 200 (200 x 1) |
| i | 0.0125% (15% / 12) |
| n | 24 |
| PV? | 4,125 |

The present value of the phone is calculated as the difference between the total present value and the present value of the free minutes: R4,743 (R8,868 – R4,125).

Thus the amount to be recognised as an asset and a liability is R4,743.

**Step 3:** Recognise asset and liability

| At commencement date | Debit | Credit |
|---|---:|---:|
| | **R** | **R** |
| Finance lease asset (cell phone) | 4,743 | |
| Finance lease liability | | 4,743 |

## Example 3: Subsequent Measurement – Finance Lease in the Financial Statements of a Lessee

Entity A entered into a lease agreement on 1 April 20X0 to lease a machine for a period of three years. The **yearly** lease payment is R60,000 payable in arrears beginning 30 April 20X0 and the rate implicit in the lease is 5%. In addition, Entity A has to pay a contingent rent based on 2% of its revenue.

**In the records of the lessee**

Entity A's revenues over the three years were as follow:

| | |
|---|---|
| Year 1 | R100, 000 |
| Year 2 | R150, 000 |
| Year 3 | R120, 000 |

The fair value of the machine is R189,000 and the present value of the minimum lease payments due is R163,395 (pmt R60,000; i 5%; n 3).

**Step 1** Determine the amount at which the asset and liability would be recognised in the records of the lessee as follows:

GRAP 13 states that the lease asset and liability should be recognised at the lower of the fair value of the leased asset or the present value of the minimum lease payments due, which is R163,395.

**Step 2** Draw up an amortisation table to split the lease payments between the interest and capital portions as follows:

| Date | Payment | Interest | Capital | Balance |
|---|---:|---:|---:|---:|
| 1 April 20X0 | | | | R163,395 |
| 30 April 20X0 | R60,000 | R8,170 | R51,830 | R111,565 |
| 30 April 20X1 | R60,000 | R5,578 | R54,422 | R57,143 |
| 30 April 20X2 | R60,000 | R2,857 | R57,143 | R- |
| Total | R180,000 | R16,605 | R163,395 | |

**Interest:** outstanding balance x percentage, i.e. 5%

**Capital:** payment less interest

The amortisation table can be populated in MS Excel or by determining the amounts using a financial calculator.

Note that the contingent rent is not added in the amortisation table.

**Step 3** Recognise the finance lease asset and liability

The journal entry will be as follows:

| Year 1 | Debit | Credit |
|---|---|---|
| | R | R |
| Finance lease asset | 163,395 | |
| Finance lease liability | | 163,395 |
| Recognising the asset leased under a finance lease | | |

The journal entries under subsequent measurement for year 1 to 3 will be as follow:

| Year 1 | Debit | Credit |
|---|---|---|
| | R | R |
| Finance lease liability | 51,830 | |
| Interest expense | 8,170 | |
| Lease expense<br>(contingent rent – R100,000 x 2%) | 2,000 | |
| Bank (actual payment) | | 62,000 |
| Payment of first instalment and contingent rent | | |

| Year 1 | Debit | Credit |
|---|---|---|
| | R | R |
| Depreciation (R163,395 / 3) | 54,465 | |
| Accumulated depreciation | | 54,465 |
| Recognising depreciation on the asset leased for year 1 | | |

| Year 2 | Debit | Credit |
|---|---|---|
| | R | R |
| Finance lease liability | 54,422 | |
| Interest expense | 5,578 | |
| Lease expense<br>(contingent rent – R150,000 x 2%) | 3,000 | |
| Bank (actual payment) | | 63,000 |
| Payment of second instalment and contingent rent | | |

| Year 2 | Debit | Credit |
|---|---|---|
| | R | R |
| Depreciation (R163,395 / 3) | 54,465 | |
| Accumulated depreciation | | 54,465 |
| Recognising depreciation on the asset leased for year 2 | | |

| Year 3 | Debit | Credit |
|---|---|---|
| | R | R |
| Finance lease liability | 57,143 | |
| Interest expense | 2,857 | |
| Lease expense<br>(contingent rent – R120,000 x 2%) | 2,400 | |
| Bank (actual payment) | | 62,400 |
| Payment of third instalment and contingent rent | | |

| Year 3 | Debit | Credit |
|---|---|---|
| | R | R |
| Depreciation (R163,395 / 3) | 54,465 | |
| Accumulated depreciation | | 54,465 |
| Recognising depreciation on the asset leased for year 3 | | |

GRAP 13 requires that contingent rent be expensed in the period when incurred, therefore it will not form part of the finance lease liability payments.

If we take the same example above but assume that the lease payments were made on a monthly basis, the amortisation table will need to be drawn up on a monthly basis as well.

### Example 4: Subsequent Measurement – Finance Lease in the Financial Statements of a Lessor

Entity A (lessee) entered into a lease agreement with Entity B (lessor) on 1 April 20X0 to lease a machine for a period of three years. The **yearly** lease payment is R60, 000 payable in arrears beginning 30 April 20X0 and the rate implicit in the lease is 5%. In addition, Entity A has to pay a contingent rent based on 2% of its revenue.

**In the records of the lessor**

Revenue for Entity A over the three years was as follows:

| | |
|---|---|
| Year 1 | R100,000 |
| Year 2 | R150,000 |
| Year 3 | R120,000 |

The carrying amount of the machine in the records of Entity B on 30 April 20x0 was R170,000. The fair value of the machine is R189,000 and the present value of the minimum lease payments due is R163,395 (pmt R60,000; i 5%; n 3).

**Step 1** Determine the amount at which the net investment would be recognised in the records of the lessor as follows:

GRAP 13 states that the net investment is the present value of the minimum lease payments due, which is R163,395.

| | | |
|---|---|---|
| Gross investment in lease | | R180,000 |
| Unearned finance income | | (R16,605) |
| **Net investment** | | **R163,395** |

**Step 2** Draw up an amortisation table to split the lease receipts between the interest and capital portions as follows:

| Date | Receipt | Interest | Capital | Balance |
|---|---|---|---|---|
| 1 April 20X0 | | | | R163,395 |
| 30 April 20X0 | R60,000 | R8,170 | R51,830 | R111,565 |
| 30 April 20X1 | R60,000 | R5,578 | R54,422 | R57,143 |
| 30 April 20X2 | R60,000 | R2,857 | R57,143 | R- |
| Total | R180,000 | R16,605 | R163,395 | |

**Interest:** outstanding balance x percentage, i.e. 5%

**Capital:** receipt less interest

The amortisation table can be populated in MS Excel or by determining the amounts using a financial calculator.

Note that the contingent rent is not added in the amortisation table.

**Step 3** Recognise the net investment and the gain/loss for the derecognition of the machine

The journal entry will be as follows:

| Year 1 | Debit | Credit |
|---|---|---|
| | R | R |
| Gross investment in lease | 180,000 | |
| Unearned finance income | | 16,605 |
| Loss on derecognition of asset | 6,605 | |
| Machine (Leased asset) | | 170,000 |
| Recognising the lease payments receivable (i.e. net investment in lease) and derecognising the machine leased | | |

The two amounts can also be netted off to reflect only the capital amount outstanding (net investment in the lease). The net effect of both methods is the same, as the gross investment in the lease and the unearned finance income are netted off for disclosure purposes.

The journal entries will be netted off as follows:

| | | |
|---|---|---|
| Net investment in lease | 163,395 | |

The journal entry under subsequent measurement for year 1 will be as follows:

| Year 1 | Debit | Credit |
|---|---|---|
| | R | R |
| Bank (actual receipt) | 62,000 | |
| Gross investment in lease | | 60,000 |
| Unearned finance income | 8,170 | |
| Interest received | | 8,170 |
| Lease revenue<br>(contingent rent – R100,000 x 2%) | | 2,000 |
| Receipt of first instalment and contingent rent | | |

GRAP 13 requires that contingent rent be recognised in the period when received, therefore it will not form part of the net investment receipts.

If we take the same example above but assume that the lease payments were made on a monthly basis, the amortisation table will need to be drawn up on a monthly basis as well.

### Example 5: Calculating the straight-lined amounts for an operating lease

Entity A entered into a lease agreement on 1 April 20X0 to lease a machine for a period of three years. The monthly lease payment is R5,000 payable in arrears beginning 30 April 20X0 and escalates with 5% annually at 30 April. In addition, Entity A has to pay a contingent rental based on 2% of its revenue. Reporting period is 31 March.

Revenue for Entity A over the three years was as follows:

| | |
|---|---|
| Year 1 | R100,000 |
| Year 2 | R150,000 |
| Year 3 | R120,000 |

**Step 1** An entity needs to calculate what the total lease payments will amount to over the lease term, as follows:

| | | |
|---|---|---|
| Year 1 | (R5,000 x 12) | R60,000 |
| Year 2 | (R60,000 x 1.05) | R63,000 |
| Year 3 | (R63,000 x 1.05) | R66,150 |
| **Total payments** | | **R189,150** |

**Step 2** The straight-lined amount needs to be calculated, which is as follows:

Total lease payments / lease term: R189,150 / 3 = R63,050 per annum

The R63,050 is the amount that will be recognised for the three years in the statement of financial performance as an expense. Note that the contingent rent is not added when calculating the straight-lined amount, as it depends on future amounts.

**Step 3** An entity needs to calculate the difference between the actual payment and straight-lined amount which will be recognised as an operating lease (liability) / asset in the statement of financial position, as follows:

Amount actually paid (per lease agreement) less straight-lined amount = operating lease (liability) / asset.

| | Over/under | Balance |
|---|---:|---:|
| Year 1 (60,000 less 63,050) | (R3,050) | (R3,050) |
| Year 2 (63,000 less 63,050) | (R50) | (R3,100) |
| Year 3 (66,150 less 63,050) | R3,100 | - |

This is the operating lease liability which will increase/decrease each year over the lease period. At the end of the lease period (our example year 3), the balance will be zero. Even if the difference (second column) results in a debit entry, it will not be shown under assets, but will remain under liabilities, therefore decreasing the balance. The first year's entry will determine if an operating lease liability or asset will be recognised.

The journal entries will be as follows:

| Year 1 | Debit | Credit |
| --- | --- | --- |
| | R | R |
| Lease expense (straight-lined amount) | 63,050 | |
| Operating lease liability | | 3,050 |
| Lease expense (contingent rent – R100,000 x 2%) | 2,000 | |
| Bank (actual payment) | | 62,000 |
| Recognising the straight-lined amount and actual amount paid | | |

| Year 2 | Debit | Credit |
| --- | --- | --- |
| | R | R |
| Lease expense (straight-lined amount) | 63,050 | |
| Operating lease liability | | 50 |
| Lease expense (contingent rent – R150,000 x 2%) | 3,000 | |
| Bank (actual payment) | | 66,000 |
| Recognising the straight-lined amount and actual amount paid | | |

| Year 3 | Debit | Credit |
| --- | --- | --- |
| | R | R |
| Lease expense (straight-lined amount) | 63,050 | |
| Operating lease liability | 3,100 | |
| Lease expense (contingent rent – R120,000 x 2%) | 2,400 | |
| Bank (actual payment) | | 68,550 |
| Recognising the straight-lined amount and actual amount paid | | |

Note that even though the contingent rent can be allocated to the same account as the normal lease payment, GRAP 13 requires that this amount be separately disclosed in the financial statements.

If we take the same example above but assume that the lease was entered into during the reporting period, assume 1 June 20X0, the calculations will change as follows:

**Step 1** An entity needs to calculate what the total lease payments will amount to over the lease term, as follows:

| | | |
|---|---|---|
| Rep period 1 | (R5,000 x 10) | R50,000 |
| Rep period 2 | (R5,000 x 2) + [(R5,000 x 1.05) R5,250 x 10)] | R62,500 |
| Rep period 3 | (R5,250 x 2 + [(R5,250 x 1.05) R5,512.50 x 10)] | R65,625 |
| Rep period 4 | (R5,512.50 x 2) | R11,025 |
| Total payments | | R189,150 |

**Step 2** The monthly straight-lined amount needs to be calculated, as follows:

Total lease payments / lease term: R189,150 / 36 (3 x 12) = R5,254.17 per month

The R52,541.67 (R5, 254.17 x 10) is the amount that will be recognised in the first reporting period (ending 31 March 20x1) in the statement of financial performance as an expense.

**Step 3** The difference between the actual payment and straight-lined amount which will be recognised as an operating lease (liability) / asset in the statement of financial position for the first reporting period is as follows:

Amount actually paid (per lease agreement) less straight-lined amount = operating lease (liability) / asset: R50,000 less R52,541.67 = (R2,541.67).

### Example 6: Examining the substance of a lease

Municipality X entered into a 20 year lease agreement with Municipal Entity Y for the use of the Convention Centre and related land ("premises"), owned by Municipality X. Municipal Entity Y is required to make a once off rental payment of R1,50 to Municipality X. All monthly operating costs associated with the premises are the responsibility of Municipal Entity Y. Accordingly, Municipality X will not incur any expenses in relation to the maintenance, repair, renovation, replacement or upkeep of the premises over the period of the lease. In addition, any improvements to the premises are executed and paid for by Municipal Entity Y.

In terms of the agreement, Municipality X provides Municipal Entity Y with the premises for the purpose of conducting the business of a convention centre (e.g. hosting of various events, exhibitions, entertainment concerts, functions and conferences).

Although this agreement technically meets the definition of a lease, the GRAP Framework requires the accounting for arrangements to reflect their substance rather than their legal or other form. In evaluating the aspects and implications of an agreement to determine its substance, weight must be given to those aspects and implications that have an economic effect.

Upon consideration of the characteristics, implications and practical reality of the arrangement between the Municipality and its Entity, the intention and substance of the arrangement is not that of a lease, as the rental payment is nominal. A once off R1,50 lease payment by Municipal Entity Y in order to use the premises for a 20-year lease period is significantly less than the fair value of the premises being leased. Accounting for the arrangement as a lease (only) will result in the Municipal Entity's financial statements not reflecting the true service potential and/or economic benefit of the assets that have been made available to the entity.

The receipt of value from another entity without directly giving approximately equal value in return meets the definition of non-exchange revenue in GRAP 23 on *Revenue from Non-exchange Transactions*, and more specifically services in-kind.

GRAP 23 requires an entity to recognise services-in-kind that:

- meet the asset definition, i.e. when the entity controls the assets;
- satisfy the recognition criteria, as it is:
  - probable that the future economic benefits or service potential will flow to the entity; and
  - the fair value of the asset can be measured reliably; and
- are significant to its operations and/or service delivery objectives

as an asset and related non-exchange revenue and it initially measure it at its fair value.

In the arrangement between Municipal Entity Y and Municipality X, the services-in-kind-received by Municipal Entity Y is the free/concessionary use of the premises, i.e. a "right-of-use" asset in respect of the underlying premises. The asset is not the actual premises. The fair value of the "right-of-use" assets for the fee/concessionary use of the premises is therefore also not the same of the fair value of the underlying premises.

The free/concessionary use of the premises that Municipal Entity Y receives is integral to both its operations and its mandated service delivery objectives of creating inspiring convention, exhibition and entertainment experiences that exceed its customers' expectations in an innovative, sustainable and proudly multi-cultural African way (its mission statement).

Municipal Entity Y therefore recognises a free/concessionary use of the premises as a "right-of-use" asset in its financial statements, measured at fair value, calculated with reference to market lease payments for other properties with similar characteristics, in similar circumstances and location, together with the nature and type of the services received in-kind.

Whether or not Municipal Entity Y should recognise a "right-of-use" services-in-kind asset only for the benefit received and consumed within a specific reporting period, or for the long-term benefit received over the full period of the arrangement (20 years) is dependent on whether Municipal Entity Y has an enforceable unconditional right in terms of the agreement to use the premises over the full 20-year period.

In this example, the agreement stipulates that:

- the agreement can only be terminated by mutual agreement between Municipality X and Municipal Entity Y, otherwise it will endure for a period of 20 years;
- Municipality X may elect to cancel the agreement if the premises are destroyed or damaged to the extent that Municipal Entity Y is prevented from having beneficial occupation of the premises; or
- Municipality X is entitled to demand that Municipal Entity Y vacates the premises if Municipal Entity Y becomes subject to certain specified circumstances.

The 2nd and 3rd bullet points are possible future events. At the time when Municipal Entity Y entered into the Agreement of lease, and up until such time as either of the future events of the agreements come into effect, Municipal Entity Y has an enforceable unconditional right to use the premises over the full 20-year period of the arrangement, as the Agreement of lease can only be terminated by mutual agreement between Municipality X and Municipal Entity Y.

Therefore, Municipal Entity Y should recognise a "right-of-use" services-in-kind asset for the full (initial) 20-year period of the arrangement. The "right-of-use" services-in-kind asset should be reduced over the 20-year period by recognising an expense equal in value to the benefit consumed or used during a particular reporting period, in order to reflect the consumption or usage of the free/concessionary use of the premises services in-kind received.

At the time when Municipal Entity Y recognises the "right-of-use" services-in-kind asset for the free/concessionary use of the premises, the corresponding credit is recognised as non-exchange services-in-kind revenue, except if GRAP 23 requires a liability to be recognised. A liability must be recognised if the "right-of-use" asset is subject to a condition. I.e. if there is a present obligation at the time when the recipient receives the funds for the future economic benefits or service potential embodied in the asset to be returned if it is not consumed as specified.

This will be the case if the agreement specifies that the right to use the underlying asset (the Convention Centre) returns to Municipality X, if Municipal Entity Y does not use the premises in accordance with the terms and conditions of the agreement of lease for the purpose of conducting the business of a convention and exhibition centre.

Assume further that the agreement stipulates that "in the event that … Municipal Entity Y, for whatever reason, becomes unable to conduct its normal course of business … then and in that event, Municipality Y shall be entitled … to demand that Municipal Entity Y vacate the premises within 30 business days and retake possession of the premises", this section:

- appears to only apply in instances where Municipal Entity Y becomes unable to conduct is normal course of business. It does not appear to apply in instances where Municipal Entity Y is able to use the premises for the purpose of conducting the business of an international convention and exhibition centre, but for whatever reason does not do so.

- provides Municipality Y with the option to demand that Municipal Entity Y vacates the premises and to retake possession of the premises. However, it is not mandatory for Municipality X to exercise this right, and it is also one of 3 different options that Municipality X could elect to exercise.

The agreement therefore does not impose a present obligation on Municipality X at the time when it obtains the "right-of-use" services-in-kind asset for the free/concessionary use of the premises that the agreement of lease ins cancelled and that Municipal Entity Y must return the right to use the premises to Municipality Y if it does not use the premises in accordance with the terms and conditions of the Agreement of lease for the purpose of conducting the business of an international convention and exhibition centre.

Therefore, the right-of-use" asset is not subject to conditions and Municipal Entity Y should recognise non-exchange services-in-kind revenue at the time when it recognises the "right-of-use" services-in-kind asset for the free/concessionary use of the premises. It would not be appropriate for Municipal Entity Y to initially recognise a liability which is subsequently released to non-exchange revenue over the 20-year lease period.

## 8. Useful links and references

| Reference | Location of reference |
|---|---|
| Frequently Asked Questions (**FAQs**) on the Standards of GRAP | ASB website: http://www.asb.co.za/frequently-asked-questions/ |
| **IGRAP 3** on *Determining Whether an Arrangement Contains a Lease* | ASB website: http://www.asb.co.za/interpretations-approved-and-effective/ |
| **IGRAP 13** on *Operating Leases – Incentives* | |
| **IGRAP 14** on *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* | |
| **IGRAP 16** on *Intangible Assets – Website Costs* | |
| **IGRAP 17** on *SCA where Grantor Controls Significant Residual Interest* | |
| **IGRAP 18** on *Recognition and Derecognition of Land* | |
| Guideline on The Application of Materiality to Financial Statements | ASB website: http://www.asb.co.za/guidelines/ |
| Standard Chart of Accounts for Local Government (**mSCOA**) | National Treasury website: http://mfma.treasury.gov.za (mSCOA – Municipal Standard Chart of Accounts) |
| Illustrative Financial Statements for local government | National Treasury website: http://mfma.treasury.gov.za (mSCOA – Municipal Standard Chart of Accounts) |