

Urgent Issues Group

Interpretation 127

July 2004

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



Australian Government

**Australian Accounting
Standards Board**

Obtaining a Copy of this Interpretation

This Interpretation is available on the AASB website: www.aasb.com.au.
Alternatively, printed copies of this Interpretation are available for purchase by contacting:

The Customer Service Officer
Australian Accounting Standards Board
Level 3
530 Collins Street
Melbourne Victoria 3000
AUSTRALIA

Postal address:
PO Box 204 Collins St West
Melbourne Victoria 8007
AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aaasb.com.au
Website: www.aasb.com.au

Other enquiries:

Phone: (03) 9617 7600
Fax: (03) 9617 7608
E-mail: standard@aaasb.com.au

COPYRIGHT

© 2004 Commonwealth of Australia

This UIG Interpretation contains International Accounting Standards Committee Foundation copyright material. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and enquiries concerning reproduction and rights for commercial purposes within Australia should be addressed to The Administration Director, Australian Accounting Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007.

All existing rights in this material are reserved outside Australia. Reproduction outside Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Australia should be addressed to the International Accounting Standards Committee Foundation at www.iasb.org.

ISSN 1449-8316

PREFACE

Reasons for Issuing UIG Interpretation 127

The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1 January 2005. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB is using the IASB Standards as the "foundation" Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.

The same approach applies to UIG pronouncements. This Interpretation is part of the set of Australian equivalents to each International Accounting Standard (IAS), International Financial Reporting Standard (IFRS) and Interpretation of the IASB (collectively defined by the IASB as IFRSs). This set includes UIG Interpretations that correspond to the IASB Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

Main Features of this Interpretation

This Interpretation is applicable to annual reporting periods beginning on or after 1 January 2005. To promote comparability among the financial reports of Australian entities, early adoption of this Interpretation is not permitted.

Application of this Interpretation will begin in the first annual reporting period beginning on or after 1 January 2005 in the context of adopting all Australian equivalents to IFRSs. The requirements of Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, the Australian equivalent of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Interpretation had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

This Interpretation requires a series of transactions which involve the legal form of a lease to be regarded as linked, and to be accounted for as one

transaction, when the overall economic effect cannot be understood without reference to the series of transactions as a whole. The Interpretation also provides indicators for assessing the substance of an arrangement, and requirements for accounting for some arrangements that consequently do not meet the definition of a lease under AASB 117 *Leases*.

Comparison with Superseded Requirements

There is no substantive difference with the requirements in Australia in UIG Abstract 50 *Evaluating the Substance of Transactions involving the Legal Form of a Lease*. Now superseded by this Interpretation, Abstract 50 was based on the requirements of Standing Interpretations Committee Interpretation SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

UIG Interpretation 127 is equivalent to Standing Interpretations Committee Interpretation SIC-27, issued by the IASB. Paragraphs that have been added to this Interpretation (and do not appear in the text of the equivalent SIC Interpretation) are identified with the prefix “Aus”, followed by the number of the relevant SIC paragraph and decimal numbering.

Entities that comply with Interpretation 127 will simultaneously be in compliance with SIC-27.

International Public Sector Accounting Standards (IPSASs) are issued by the Public Sector Committee of the International Federation of Accountants. IPSAS 13 *Leases* (December 2001) does not address the matters covered by the Interpretation.

URGENT ISSUES GROUP
INTERPRETATION 127
***EVALUATING THE SUBSTANCE OF
TRANSACTIONS INVOLVING THE
LEGAL FORM OF A LEASE***

ISSUE

1. An entity may enter into a transaction or a series of structured transactions (an arrangement) with an unrelated party or parties (an Investor) that involves the legal form of a lease. For example, an entity may lease assets to an Investor and lease the same assets back, or alternatively, legally sell assets and lease the same assets back. The form of each arrangement and its terms and conditions can vary significantly. In the lease and leaseback example, it may be that the arrangement is designed to achieve a tax advantage for the Investor that is shared with the entity in the form of a fee, and not to convey the right to use an asset.
2. When an arrangement with an Investor involves the legal form of a lease, the issues are:
 - (a) how to determine whether a series of transactions is linked and should be accounted for as one transaction;
 - (b) whether the arrangement meets the definition of a lease under Accounting Standard AASB 117 *Leases*; and, if not,
 - (i) whether a separate investment account and lease payment obligations that might exist represent assets and liabilities of the entity (e.g., consider the example described in paragraph A2(a) of Appendix A);
 - (ii) how the entity should account for other obligations resulting from the arrangement; and
 - (iii) how the entity should account for a fee it might receive from an Investor.

CONSENSUS

3. A series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely interrelated, negotiated as a single transaction, and takes place concurrently or in a continuous sequence. (Appendix A provides illustrations of application of this Interpretation.)
4. The accounting shall reflect the substance of the arrangement. All aspects and implications of an arrangement shall be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.
5. AASB 117 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. Indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under AASB 117 include (Appendix B provides illustrations of application of this Interpretation):
 - (a) an entity retains all the risks and rewards incident to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement;
 - (b) the primary reason for the arrangement is to achieve a particular tax result, and not to convey the right to use an asset; and
 - (c) an option is included on terms that make its exercise almost certain (e.g., a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).
6. The definitions and guidance in paragraphs 49-64 of the *Framework for the Preparation and Presentation of Financial Statements* shall be applied in determining whether, in substance, a separate investment account and lease payment obligations represent assets and liabilities of the entity. Indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and shall not be recognised by the entity include:

- (a) the entity is not able to control the investment account in pursuit of its own objectives and is not obligated to pay the lease payments. This occurs when, for example, a prepaid amount is placed in a separate investment account to protect the Investor and may only be used to pay the Investor, the Investor agrees that the lease payment obligations are to be paid from funds in the investment account, and the entity has no ability to withhold payments to the Investor from the investment account;
 - (b) the entity has only a remote risk of reimbursing the entire amount of any fee received from an Investor and possibly paying some additional amount, or, when a fee has not been received, only a remote risk of paying an amount under other obligations (e.g., a guarantee). Only a remote risk of payment exists when, for example, the terms of the arrangement require that a prepaid amount is invested in risk-free assets that are expected to generate sufficient cash flows to satisfy the lease payment obligations; and
 - (c) other than the initial cash flows at inception of the arrangement, the only cash flows expected under the arrangement are the lease payments that are satisfied solely from funds withdrawn from the separate investment account established with the initial cash flows.
7. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, AASB 139 *Financial Instruments: Recognition and Measurement* or AASB 1023 *General Insurance Contracts*, depending on the terms.
8. The criteria in paragraph 20 of AASB 118 *Revenue* shall be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an entity might receive. Factors such as whether there is continuing involvement in the form of significant future performance obligations necessary to earn the fee, whether there are retained risks, the terms of any guarantee arrangements, and the risk of repayment of the fee, shall be considered. Indicators that individually demonstrate that recognition of the entire fee as income when received, if received at the beginning of the arrangement, is inappropriate include:
- (a) obligations either to perform or to refrain from certain significant activities are conditions of earning the fee received, and therefore execution of a legally binding

arrangement is not the most significant act required by the arrangement;

- (b) limitations are put on the use of the underlying asset that have the practical effect of restricting and significantly changing the entity's ability to use (e.g., deplete, sell or pledge as collateral) the asset;
- (c) the possibility of reimbursing any amount of the fee and possibly paying some additional amount is not remote. This occurs when, for example;
 - (i) the underlying asset is not a specialised asset that is required by the entity to conduct its business, and therefore there is a possibility that the entity may pay an amount to terminate the arrangement early; or
 - (ii) the entity is required by the terms of the arrangement, or has some or total discretion, to invest a prepaid amount in assets carrying more than an insignificant amount of risk (e.g., currency, interest rate or credit risk). In this circumstance, the risk of the investment's value being insufficient to satisfy the lease payment obligations is not remote, and therefore there is a possibility that the entity may be required to pay some amount.

9. The fee shall be presented in the income statement based on its economic substance and nature.

Disclosure

10. All aspects of an arrangement that does not, in substance, involve a lease under AASB 117 shall be considered in determining the appropriate disclosures that are necessary to understand the arrangement and the accounting treatment adopted. An entity shall disclose the following in each period that an arrangement exists:
- (a) a description of the arrangement including:
 - (i) the underlying asset and any restrictions on its use;
 - (ii) the life and other significant terms of the arrangement;

- (iii) the transactions that are linked together, including any options; and
 - (b) the accounting treatment applied to any fee received, the amount recognised as income in the period, and the line item of the income statement in which it is included.
- 11. The disclosures required in accordance with paragraph 10 of this Interpretation shall be provided individually for each arrangement or in aggregate for each class of arrangement. A class is a grouping of arrangements with underlying assets of a similar nature (e.g., power plants).

Application

- Aus11.1** This Interpretation applies to:
 - (a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act 2001* and that is a reporting entity;
 - (b) general purpose financial reports of each other reporting entity; and
 - (c) financial reports that are, or are held out to be, general purpose financial reports.
- Aus11.2** This Interpretation applies to annual reporting periods beginning on or after 1 January 2005.
- Aus11.3** This Interpretation shall not be applied to annual reporting periods beginning before 1 January 2005.
- Aus11.4** The requirements specified in this Interpretation apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.
- Aus11.5** When applicable, this Interpretation supersedes Abstract 50 *Evaluating the Substance of Transactions involving the Legal Form of a Lease*, as issued in September 2002.
- Aus11.6** Abstract 50 remains applicable until superseded by this Interpretation.

DISCUSSION

12. Paragraph 9 of AASB 111 *Construction Contracts* requires a group of contracts to be treated as a single contract when the group of contracts is negotiated as a single package, the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin, and the contracts are performed concurrently or in a continuous sequence. In such a situation, a series of transactions that involve the legal form of a lease are linked and accounted for as one transaction, because the overall economic effect cannot be understood without reference to the series of transactions as a whole.
13. An agreement is accounted for as a lease in accordance with AASB 117 when it 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. For information to represent faithfully the transactions it purports to represent, paragraph 35 of the *Framework* indicates that it is necessary that transactions are accounted for and presented in accordance with their substance and economic reality, not merely their legal form.
14. When an entity does not control the assets that will be used to satisfy the lease payment obligations, and is not obligated to pay the lease payments, it does not recognise the assets and lease payment obligations, because the definitions of an asset and a liability have not been met. This is different from the circumstance when an entity controls the assets, is obligated to pay the lease payments, and then later transfers assets to a third party (including a trust). In that circumstance, the transfer of assets (sometimes called an “in-substance” defeasance) does not by itself relieve the entity of its primary obligation, in the absence of legal release. A financial asset and a financial liability, or a portion of either, are derecognised only when the requirements of paragraphs 15-37 and 39-42 of AASB 139 are met.
15. AASB 1023 provides guidance for recognising and measuring financial guarantees and similar instruments that provide for payments to be made if the debtor fails to make payments when due, if that contract transfers significant insurance risk to the issuer. Financial guarantee contracts that provide for payments to be made in response to changes in relation to a variable (sometimes referred to as an “underlying”) are subject to AASB 139.
16. AASB 118 addresses the accounting treatment of revenue. Paragraph 75 of the *Framework* indicates that gains are no different in nature from revenue. Therefore, the requirements of AASB 118 apply by analogy or otherwise. Example 14(c) in the Appendix of AASB 118

states that a fee earned on the execution of a significant act, which is much more significant than any other act, is recognised as income when the significant act has been completed. The example also indicates that it is necessary to distinguish between fees earned on completion of a significant act and fees related to future performance or risks retained.

Date of SIC's Consensus: [Deleted by the UIG]

Effective Date of SIC-27: [Deleted by the UIG]

APPENDICES

These appendices accompany, but are not part of, Interpretation 127.

APPENDIX A: LINKED TRANSACTIONS

- A1. The Interpretation requires consideration of whether a series of transactions that involve the legal form of a lease are linked to determine whether the transactions are accounted for as one transaction.
- A2. Extreme examples of transactions that are viewed as a whole and accounted for as single transactions, include:
- (a) An entity leases an asset to an Investor (the headlease) and leases the same asset back for a shorter period of time (the sublease). At the end of the sublease period, the entity has the right to buy back the rights of the Investor under a purchase option. If the entity does not exercise its purchase option, the Investor has options available to it under each of which the Investor receives a minimum return on its investment in the headlease – the Investor may put the underlying asset back to the entity, or require the entity to provide a return on the Investor’s investment in the headlease.

The predominant purpose of the arrangement is to achieve a tax advantage for the Investor, which is shared with the entity in the form of a fee, and not to convey the right to use an asset. The Investor pays the fee and prepays the lease payment obligations under the headlease. The agreement requires the amount prepaid to be invested in risk-free assets and, as a requirement of finalising the execution of the legally binding arrangement, placed into a separate investment account held by a Trustee outside of the control of the entity. The fee is retained by the entity.

Over the term of the sublease, the sublease payment obligations are satisfied with funds of an equal amount withdrawn from the separate investment account. The entity guarantees the sublease payment obligations, and will be required to satisfy the guarantee should the separate investment account have insufficient funds. The entity, but not the Investor, has the right to terminate the sublease early under certain circumstances (e.g., a change in local or international tax law causes the Investor to lose part or all of the tax benefits, or the entity decides to dispose of (e.g., replace, sell or deplete) the underlying asset) and upon

payment of a termination value to the Investor. If the entity chooses early termination, then it would pay the termination value from funds withdrawn from the separate investment account, and if the amount remaining in the separate investment account is insufficient, the difference would be paid by the entity. The underlying asset is a specialised asset that the entity requires to conduct its business.

- (b) An entity leases an asset to another entity for its entire economic life and leases the same asset back under the same terms and conditions as the original lease. The two entities have a legally enforceable right to set off the amounts owing to one another, and an intention to settle these amounts on a net basis.
- (c) An entity (Entity A) leases an asset to another entity (Entity B), and obtains a non-recourse loan from a financier (by using the lease rentals and the asset as collateral). Entity A sells the asset subject to the lease and the loan to a trustee, and leases the same asset back. Entity A also concurrently agrees to repurchase the asset at the end of the lease for an amount equal to the sale price. The financier legally releases Entity A from the primary responsibility for the loan, and Entity A guarantees repayment of the non-recourse loan if Entity B defaults on the payments under the original lease. Entity B's credit rating is assessed as AAA and the amounts of the payments under each of the leases are equal. Entity A has a legally enforceable right to set-off the amounts owing under each of the leases, and an intention to settle the rights and obligations under the leases on a net basis.
- (d) An entity (Entity A) legally sells an asset to another entity (Entity B) and leases the same asset back. Entity B is obligated to put the asset back to Entity A at the end of the lease period at an amount that has the overall practical effect, when also considering the lease payments to be received, of providing Entity B with a yield of LIBOR plus 2 per cent per year on the purchase price.

APPENDIX B: THE SUBSTANCE OF AN ARRANGEMENT

- B1. The Interpretation requires consideration of the substance of an arrangement to determine whether it includes the conveyance of the right to use an asset for an agreed period of time.

- B2. In each of the examples described in Appendix A, the arrangement does not, in substance, involve a lease under AASB 117 for the following reasons:
- (a) in the example described in paragraph A2(a), the arrangement is designed predominantly to generate tax benefits that are shared between the two entities. Even though the periods of the headlease and sublease are different, the options available to each of the entities at the end of the sublease period are structured such that the Investor assumes only an insignificant amount of asset risk during the headlease period. The substance of the arrangement is that the entity receives a fee for executing the agreements, and retains the risks and rewards incident to ownership of the underlying asset.
 - (b) in the example described in paragraph A2(b), the terms and conditions and period of each of the leases are the same. Therefore, the risks and rewards incident to ownership of the underlying asset are the same as before the arrangement. Further, the amounts owing are offset against one another, and so there is no retained credit risk. The substance of the arrangement is that no transaction has occurred.
 - (c) in the example described in paragraph A2(c), Entity A retains the risks and rewards incident to ownership of the underlying asset, and the risk of payment under the guarantee is only remote (due to the AAA credit rating). The substance of the arrangement is that Entity A borrows cash, secured by the underlying asset.
 - (d) in the example described in paragraph A2(d), Entity A's risks and rewards incident to owning the underlying asset do not substantively change. The substance of the arrangement is that Entity A borrows cash, secured by the underlying asset and repayable in instalments over the lease period and in a final lump sum at the end of the lease period. The terms of the option preclude recognition of a sale. Normally, in a sale and leaseback transaction, the risks and rewards incident to owning the underlying asset sold are retained by the seller only during the period of the lease.

REFERENCES

Australia

The Urgent Issues Group discussed Issues Paper UIG/SIC 04/1 “Adoption of Various SIC Interpretations in Australia” in relation to this Interpretation at its meeting on 4 May 2004.

Accounting Standard AASB 111 *Construction Contracts*

Accounting Standard AASB 117 *Leases*

Accounting Standard AASB 118 *Revenue*

Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*

Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement*

Accounting Standard AASB 1023 *General Insurance Contracts*

Framework for the Preparation and Presentation of Financial Statements

International Accounting Standards Board

International Accounting Standard IAS 17 *Leases*

Standing Interpretations Committee Interpretation SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

IFAC Public Sector Committee

International Public Sector Accounting Standard IPSAS 13 *Leases*