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Hong Kong (SIC) Interpretation 27

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



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Interpretation 27

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

HK(SIC) Interpretation 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (HK(SIC)-Int 27) is set out in paragraphs 3-11. HK(SIC)-Int 27 is accompanied by a Basis for Conclusions and appendices illustrating the application of the Interpretation. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

References

- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- ~~HKAS 11 *Construction Contracts*~~
- HKAS 17 *Leases*
- ~~HKAS 18 *Revenue*~~
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- ~~HKAS 39 *Financial Instruments: Recognition and Measurement* (as revised in 2003)~~
- HKFRS 4 *Insurance Contracts*
- HKFRS 9 *Financial Instruments*
- HKFRS 15 *Revenue from Contracts with Customers*

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

Conclusions

- 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 HKAS 17 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. Indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under HKAS 17 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 (eg, a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).
- 6 The definitions and guidance in paragraphs 49 – 64 of the *Framework*^{*} shall be applied in determining whether, in substance, a separate investment account and lease payment obligations represent assets and liabilities of the Entity. Indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and shall not be recognised by the Entity include:
- (a) the Entity is not able to control the investment account in pursuit of its own objectives and is not obligated to pay the lease payments. This occurs when, for example, a prepaid amount is placed in a separate investment account to protect the Investor and may only be used to pay the Investor, the Investor agrees that the lease payment obligations are to be paid from funds in the investment account, and the Entity has no ability to withhold payments to the Investor from the investment account;
 - (b) the Entity has only a remote risk of reimbursing the entire amount of any fee received from an Investor and possibly paying some additional amount, or, when a fee has not been received, only a remote risk of paying an amount under other obligations (eg, a guarantee). Only a remote risk of payment exists when, for example, the terms of the arrangement require that a prepaid amount is invested in risk-free assets that are expected to generate sufficient cash flows to satisfy the lease payment obligations; and
 - (c) other than the initial cash flows at inception of the arrangement, the only cash flows expected under the arrangement are the lease payments that are satisfied solely from funds withdrawn from the separate investment account established with the initial cash flows.
- 7 Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under HKAS 37, ~~HKAS 39 or~~ HKFRS 4 or HKFRS 9, depending on the terms.
- 8 The ~~criteria requirements in paragraph 20 of HKAS 18~~ HKFRS 15 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 (eg, deplete, sell or pledge as collateral) the asset;

* The reference to *Framework* is to *Framework for the Preparation and Presentation of Financial Statements*, issued by the HKICPA in 1997. In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraphs 49-64 are now paragraphs 4.4-4.19 of the *Conceptual Framework*.

- (c) the possibility of reimbursing any amount of the fee and possibly paying some additional amount is not remote. This occurs when, for example,
- (i) the underlying asset is not a specialised asset that is required by the Entity to conduct its business, and therefore there is a possibility that the Entity may pay an amount to terminate the arrangement early; or
 - (ii) the Entity is required by the terms of the arrangement, or has some or total discretion, to invest a prepaid amount in assets carrying more than an insignificant amount of risk (eg, currency, interest rate or credit risk). In this circumstance, the risk of the investment's value being insufficient to satisfy the lease payment obligations is not remote, and therefore there is a possibility that the Entity may be required to pay some amount.
- 9 The fee shall be presented in the statement of comprehensive income based on its economic substance and nature.

Disclosure

- 10 All aspects of an arrangement that does not, in substance, involve a lease under HKAS 17 shall be considered in determining the appropriate disclosures that are necessary to understand the arrangement and the accounting treatment adopted. An Entity shall disclose the following in each period that an arrangement exists:
- (a) a description of the arrangement including:
 - (i) the underlying asset and any restrictions on its use;
 - (ii) the life and other significant terms of the arrangement;
 - (iii) the transactions that are linked together, including any options; and
 - (b) the accounting treatment applied to any fee received, the amount recognised as income in the period, and the line item of the statement of comprehensive income in which it is included.
- 11 The disclosures required in accordance with paragraph 10 of this Interpretation shall be provided individually for each arrangement or in aggregate for each class of arrangement. A class is a grouping of arrangements with underlying assets of a similar nature (eg, power plants).

Basis for Conclusions

HK(SIC)-Int 27 is based on SIC Interpretation 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. In approving HK(SIC)-Int 27, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the SIC's Basis for Conclusions on SIC Interpretation 27. Accordingly, there are no significant differences between HK(SIC)-Int 27 and SIC Interpretation 27. The SIC's Basis for Conclusions is reproduced below. The paragraph numbers of SIC Interpretation 27 referred to below generally correspond with those in HK(SIC)-Int 27.

This Basis for Conclusions accompanies, but is not part of, SIC-27.

[The requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments. To avoid confusion with earlier amendments marked up on the original text to reflect the revision of IAS 39 in 2003 and the subsequent issue of IFRS 4, paragraphs 14 and 15 have been amended for consistency with IFRS 9. References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.]

- 12 Paragraph 9 of IAS 11 *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.

* IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts*. IFRS 15 requires contracts to be combined if they meet specified criteria.

- 13 An agreement is accounted for as a lease in accordance with IAS 17 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*^β 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, 39-42, AG36-AG52 and AG57-AG63 of IAS 39~~ 3.2.1-3.2.23, 3.3.1-3.3.4, B3.2.1-B3.2.17 and B3.3.1-B3.3.7 of IFRS 9 are met.
- 15 IFRS 4 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 IAS 39.[#]
- 16 IAS 18* addresses the accounting treatment of revenue. Paragraph 75 of the *Framework*^δ indicates that gains are no different in nature from revenue. Therefore, the requirements of IAS 18 apply by analogy or otherwise. Example 14(c) in the Appendix of IAS 18 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 issue

December 2004

Effective date

This Interpretation becomes effective for annual accounting periods beginning on or after 1 January 2005; earlier application is encouraged. Changes in accounting policies shall be accounted for in accordance with HKAS 8.

This Interpretation supersedes Interpretation 14 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (issued in July 2002).

HKFRS 9 amended paragraph 7. An entity shall apply that amendment when it applies HKFRS 9.

HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended the 'References' section and paragraph 8. An entity shall apply those amendments when it applies HKFRS 15.

^β superseded by Chapter 3 of the *Conceptual Framework*. References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

[#] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

^{*} IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue*. IFRS 15 eliminated the guidance on recognising revenue on the execution of a significant act.

^δ now paragraph 4.30 of the *Conceptual Framework*.

Appendix A

Linked transactions

These appendices accompanies, but is not part of, SIC-27.

- 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 (eg 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 (eg, 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

This appendix accompanies, but is not part of, SIC-27.

- 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 IAS 17 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.