

HONG KONG SOCIETY OF ACCOUNTANTS

Financial Accounting Standards Committee

Urgent Issues & Interpretations Sub-Committee

Interpretation

14

Evaluating the Substance of Transactions

Involving the Legal Form of a Lease

Interpretations are authoritative guidance on the application of Statements of Standard Accounting Practice with which enterprises should comply if their financial statements purport to give a true and fair view. Unless indicated otherwise, Interpretations have the same status as the background material and implementation guidance contained in Statements of Standard Accounting Practice. Interpretations are not intended to apply to immaterial items.

References: SSAP 1 *Presentation of Financial Statements*

SSAP 14 *Leases*

SSAP 18 *Revenue*

ISSUES

1. An Enterprise 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 Enterprise 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 Enterprise 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 SSAP 14; and, if not,
 - (i) whether a separate investment account and lease payment obligations that might exist represent assets and liabilities of the Enterprise (e.g., consider the example described in paragraph 2(a) of Appendix A);
 - (ii) how the Enterprise should account for other obligations resulting from the arrangement; and
 - (iii) how the Enterprise 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 should 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 should reflect the substance of the arrangement. All aspects and implications of an arrangement should be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect.
5. SSAP 14 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 SSAP 14 include (Appendix B provides illustrations of application of this Interpretation):
 - (a) an Enterprise 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 47 - 62 of the Framework should be applied in determining whether, in substance, a separate investment account and lease payment obligations represent assets and liabilities of the Enterprise. 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 should not be recognised by the Enterprise include:
 - (a) the Enterprise 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 Enterprise has no ability to withhold payments to the Investor from the investment account;
 - (b) the Enterprise 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, should be accounted for under SSAP 28, Provisions, Contingent Liabilities and Contingent Assets, if applicable.¹

¹ In accordance with SSAP 1 paragraph 23, management could consider IAS 39 "Financial Instruments: Recognition and Measurement" in the case where an obligation of an arrangement constitutes a financial instrument.

8. The criteria in paragraph 19 of SSAP 18 should be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an Enterprise 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, should 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 Enterprise'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 Enterprise to conduct its business, and therefore there is a possibility that the Enterprise may pay an amount to terminate the arrangement early; or
 - (ii) the Enterprise 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 Enterprise may be required to pay some amount.
9. The fee should 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 SSAP 14 should be considered in determining the appropriate disclosures that are necessary to understand the arrangement and the accounting treatment adopted. An Enterprise should 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 should 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).

BASIS FOR CONCLUSIONS

12. Paragraph 8 of SSAP 23, 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 SSAP 14 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 33 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 Enterprise 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 Enterprise 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 Enterprise of its primary obligation, in the absence of legal release.
15. In addition to addressing the general requirements for recognition of a provision, SSAP 28 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. SSAP 28 also provides guidance when disclosure of a contingent liability is required.
16. SSAP 18 addresses the accounting treatment of revenue. Paragraph 73 of the Framework indicates that gains are no different in nature from revenue. Therefore, the requirements of SSAP 18 apply by analogy or otherwise. Example A14(c) to the Appendix of SSAP 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: 25 June 2002

Effective Date: This Interpretation becomes effective on 30 June 2002.

Appendices

These appendices are illustrative only and do not form part of the Interpretation. The purpose of these Appendices is to illustrate the application of the Interpretation to assist in clarifying its meaning.

APPENDIX A: LINKED TRANSACTIONS

1. 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.
2. Extreme examples of transactions that are viewed as a whole and accounted for as single transactions, include:
 - (a) An Enterprise 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 Enterprise has the right to buy back the rights of the Investor under a purchase option. If the Enterprise 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 Enterprise, or require the Enterprise 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 Enterprise 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 Enterprise. The fee is retained by the Enterprise.

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 Enterprise guarantees the sublease payment obligations, and will be required to satisfy the guarantee should the separate investment account have insufficient funds. The Enterprise, 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 Enterprise 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 Enterprise 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 Enterprise. The underlying asset is a specialised asset that the Enterprise requires to conduct its business.

- (b) An enterprise leases an asset to another enterprise for its entire economic life and leases the same asset back under the same terms and conditions as the original lease. The two enterprises 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 enterprise (Enterprise A) leases an asset to another enterprise (Enterprise B), and obtains a non-recourse loan from a financier (by using the lease rentals and the asset as collateral). Enterprise A sells the asset subject to the lease and the loan to a trustee, and leases the same asset back. Enterprise 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 Enterprise A from the primary responsibility for the loan, and Enterprise A guarantees repayment of the non-recourse loan if Enterprise B defaults on the payments under the original lease. Enterprise B's credit rating is assessed as AAA and the amounts of the payments under each of the leases are equal. Enterprise 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 enterprise (Enterprise A) legally sells an asset to another enterprise (Enterprise B) and leases the same asset back. Enterprise B is obligated to put the asset back to Enterprise 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 Enterprise B with a yield of Libor plus 2% p.a. on the purchase price.

APPENDIX B: THE SUBSTANCE OF AN ARRANGEMENT

1. 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.
2. In each of the examples described in Appendix A, the arrangement does not, in substance, involve a lease under SSAP 14 for the following reasons:
 - (a) in the example described in paragraph 2(a), the arrangement is designed predominantly to generate tax benefits that are shared between the two enterprises. Even though the periods of the headlease and sublease are different, the options available to each of the enterprises 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 Enterprise 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 2(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 2(c), Enterprise 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 Enterprise A borrows cash, secured by the underlying asset.
 - (d) in the example described in paragraph 2(d), Enterprise A's risks and rewards incident to owning the underlying asset do not substantively change. The substance of the arrangement is that Enterprise 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.