



IGRAP 3

ACCOUNTING STANDARDS BOARD

INTERPRETATION OF THE STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE

DETERMINING WHETHER AN ARRANGEMENT CONTAINS A LEASE

(IGRAP 3)

Acknowledgement

This Interpretation of the Standards of Generally Recognised Accounting Practice (IGRAP) is drawn primarily from the equivalent Interpretation of the International Financial Reporting Standard on *Determining Whether an Arrangement Contains a Lease* (IFRIC 4) issued by the International Financial Reporting Interpretations Committee (IFRIC) of the International Accounting Standards Board (IASB). The IASB has issued a comprehensive body of IFRICs. Extracts of the IFRIC on *Determining Whether an Arrangement Contains a Lease* are reproduced in these Interpretations of the Standards of GRAP with the permission of the IASB.

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DETERMINING WHETHER AN ARRANGEMENT CONTAINS A LEASE

Introduction

Interpretations of the Standards of Generally Recognised Accounting Practice

The Accounting Standards Board (Board) is required in terms of the Public Finance Management Act, Act No. 1 of 1999, as amended (PFMA), to determine generally recognised accounting practice referred to as Standards of Generally Recognised Accounting Practice (GRAP).

The Board must determine GRAP for:

- (a) departments (national and provincial);
- (b) public entities;
- (c) constitutional institutions;
- (d) municipalities and boards, commissions, companies, corporations, funds or other entities under the ownership control of a municipality; and
- (e) Parliament and the provincial legislatures.

The above are collectively referred to as “entities”.

The Board has approved the application of Statements of Generally Accepted Accounting Practice (GAAP), codified by the Accounting Practices Board (APB) and issued by the South African Institute of Chartered Accountants (SAICA) to be GRAP for:

- (a) government business enterprises (GBEs)(as defined in the PFMA);
- (b) trading entities (as defined in the PFMA);
- (c) any other entity, other than a municipality, whose ordinary shares, potential ordinary shares or debt are publicly traded on the capital markets; and
- (d) entities under the ownership control of any of these entities.

The Board believes that Statements of GAAP are relevant and applicable to financial statements prepared by all such entities including those under their ownership control.

Financial statements should be described as complying with Standards of GRAP only if they comply with all the requirements of each applicable Standard of GRAP and any related Interpretations of the Standards of GRAP.

Any limitation of the applicability of specific Standards or Interpretations of the Standards of GRAP is made clear in those Standards or Interpretations of the Standards of GRAP.

The Interpretation of the Standard of GRAP on *Determining Whether an Arrangement Contains a Lease* is set out in paragraphs .01 to .18. All paragraphs in this Interpretation of the Standards of GRAP have equal authority. The status and authority of appendices are dealt with in the preamble to each appendix. This Interpretation of the Standards of GRAP should be read in the context of its objective, its basis for conclusions if applicable, the *Preface to Standards of GRAP*, the *Preface to the Interpretations of the Standards of GRAP* and the *Framework for the Preparation and Presentation of Financial Statements*.

Standards of GRAP and Interpretations of Standards of GRAP should also be read in conjunction with any directives issued by the Board prescribing transitional provisions, as well as any regulations issued by the Minister of Finance regarding the effective dates of the Standards of GRAP, published in the Government Gazette.

Reference may be made to a Standard of GRAP that has not been issued at the time of issue of this Interpretation of the Standards of GRAP. This is done to avoid having to change the Standards already issued when a later Standard is subsequently issued. Paragraph .12 of the Standard of GRAP on *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Interpretation of the Standards of GRAP on *Determining Whether an Arrangement Contains a Lease*

References

- GRAP 3 *Accounting Policies, Changes in Accounting Estimates and Errors* (as revised in 2010)
- GRAP 13 *Leases* (as revised in 2010)
- GRAP 17 *Property, Plant and Equipment* (as revised in 2010)
- GRAP 102 *Intangible Assets*
- *Guideline on Accounting for Public-private Partnerships (PPPs)*

Background

- .01 An entity may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (e.g. an item of property, plant or equipment) in return for a payment or series of payments. Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:
- outsourcing arrangements (e.g. where a municipality outsources its waste collection service to a private party).
 - take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (e.g. a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).
- .02 This Interpretation of the Standards of GRAP provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with the Standard of GRAP on *Leases* (as revised in 2010). It does not provide guidance for determining how such a lease should be classified under that Standard of GRAP.
- .03 In some arrangements, the underlying asset that is the subject of the lease is a portion of a larger asset. This Interpretation of the Standards of GRAP does not address how to determine when a portion of a larger asset is itself the underlying asset for the purposes of applying the Standard of GRAP on *Leases* (as revised in 2010). Nevertheless, arrangements in which the underlying asset would represent a unit of account in either the Standard of GRAP on *Property, Plant and*

Equipment (as revised in 2010) or the Standard of GRAP on *Intangible Assets* are within the scope of this Interpretation of the Standards of GRAP.

Scope

- .04 This Interpretation of the Standards of GRAP does not apply to arrangements that are, or contain, leases excluded from the scope of the Standard of GRAP on *Leases* (as revised in 2010).

Issues

- .05 The issues addressed in this Interpretation of the Standards of GRAP are:
- (a) how to determine whether an arrangement is, or contains, a lease as defined in the Standard of GRAP on *Leases* (as revised in 2010);
 - (b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and
 - (c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Consensus

Determining whether an arrangement is, or contains, a lease

- .06 Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:
- (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and
 - (b) the arrangement conveys a right to use the asset.

Fulfilment of the arrangement is dependent on the use of a specific asset

- .07 Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. For example, if the supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfilment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease. A warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly does not preclude lease treatment. In addition, a contractual provision

(contingent or otherwise) permitting or requiring the supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

- .08 An asset has been implicitly specified if, for example, the 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.

Arrangement conveys a right to use the asset

- .09 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:
- (a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
 - (b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
 - (c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser 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 the purchaser will pay 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 the output.

Assessing or reassessing whether an arrangement is, or contains, a lease

- .10 The assessment of whether an arrangement contains a lease shall be made at the inception of the arrangement, being the earlier of the date of the arrangement and the date of commitment by the parties to the principal terms of the arrangement, on the basis of all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any one of the following conditions is met:
- (a) There is a change in the contractual terms, unless the change only renews or extends the arrangement.
 - (b) A renewal option is exercised or an extension is agreed to by the parties to the arrangement, unless the term of the renewal or extension had initially been included in the lease term in accordance with paragraph .06 of the Standard of

GRAP on *Leases* (as revised in 2010). A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated under paragraphs .06 to .09 only with respect to the renewal or extension period.

- (c) There is a change in the determination of whether fulfilment is dependent on a specified asset.
 - (d) There is a substantial change to the asset, for example a substantial physical change to property, plant or equipment.
- .11 A reassessment of an arrangement shall be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. If an arrangement is reassessed and is determined to contain a lease (or not to contain a lease), lease accounting shall be applied (or cease to apply) from:
- (a) in the case of (a), (c) or (d) in paragraph .10, when the change in circumstances giving rise to the reassessment occurs;
 - (b) in the case of (b) in paragraph .10, the inception of the renewal or extension period.

Separating payments for the lease from other payments

- .12 If an arrangement contains a lease, the parties to the arrangement shall apply the requirements of the Standard of GRAP on *Leases* (as revised in 2010) to the lease element of the arrangement, unless exempted from those requirements in accordance with paragraph .02 of the Standard of GRAP on *Leases* (as revised in 2010). Accordingly, if an arrangement contains a lease, that lease shall be classified as a finance lease or an operating lease in accordance with paragraphs .10 to .21 of the Standard of GRAP on *Leases* (as revised in 2010). Other elements of the arrangement not within the scope of the Standard of GRAP on *Leases* (as revised in 2010) shall be accounted for in accordance with other Standards.
- .13 For the purpose of applying the requirements of the Standard of GRAP on *Leases* (as revised in 2010), payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease and those for other elements on the basis of their relative fair values. The minimum lease payments as defined in paragraph .06 of the Standard of GRAP on *Leases* (as revised in 2010) include only payments for the lease (i.e. the right to use the asset) and exclude payments for other elements in the arrangement (e.g. for services and the cost of

inputs).

- .14 In some cases, separating the payments for the lease from payments for other elements in the arrangement will require the purchaser to use an estimation technique. For example, a purchaser may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements, or by estimating the payments for the other elements in the arrangement by reference to comparable agreements and then deducting these payments from the total payments under the arrangement.
- .15 If a purchaser concludes that it is impracticable to separate the payments reliably, it shall:
- (a) in the case of a finance lease, recognise an asset and a liability at an amount equal to the fair value of the underlying asset that was identified in paragraphs .07 and .08 as the subject of the lease. Subsequently the liability shall be reduced as payments are made and an imputed finance charge on the liability recognised using the purchaser's incremental borrowing rate of interest.¹
 - (b) in the case of an operating lease, treat all payments under the arrangement as lease payments for the purposes of complying with the disclosure requirements of the Standard of GRAP on *Leases* (as revised in 2010), but
 - (i) disclose those payments separately from minimum lease payments of other arrangements that do not include payments for non-lease elements, and
 - (ii) state that the disclosed payments also include payments for non-lease elements in the arrangement.

Transitional provisions

- .16 All changes resulting from the application of this Interpretation of the Standards of GRAP shall be accounted for in accordance with the requirements of the Standard of GRAP on Accounting Policies, Changes in Accounting Estimates and Errors (as revised in 2010).**

Effective date

Initial adoption of the Standards of GRAP

¹ i.e. the lessee's incremental borrowing rate of interest as defined in paragraph.06 of the Standard of GRAP on *Leases* (as revised in 2010).

.17 This Interpretation of the Standards of GRAP becomes effective with reference to the effective date of the applicable Standards of GRAP as determined by the Minister of Finance in a regulation to be published in accordance with section 91(1)(b) of the Public Finance Management Act, Act No. 1 of 1999, as amended.

Entities already applying Standards of GRAP

.18 An entity shall apply this Interpretation of the Standards of GRAP for annual financial statements covering periods beginning on or after 1 April 2011.

Appendix

Illustrative examples

This appendix is illustrative only and does not form part of this Interpretation of the Standards of GRAP. The purpose of the appendix is to illustrate the application of this Interpretation to assist in clarifying its meaning.

Example of an arrangement that contains a lease

Facts

- IE1 A municipality (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed for distribution for a specified period of time. The supplier designs and builds a facility to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:
- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
 - The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
 - The supplier is responsible for repairs, maintenance, and capital expenditures.
 - The supplier must stand ready to deliver a minimum quantity of gas each month.
 - Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
 - If the facility does not produce the stated minimum quantity, the supplier

must return all or a portion of the fixed capacity charge.

Assessment

IE2 The arrangement contains a lease within the scope of the Standard of GRAP on *Leases* (as revised in 2010). An asset (the facility) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive. The purchaser has obtained the right to use the facility because, on the facts presented - in particular, that the facility is designed to meet only the purchaser's needs and the supplier has no plans to expand or modify the facility - it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility's output and the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Example of an arrangement that does not contain a lease

Facts

IE3 The department of health (the purchaser) enters into an arrangement with a third party (the supplier) to supply a specific component part used for an x-ray machine in public hospitals for a specified period of time. The supplier designs and constructs a plant to produce the component part. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

- The supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfil the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomic.
- The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still pay only for the actual quantity taken.
- The supplier has the right to sell the component parts to other customers and has a history of doing so (by selling in the replacement parts market), so it is expected that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the supplier's plant.

Assessment

- IE4 The arrangement does not contain a lease within the scope of the Standard of GRAP on *Leases* (as revised in 2010). An asset (the plant) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomic. However, the purchaser has not obtained the right to use the plant because the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and the likelihood that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the plant is more than remote, on the basis of the facts presented. In addition, the price that the purchaser pays is fixed per unit of output taken.

Comparison with the Interpretation of IFRS on *Determining Whether an Arrangement Contains a Lease* (IFRIC 4) (December 2004)

This Interpretation of the Standards of GRAP on *Determining Whether an Arrangement Contains a Lease* (IGRAP 3) is drawn primarily from the Interpretation of IFRS on *Determining Whether an Arrangement Contains a Lease* (IFRIC 4). The main differences between this Interpretation and IFRIC 4 are as follows:

- The principles in this Interpretation have been included in the *Guideline on Accounting for Public-private Partnerships (PPPs)*. The scope of this Interpretation has therefore been amended to also include PPP agreements. IFRIC 4 excludes from its scope PPP agreements that fall within the scope of IFRIC 12.
- The examples in this Interpretation and the appendix to the Interpretation have been amended to be South African specific.
- The transitional provisions included in this Interpretation are different to those included in IFRIC 4.