

TOPIC 3.5: LEASES

This section of the manual sets out the FSOP's that need to be executed by the municipality regarding Leases. The FSOP's are drafted in the following categories:

- 3.5.1 Overview of the accounting for leases**
- 3.5.2 Classification of leases**
- 3.5.3 Procedures during the existence of leases**
- 3.5.4 Annual Financial Statement disclosure requirements**
- 3.5.5 Exemptions related to the implementation of IAS 17**

3.5.1 OVERVIEW OF THE ACCOUNTING FOR LEASES

When accounting for leases the municipality must ensure that the necessary finance standard operating procedures are executed to address the following issues, which are summarised here, but for which the detailed FSOP's are set out in the rest of this section.

| Category | Section FSOP |
|---|-----------------------------|
| <p>1. Classification of Leases. The municipality must ensure that all leases are identified and correctly classified in accordance with the criteria set out in GRAP 13 (previously IAS 17) as either a finance lease or an operating lease.</p> | <p>Section 3.5.2</p> |
| <p>2. During the term of a lease it must be correctly accounted for, from the point of the municipality, either as the lessor or as the lessee.</p> | <p>Section 3.5.3</p> |
| <p>3. The municipality must ensure that all disclosure requirements for leases as set out in GRAP 13 (previously IAS 17) are met.</p> | <p>Section 3.5.4</p> |
| <p>4. Exemptions related to the implementation of IAS 17. An exemption from the requirements of IAS 17 have been offered to high capacity municipalities (HCM), medium capacity municipalities (MCM) and low capacity municipalities (LCM) by NT. The requirements have been discussed in full from section 3.5.2 onwards, but the exemption is set out here to provide guidance to municipalities implementing this standard on a piecemeal basis:</p> <p>EXEMPTION – 30 JUNE 2008</p> <ul style="list-style-type: none"> • Any HCM that prepares its AFS in accordance with GRAP for the year ending 30 June 2008, need not recognise operating lease payments / receipts on a straight-line basis if the amounts are recognised on the basis of the cash flows in the lease agreement. (IAS 17.33 – 34 and 50 – 51, SAICA circular 12/06.8 – 11). ➤ MCM and LCM can prepare IMFO AFS for 2008, and therefore ignore IAS 17 in totality, but if they prepare GRAP AFS the exemption above apply to them. <p>EXEMPTION – 30 JUNE 2009</p> <ul style="list-style-type: none"> ➤ All HCM and MCM must for the year ending 30 June 2009 comply with all the requirements of GRAP 13 on Leases and must restate the comparative figures. Transitional provisions discussed in section 3.5.5 must be applied. ➤ LCM can prepare IMFO AFS for 2009 and therefore ignore GRAP 13 and IAS 17 in totality. If however the LCM opts to prepare GRAP AFS for 30 June 2009, it must comply with all the requirements of GRAP 13 on Leases. | <p>Section 3.5.5</p> |


3.5.2 CLASSIFICATION OF LEASES

Lease financing has over time been established as one of the major forms of financing across the world. A lease arrangement involves a lessor conveying the right to a lessee to use an asset for an agreed period of time in return for a series of payments.

The arguments for and against lease arrangements can be summarised as follows:

| <i>Arguments in favour of leases</i> | <i>Arguments against leases</i> |
|---|--|
| The municipality obtains the use of an asset without major capital outflows (on date of receipt of the asset) | Finance through a lease is usually more expensive than through other forms of financing |
| | In the case of an operating lease, the benefit of an increase in value of an asset would accrue to the lessor (the owner). |

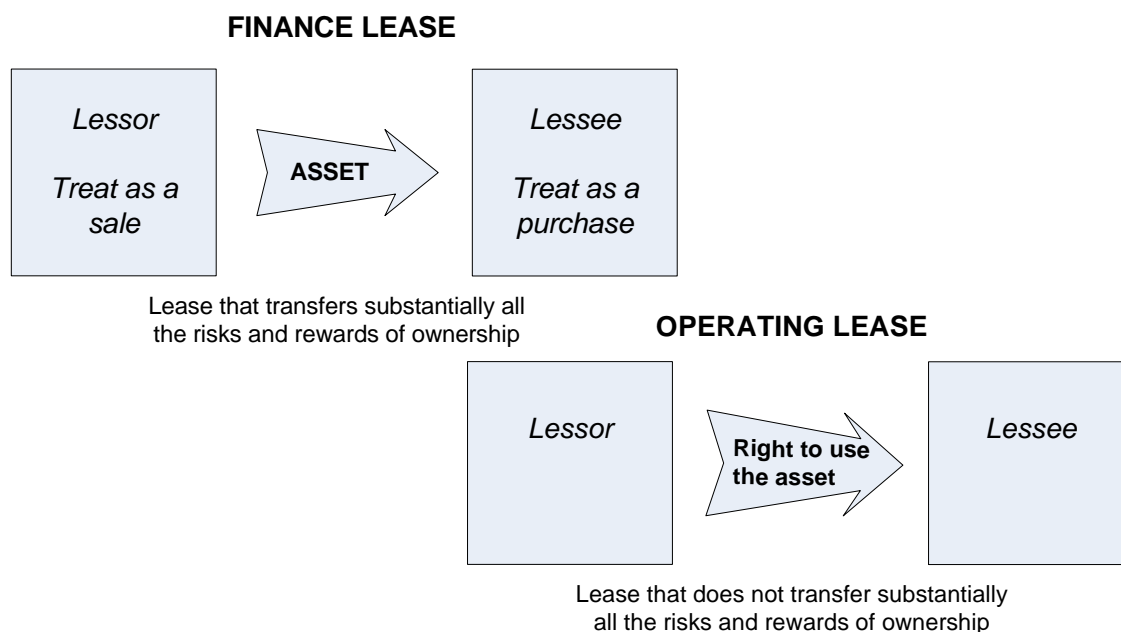
Classification of leases

| | |
|--|--|
|  | <p>A lease is a contract that gives the lessee (the renter) the right to use an asset for an agreed period of time in return for a payment or series of payments.</p> <p>A finance lease is a lease that transfers substantially all risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.</p> <p>An operating lease is a lease other than a finance lease.</p> |
|--|--|

Lease classification is a key element in accounting for leases because it determines how the lessee and lessor account for the leased asset. An analysis of a lease must be based on its substance or commercial reality. The conditions of a lease may suggest a municipality has only limited exposure to the risks and benefits of a leased asset, whereas commercial reality may suggest otherwise.

Fundamental to lease classification is the identification of potential risks and rewards of leased assets and the way they are borne/enjoyed by the parties to a lease. All assets have a unique capacity to expose an entity to risks and rewards. For example, assets such as IT equipment are subject to rapid technological change and exposed to higher risk of technical obsolescence than other assets.

Finance lease vs. Operating lease

**Example – Risks and rewards of ownership**

A municipality leases computer hardware that is capable of operating for 7 years whilst the lease term is for 3 years.

Although the physical life of the hardware is 7 years, certain factors will however result in a different economic life, such as –

- Advances in technology;
- Improvements in working practices; and
- Competition and the effect that it has on efficiency.

More emphasis is usually put on the risks that the lessor retains than on benefits associated with ownership or use of the asset. Where the lessor retains little or no asset-related risk, the agreement is likely to be a finance lease. By comparison, when the lease exposes the lessor to movements in the asset's market value, utilisation or performance, the lease is usually an operating lease.

Finance lease

A finance lease is a lease in which substantially all the risks and rewards associated with ownership are transferred to the lessee, regardless of whether legal title or ownership is also transferred. The accounting standards do not define “substantially all” when considering risks and rewards of ownership or provide a series or bright line numerical tests. Qualitative and quantitative evidence that is normally indicative of a finance lease should be considered when assessing risks and rewards of ownership, such as –

a) Transfer of ownership at the end of the lease term

The lease is usually a finance lease if the municipality will obtain ownership of the asset at the end of the lease term.

b) The lessee has a bargain purchase option

A bargain purchase option is a means of obtaining ownership of a leased asset. Reference to an option at a fixed price or to the asset's depreciated cost may indicate a bargain purchase option which is likely to be less than the asset's fair value at the end of the lease term (provided that it is reasonably certain at the inception of the lease that the lessee will exercise the option).

c) The lease term covers a major part of the asset's economic life

There is a presumption that the lease is a finance lease if the lessee has use of the asset for a major part of its economic life.



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.

A **non-cancellable lease** is a lease that is cancellable only:

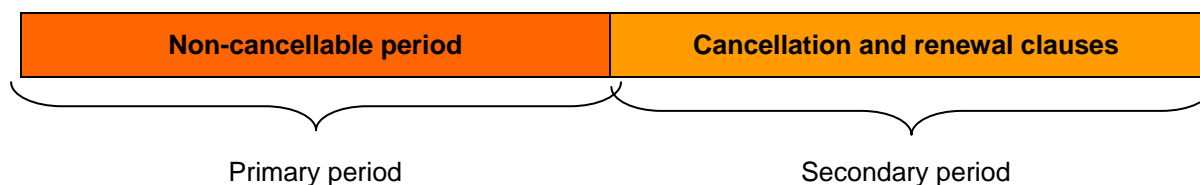
- upon occurrence of some remote contingency;
- with the permission of the lessor;
- if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
- upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

Economic life is either:

- (a) the period over which an asset is expected to yield economic benefits or service potential to one or more users, or
- (b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits or service potential embodied in the asset are expected to be consumed by the entity.

The **lease term** comprises of a primary period and a secondary period as illustrated below:



Each aspect must be considered carefully in order to appropriately identify the lease period and its influence on the classification of the lease.

Cancellation clauses (cancel agreement without penalty):

If a lease contains a cancellation clause then the lease period will be the period from the commencement date of the lease to the earliest point at which the cancellation clause is exercisable by the lessee.

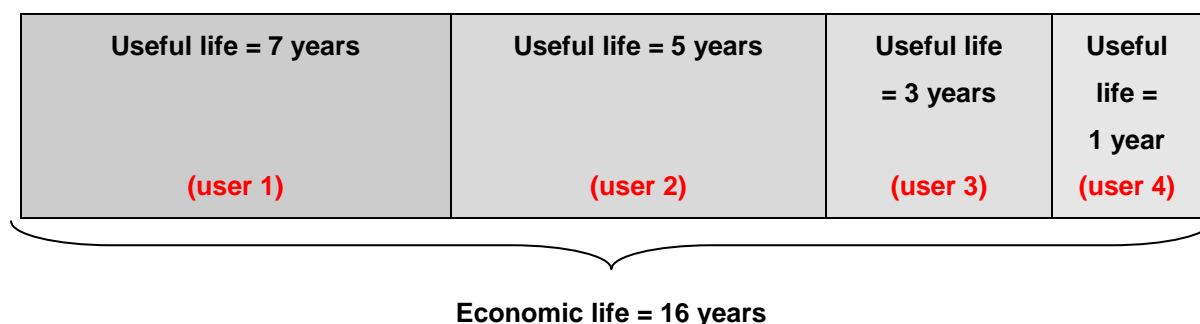
Cancellation clauses (where the lessor is compensated for losses)

If the lessee is 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 disregarded in determining the lease term.

Renewal clauses (options to extend the lease)

If there is a compelling reason for the lessee to extend the lease, for example the lease instalments in the secondary period are considerably lower then the lease term would include both the minimum period and the renewal period.

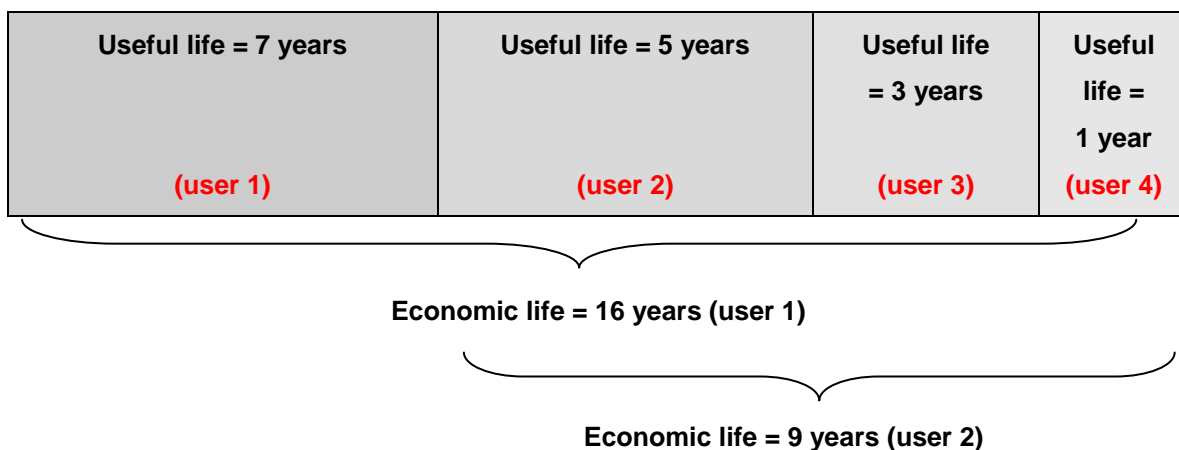
The **economic life** of an asset is the total life of an asset i.e. the period over which the asset is expected to be usable by the current lessee and any subsequent user. It can best be explained through the following illustration:



The accounting standard does not define what is meant by major part of the economic life. An entity will have to apply judgement (based on all relevant factors) in determining whether or not the asset will be leased for its economic life.


If an asset that was previously leased becomes subject to a new lease, the economic life is deemed to be the remaining economic life of the asset from the commencement date of the new lease.

Using the information in the table above, the economic life of the asset for user 1 and 2 differs as follows:



- d) The present value of the minimum lease payments approximates the fair value of the asset

Payments made by a lessee that are a substantial portion of a leased asset's fair value is presumed to give rise to a finance lease. The presumption is that the lessee will have received substantially all the benefits of ownership because it will have paid an amount that is close to the asset's fair value.

| | | | |
|--|---|--|---|
|  | <p>The minimum lease payments are the payments that the lessee is, or can be, required to make to the lessor over the lease term.</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"> <p>Includes:</p> <ul style="list-style-type: none"> • Non-cancellable lease payments • Guaranteed residual value • Purchase option (if reasonable certainty of exercise) </td> <td style="width: 50%; vertical-align: top;"> <p>Excludes:</p> <ul style="list-style-type: none"> • Contingent rent • Cost for services (such as maintenance & insurance) • Taxes (if paid by and reimbursed to the lessor) </td> </tr> </table> | <p>Includes:</p> <ul style="list-style-type: none"> • Non-cancellable lease payments • Guaranteed residual value • Purchase option (if reasonable certainty of exercise) | <p>Excludes:</p> <ul style="list-style-type: none"> • Contingent rent • Cost for services (such as maintenance & insurance) • Taxes (if paid by and reimbursed to the lessor) |
| <p>Includes:</p> <ul style="list-style-type: none"> • Non-cancellable lease payments • Guaranteed residual value • Purchase option (if reasonable certainty of exercise) | <p>Excludes:</p> <ul style="list-style-type: none"> • Contingent rent • Cost for services (such as maintenance & insurance) • Taxes (if paid by and reimbursed to the lessor) | | |

- e) The leased asset is constructed to the municipality's specification and could not be used by others without significant modification

Such an asset will have limited market value and the lessor will typically have to recover its investment during the primary lease term or by giving the lessee an option to purchase the asset.

In addition to the general indicators listed above, the following situations may individually or in combination also lead to a lease being classified as a finance lease:

- On cancellation of the lease, the lessor's losses associated with the cancellation, e.g. loss of rental revenue are carried by the lessee;
- Movements in the fluctuation of the fair value of the residual accrue to the lessee; and

- The lease may upon expiration of the lease agreement, continue the lease at a rent which is substantially lower than market rent.

Classification of a lease is made at the inception of the lease and should be adhered to even if changes in circumstance occur. Where both parties agree to the changes that would initially have resulted in a different classification, the amended agreement is considered to be a new agreement.

The most important factor to take into consideration when classifying leases as either finance or operating, is the substance of the transaction rather than the legal form of the contract.

The difference between a finance lease and an operating lease can be summarised as follows:

| <i>Finance lease</i> | <i>Operating lease</i> |
|--|--|
| Payments recover cost and interest | Payment is not directly related to the cost of the asset |
| Term is estimated to be the same as the economic life of the asset | Term is usually shorter than economic life |
| Renewal is usually a nominal purchase option | Renewal is negotiable |
| Lease is usually not cancellable | Cancellation is negotiable |
| Control is usually transferred to the lessee | Control remains with the lessor |
| Maintenance is usually carried by the lessee | Maintenance is usually carried by the lessor |

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|--|---|-----------|----------------------|--|
| 1 | The classification of a lease as either a finance lease or an operating lease determines the accounting treatment of that lease. | <p>Identifying all leases: The Head of Corporate/Legal Services should issue an instruction that all contractual agreements to which the municipality is a party, must be scrutinised. All operating and finance leases should be identified and its details (such as name of supplier, contract period, asset leased, contract amount, escalation in prices and period of payment) listed.</p> <p>This list should be updated with all new lease agreements entered into as well as all agreements that expired.</p> <p>The updated list should be forwarded to the Head of Finance for control and budget purposes.</p> | FCP | CFO | 30 June each year & as and when new contracts are negotiated |
| 2 | <p>Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.</p> <p>According to GRAP 13.10 (previously IAS 17.8) a lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership.</p> | <p>Classification of leases: The decision tree at the end of this section should assist in determining whether a lease should be classified as a finance lease or an operating lease.</p> <p>Also refer to Annexure 1 below for examples of situations which would normally lead to a lease being classified as a finance lease.</p> | FCP | CFO | 30 June each year |

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|---|------|-----------|----------------------|---------------------------|
| | <p>The risks associated with ownership include:</p> <ul style="list-style-type: none"> • the possibility of losses from damage, • breakdown, • under-utilisation of capacity, • obsolescence or • losses on the realisation (sale) of the asset. <p>The rewards associated with ownership include:</p> <ul style="list-style-type: none"> • revenue generation and • future service potential arising from the use of the asset, as well as • gains on realisation. | | | | |

3.5.3 PROCEDURES DURING THE EXISTENCE OF LEASES

The relevant accounting guidance is contained in GRAP 13 (previously IAS 17). The accounting principles which will be discussed below will be based on the relevant sections of GRAP 13 (previously IAS 17). The sections that will be covered are:


- A Leases in the financial statements of lessees.**
 - a) Accounting treatment of finance leases
 - b) Accounting treatment of operating leases
 - c) Accounting treatment of a finance lease previously accounted for as an operating lease
 - d) Accounting treatment of sale and leaseback transactions
- B Leases in the financial statements of lessors.**
 - a) Accounting treatment of finance leases
 - b) Accounting treatment of operating leases

A. ACCOUNTING TREATMENT OF LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

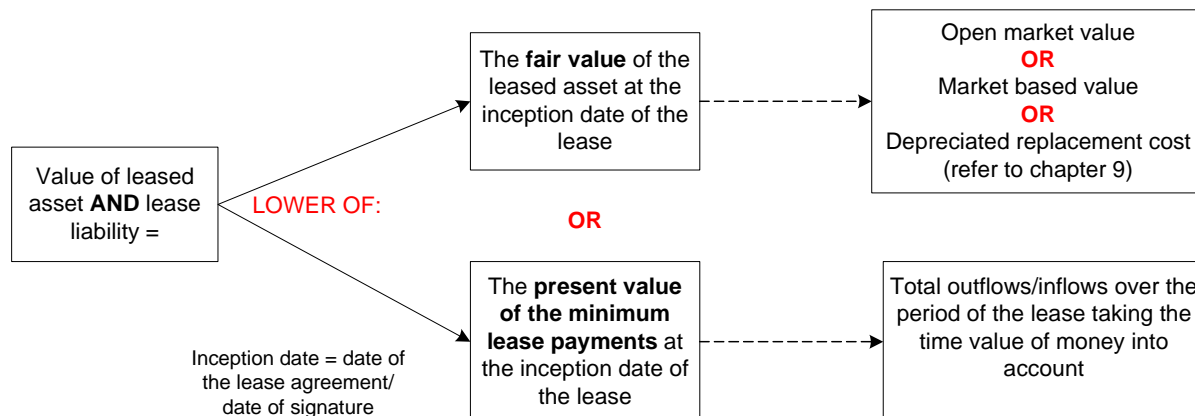
a) ACCOUNTING TREATMENT OF FINANCE LEASES

It has already been established that a lease is accounted for according to its substance and economic reality rather than its legal form. Where a lease transfers substantially all the risks and rewards of ownership, the lessee actually acquires the economic benefits and service potential of the asset in return for an obligation to pay an amount that approximates the fair value of the asset.

Consequently, the leased asset and the obligation to pay future rentals (lease liability) is recognised in the lessee's statement of financial position at the commencement of the lease term.

| | |
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|  | <p>The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e. the recognition of the assets, liabilities, revenue and expenses resulting from the lease, as appropriate).</p> <p>The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:</p> <ul style="list-style-type: none"> (a) a lease is classified as either an operating or finance lease, and (b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease terms are determined. |
|---|--|

Initial recognition of the leased asset and lease liability is a the lesser of the fair value of the leased property (cash price of the property if it was bought) and the present value of the minimum lease payments.




There is a presumption that at the inception of the lease, the asset and liability values are equal. However, the value of the asset and the liability may subsequently differ due to depreciation and the method used to reduce the liability.

A leased asset cannot be recognised above its fair value and is depreciated in accordance with the municipality's accounting policy for property, plant and equipment or the lease term (whichever is shorter). However, if at inception of the lease it is reasonably certain that the lessee will obtain ownership of the asset by the end of the lease term, then the asset should be depreciated over the expected useful life of the asset.

The subsequent accounting treatment for the leased asset should be similar to other owned assets e.g. if a lessee has an accounting policy under which all PPE is revalued then this policy should also be applied to similar assets leased under finance leases.


The minimum lease payments are payments that the lessee is required to make in terms of the lease agreement over the lease term and includes the guaranteed residual value.

| | |
|---|---|
|  | <p>Minimum lease payments (for a lessee) are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and, where appropriate, taxes to be paid by and reimbursed to the lessor, together with any amounts guaranteed by the lessee or by a party related to the lessee</p> <p>Guaranteed residual value (for a lessee) is that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable).</p> <p>Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.</p> |
|---|---|

The guaranteed residual value is merely a deferred lease payment which is payable with the final instalment. For example, motor vehicles can be leased with a guaranteed residual value of up to 60 %. In theory, the residual value is the estimated market value of the asset at the end of the lease term, thus the amount payable at the end of the lease term.

The unguaranteed residual value is always excluded from the determination of the minimum lease payments.

Contingent rents should be recognised as expenses in the statement of financial performance in the periods in which they are incurred. These costs are not included in the calculation of the minimum lease payments.

| | |
|---|--|
|  | <p>Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).</p> |
|---|--|

Each lease payment is apportioned between the reduction of the outstanding obligation and finance charges. The finance charges are recognised in the statement of financial performance so as to achieve a constant interest rate over the lease term, e.g. using the implicit interest rate method. The municipality may use some form of approximation to simplify the calculation, e.g. sum-of-the-digits method.

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|--|--|-----------|----------------------|---------------------------|
| 1 | Appropriate accounting treatment according to GRAP 13.34 – 13.47 (previously IAS 17.20 – 17.32) | <p>Ensure the correct accounting treatment of finance leases in the financial statements of the lessees:</p> <ul style="list-style-type: none"> • Assets obtained by means of a finance lease should be capitalised i.e. an asset and a liability recognised at the cash cost of the asset leased. • Annual depreciation on the leased asset should be expensed. • Annual finance charges should be expensed • The balance of the lease at year-end should be disclosed as a non-current liability, excluding the short-term portion transferred to current liabilities. <p>The accounting treatment of finance leases is best explained by way of a practical example. See example 1 & 2 in Annexure 2 below.</p> | AP | CFO | 30 June each year |

FLUCTUATIONS IN INTEREST RATES ON FINANCE LEASES

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|--|--|-----------|----------------------|---------------------------|
| 1 | Fluctuations in interest rates in accordance with GRAP | <p>Where provision is made in terms of a finance lease agreement for fluctuations in the rate of interest, the total minimum lease payments may vary with each fluctuation.</p> <p>Ensure that when a change in rate occurs, the total finance charge to be allocated to subsequent periods will change but no adjustments are made to previously recorded amounts.</p> <p>The accounting treatment of the fluctuations in interest rates is best explained by way of a practical example. See example 2 in Annexure 2 below.</p> | AP | CFO | 30 June each year |

b) ACCOUNTING TREATMENT OF OPERATING LEASES

A lessee under an operating lease does not recognise the leased asset on its statement of financial position nor does it recognise a liability for rentals in respect of future periods.

Except where another basis relates better to the time pattern of benefits expected from a leased asset, the lease payments of an operating lease are recognised as an expense in the statement of financial performance on a straight-line basis over the lease term, even if the actual payments are not on that basis. The difference between the equalised lease payment and the actual cash flow is recognised as a deferred asset or liability in the statement of financial position.

Operating lease incentives, such a rent-free periods are considered an integral part of the consideration for the use of the asset and should be recongised over the lease term on the same basis as the lease payments.

The charging against operating surpluses/deficits of lease payments may not result in the matching of costs with revenue if the lease payments are computed on factors that are not directly related to the period over which the benefit is derived from the leased asset. In such instances, the lease payments need to be deferred or provision needs to be made for future lease payments.

This could arise where:

- the lease payments are not spread equally over the lease term ,
- the lessee is required to make payments prior to bringing the leased asset into use,
- the lease involves an initial term which is significantly less than the period over which benefit is to be derived from the leased asset and there is an option to renew the lease at lease payments which are either significantly less or more than the lease payments during the initial term, and renewal of the lease is reasonably assured.

b) ACCOUNTING TREATMENT OF OPERATING LEASES

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|---|--|-----------|----------------------|---------------------------|
| 1 | <p>The accounting treatment of operating leases is outlined in GRAP 13 (previously IAS 17) as follows:</p> <p>Under an operating lease, risks and rewards associated with ownership are not transferred to the lessee. The responsibility of the lessee under the lease contract is limited to the payment of the periodic lease payments over the period of the lease, which is normally substantially less than the useful life of the leased asset. It is, therefore, inappropriate to capitalise an asset held under an operating lease.</p> | <p>Ensure that the asset held under an operating lease are not capitalised in the FS of the lessees.</p> <p>The costs paid for operating leases should be allocated to a specific vote in the GL that is reserved for operating lease expenses. The lease payment should be allocated to expenses on a straight line basis, even if this differs from the agreed payment basis</p> <p>Any insurance or maintenance costs incurred by the entity as a result of the operating lease agreement should be allocated to related expense accounts and not to the operating lease expense account.</p> <p>Maintenance of assets obtained through operating leases: In most cases involving operating leases, the lessor should be responsible for the maintenance of leased assets. The contractual obligations for maintenance of the assets should be identified from the contracts by corporate/legal services and a maintenance roster should be prepared. The maintenance</p> | AP | CFO | 30 June each year |

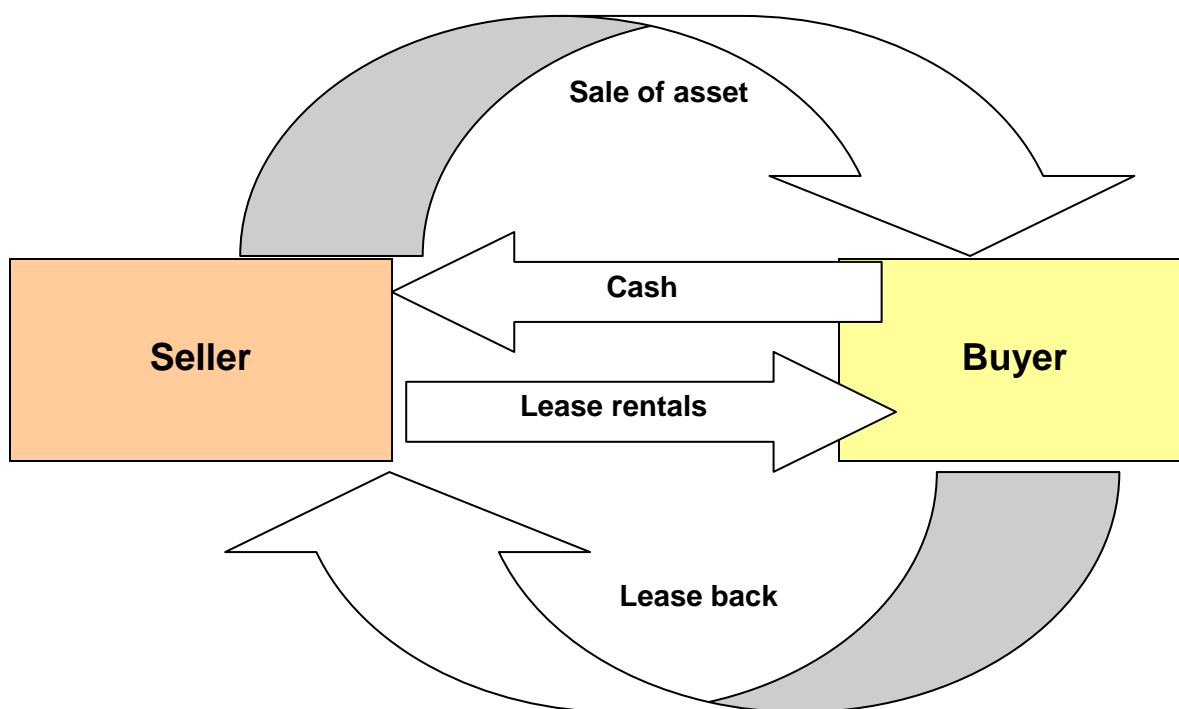
| | | | | | |
|--|--|---|--|--|--|
| | | <p>roster should be forwarded to the official responsible for the control of the asset who should ensure that the asset is appropriately maintained in accordance with the roster.</p> <p>The accounting treatment of operating leases is best explained by way of a practical example. See example 3 in Annexure 2 below.</p> | | | |
|--|--|---|--|--|--|

c) **ACCOUNTING TREATMENT OF A FINANCE LEASE PREVIOUSLY ACCOUNTED FOR AS A OPERATING LEASE**

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|--|---|-----------|----------------------|---------------------------|
| 1 | Accounting for a change in the classification of a lease | The accounting treatment of a finance lease, previously incorrectly accounted for as an operating lease, is best explained by way of a practical example. See example 4 in Annexure 2 below. | AP | CFO | 30 June each year |

**d) ACCOUNTING TREATMENT OF SALE AND LEASEBACK TRANSACTIONS
IN THE FINANCIAL STATEMENTS OF LESSEES**

A sale and leaseback arrangement involves a municipality selling an asset to a lessor who, in turn, leases the same asset back to the municipality, with the municipality then becoming a lessee.



Each component of the transaction is accounted for separately in the records of each party.

The accounting treatment of the sale and leaseback agreement depends on the classification of the lease as a finance lease or an operating lease.

Sale and finance leaseback

Where the seller enters into a finance leaseback the transaction is merely a re-financing arrangement. The seller never actually disposes of the asset and so it should not recognise a surplus/deficit on the sale. Any surplus (i.e. the difference between the selling price and carrying value of the asset at the date of sale) is deferred and recognised in the statement of financial performance over the lease term.

Sale and operating leaseback

Where the seller enters into a operating leaseback, it effectively disposes of substantially all the risks and rewards of ownership in the sale transaction and may re-acquire some of the risks and rewards in the leaseback. Accordingly, the transaction should be treated as a disposal and any surplus/deficit on the transaction should be recognised as follows:

| Sale price <u>at fair value</u> | Carrying amount equal to fair value | Carrying amount less than fair value | Carrying amount above fair value |
|--|--|---|---|
| Profit | No profit | Recognise profit immediately | Not applicable |
| Loss | No loss | Not applicable | Recognise loss immediately |

| Sale price <u>below fair value</u> | Carrying amount equal to fair value | Carrying amount less than fair value | Carrying amount above fair value |
|--|--|---|---|
| Profit | No profit | Recognise profit immediately | No profit |
| Loss (not compensated by future lease payments at below market value) | Recognise loss immediately | Recognise loss immediately | N/A (Impair asset) |
| Loss (compensated by future lease payments at below market price) | Defer and amortise loss | Defer and amortise loss | N/A (Impair asset) |

| Sale price <u>above fair value</u> | Carrying amount equal to fair value | Carrying amount less than fair value | Carrying amount above fair value |
|---|--|---|---|
| Profit | Defer and amortise profit | Defer and amortise profit | Defer and amortise profit |
| Loss | No loss | No loss | N/A (Impair asset) |

• **SALE AND LEASEBACK BY WAY OF A FINANCE LEASE AGREEMENT**

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|-------|---|-----------|----------------------|---------------------------|
| 1 | | <p>If a sale and leaseback transaction results in a finance lease, ensure that any excess of sales proceeds over the carrying amount are not immediately recognised as revenue in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term.</p> <p>The accounting treatment of operating leases is best explained by way of a practical example. See example 5 in Annexure 2 below.</p> | AP | CFO | 30 June each year |

• **SALE AND LEASEBACK BY WAY OF AN OPERATING LEASE AGREEMENT**

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|-------|---|-----------|----------------------|---------------------------|
| 1 | | <ul style="list-style-type: none"> • If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any gain or loss should be recognised immediately. • If the sale price is below fair value, any gain or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market | AP | CFO | 30 June each year |

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|-------|--|-----------|----------------------|---------------------------|
| | | <p>price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.</p> <ul style="list-style-type: none"> If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used. <p>If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.</p> | | | |


B ACCOUNTING TREATMENT OF LEASES IN THE FINANCIAL STATEMENTS OF LESSORS

In this scenario the lessor recognises the lease payments receivable as an asset in the statement of financial position. The finance income received by the lessor is allocated on a systematic basis over the lease term, similar to the implicit interest rate method discussed above.

As with finance leases in the financial statements of the lessee, the sum-of-digits method may be used to distinguish between the capital repayments and finance revenue.

The receivable recognised in the statement of financial position should be equal to the net investment of the lessor in the lease arrangement. The calculation of the net investment can be illustrated through the following formula –

$$\text{Net investment} = \text{gross investment discounted at the implicit interest rate}$$

| | |
|--|---|
|  | <p>Gross investment in the lease is the aggregate of:</p> <ul style="list-style-type: none"> (a) the minimum lease payments receivable by a lessor under a finance lease, and (b) any unguaranteed residual value accruing to the lessor. |
|--|---|

The gross investment can be described as the total of:

- a) payments that the lessee is obliged to make in terms of the arrangement excluding amounts recovered by the lessor such as VAT, costs of services and contingent rent,


PLUS

- b) any guaranteed residual value

PLUS

- c) any unguaranteed residual value

Using the interest rate implicit in the lease, the gross investment is discounted over the lease term. The different between the gross investment and net investment represents unearned finance revenue.

| | |
|---|--|
|  | <p>Guaranteed residual value (for lessor) is that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.</p> |
|---|--|

Initial direct costs are included in the in the initial measurement of the finance lease receivable and thus reduce the amount of financial income recognised over the lease term.

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|--|--|-----------|----------------------|---------------------------|
| 1 | In terms of section 164 of the MFMA no municipality may make loans to councillors or officials of a municipality; directors or officials of a municipal entity; or members of the public. Before the introduction of the MFMA municipalities were however allowed to make loans and this resulted in municipalities acting as a lessor. A common example was the provision of low interest car loans to municipal officials. For the remainder of the time period of these existing loans the municipality will need to account for these leases in terms of IAS 17. | Scrutinise the vehicle loans votes in the GL to ensure that no loans were made during the year under review and that the loans outstanding as at year-end existed before the introduction of the MFMA. | LCP | CFO | 30 June each year |

a) ACCOUNTING TREATMENT OF FINANCE LEASES

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|---|--|-----------|----------------------|---------------------------|
| 1 | <p>The relevant principles contained in IAS 17 relating to the treatment of finance leases in the financial statements of lessors are as follows:</p> <ul style="list-style-type: none"> Lessors should recognise lease payments receivable under a finance lease as assets in their statements of financial position. They should present such assets as a receivable at an amount equal to the net investment in the lease. The recognition of finance revenue should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease. | <p>Accounting Procedure: Finance leases in the FS of the lessor.</p> <p>Ensure the correct accounting treatment of finance leases in the financial statements of the lessor:</p> <ul style="list-style-type: none"> Annual finance revenue should be recognised as interest received. The balance of the lease investment at year-end should be disclosed as a non-current asset, excluding the short-term portion transferred to current assets. <p>The accounting treatment of finance leases in the financial statements of a municipality that acts as a lessor, is best explained by way of a practical example. See example 6 in Annexure 2 below.</p> | AP | CFO | 30 June each year |

b) ACCOUNTING TREATMENT OF OPERATING LEASES

Assets subject to operating leases are presented in the statement of financial position according to their nature, e.g. property, plant and equipment or investment property. The lease revenue is recognised on a straight-line basis over the lease term.

Initial direct costs incurred in negotiating the lease is capitalised to the carrying value of the leased asset and is recognised as an expense in the statement of financial performance on the same basis as the lease revenue.



Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or trader lessors.

b) ACCOUNTING TREATMENT OF OPERATING LEASES

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|--|--|-----------|----------------------|---------------------------|
| 1 | <p>The relevant principles contained in IAS 17 relating to the treatment of finance leases in the financial statements of lessors are as follows:</p> <ul style="list-style-type: none"> ▪ Under an operating lease, the risks and rewards associated with ownership of an asset remain with the lessor. Therefore, the asset is treated by the lessor as a depreciable asset or an investment property and rentals receivable are included in revenue over the lease term. A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not equivalent of a sale. ▪ Costs, including depreciation, incurred in earning the rental revenue are charged to revenue when incurred. Rental revenue (excluding receipts for services provided such as insurance and maintenance) is normally recognised on a straight line basis over the lease term even if the receipts are not on such a basis, | <p>Accounting Procedure: Operating leases in the FS of the lessor.</p> <p>Ensure the correct accounting treatment of operating leases in the financial statements of the lessor:</p> <ul style="list-style-type: none"> • Ensure that the asset is treated by the lessor as a depreciable asset or an investment property. • Ensure that rentals receivable are included in revenue over the lease term. • Ensure that depreciation, incurred in earning the rental revenue is charged to revenue when incurred over the useful life of the asset. | AP | CFO | 30 June each year |

| # | FMBPR | FSOP | FSOP Type | Responsible Official | Date of Execution of FSOP |
|---|---|------|-----------|----------------------|---------------------------|
| | <p>unless another systematic basis is more representative of the time pattern of the earnings process arising from the lease.</p> <ul style="list-style-type: none"> ▪ The asset leased under the operating lease is depreciated on a basis consistent with the lessor's normal depreciation policy for a similar asset, the depreciable amount of the asset being allocated on a systematic basis to each accounting period during its useful life. | | | | |

3.5.4. AFS DISCLOSURE REQUIREMENTS

LESSEES

Lessees should make the following disclosures for finance leases:

- (a) For each class of asset, the net carrying amount at the reporting date;
- (b) A reconciliation between the total of minimum lease payments at the reporting date, and their present value.
- (c) In addition, an entity should disclose the total of minimum lease payments at the reporting date, and their present value, for each of the following periods:
 - (i) Not later than one year;
 - (ii) Later than one year and not later than five years; and
 - (iii) Later than five years;
- (d) Contingent rents recognized in the statement of financial performance for the period;
- (e) The total of future minimum sublease payments expected to be received under non-cancellable subleases at the reporting date; and
- (f) A general description of the lessee's significant leasing arrangements including, but not limited to, the following:
 - (i) The basis on which contingent rent payments are determined;
 - (ii) The existence and terms of renewal or purchase options and escalation clauses; and
 - (iii) Restrictions imposed by lease arrangements, such as those concerning return of net surplus, return of capital contributions, dividends, additional debt and further leasing.

Lessees should make the following disclosures for operating leases:

- (a) The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
 - (i) Not later than one year;
 - (ii) Later than one year and not later than five years; and
 - (iii) Later than five years;
- (b) The total of future minimum sublease payments expected to be received under non-cancellable subleases at the reporting date;
- (c) Lease and sublease payments recognised in the statement of financial performance for the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments;
- (d) A general description of the lessee's significant leasing arrangements including, but not limited to, the following:
 - (i) The basis on which contingent rent payments are determined;
 - (ii) The existence and terms of renewal or purchase options and escalation clauses; and
 - (iii) Restrictions imposed by lease arrangements, such as those concerning return of net surplus, return of capital contributions, dividends, additional debt, and further leasing.

LESSORS

Lessors should make the following disclosures for finance leases:

- (a) A reconciliation between the total gross investment in the lease at the reporting date, and the present value of minimum lease payments receivable at the reporting date. In addition, an entity should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the reporting date, for each of the following periods:
 - (i) Not later than one year;
 - (ii) Later than one year and not later than five years; and
 - (iii) Later than five years;
- (b) Unearned finance revenue;
- (c) The unguaranteed residual values accruing to the benefit of the lessor;
- (d) The accumulated allowance for uncollectible minimum lease payments receivable;
- (e) Contingent rents recognised in the statement of financial performance; and
- (f) A general description of the lessor's significant leasing arrangements.

As an indicator of growth in leasing activities it is often useful to also disclose the gross investment less unearned revenue in new business added during the accounting period, after deducting the relevant amounts for cancelled leases.

Lessors should make the following disclosures for operating leases:

- (a) The future minimum lease payments under non cancellable operating leases in the aggregate and for each of the following periods:
 - (i) Not later than one year;
 - (ii) Later than one year and not later than five years; and
 - (iii) Later than five years;
- (b) Total contingent rents recognised in the statement of financial performance; and
- (c) A general description of the lessor's significant leasing arrangements.

3.5.5 EXEMPTION RELATED TO THE IMPLEMENTATION OF IAS 17.

Refer to section 3.5.1 Overview of the accounting for leases, for a discussion on the exemption related to the implementation of IAS 17.

For **municipalities making use of the exemption** granted for IAS 17, the interim requirements applicable during the exemption period are as follows:

- The operating lease payments / receipts must be recognised on the basis of the cash flows in the lease agreement.
- Certain disclosures, set out in the communication from National Treasury, titled 'Application of accounting standards (updated August 2007)', must be made as part of the 'Leases' accounting policy in respect of the exemption.

From 1 July 2008 (reporting date 30 June 2009) **GRAP 13, on Leases**, becomes effective for High capacity and Medium capacity municipalities, while for Low capacity municipalities it becomes effective from 1 July 2009 (reporting date 30 June 2010).

The **transitional provisions** of GRAP 13 states that all changes resulting from the application of the Standard of GRAP on Leases shall be accounted for in accordance with the requirements of the Standard of GRAP on Accounting Policies, Changes in Accounting Estimates and Errors (therefore **retrospectively**).

- Where biological assets that form part of an agricultural activity are leased, **low and medium capacity** municipalities are however allowed to apply the transitional provision in GRAP 101 on Agriculture, whereby **three years** are allowed from the date of initial adoption of the Standard to comply with the measurement requirements of the Standard.


ANNEXURE 1 – Examples of situations which would normally lead to a lease being classified as a finance lease

The lease does **not need to meet all these criteria** to be classified as a finance lease:

- The lease **transfers ownership of the asset to the lessee by the end of the lease term**.
- 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, so that at the inception of the lease it is reasonably certain that the option will be exercised.
- The **lease term is for the major part of the economic life** (the period over which an asset is expected to yield economic benefits or service potential to one or more users) of the asset even if title is not transferred. *(In terms of the withdrawn GAMAP 102, the major part of the economic life was regarded as 75% or more of the economic life. No guideline is however offered by IAS 17 on what is regarded as the major part of the economic life.)*
- At the inception of the lease the **present value of the minimum lease payments amounts to at least substantially all (at least 90%) of the fair value** of the leased asset.
- The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.
- The leased assets cannot easily be replaced by another asset.
- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease)
- The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

ANNEXURE 2 – Illustrative examples

Example 1: Illustration of approach and accounting entries associated with a finance lease

| | |
|---|--|
|  | <p>SA Municipality enters into a finance lease with ABC Bank on the first day of the financial year ended 30 June 2008 (i.e. on 1 July 2007). The cash price of the asset, a delivery vehicle, is R26 000 (including VAT of 14 %). The following conditions relate to the lease:</p> <p>Finance lease payments, payable annually in arrears on 30 June each year, are R12 000 per annum. The lease agreement is for three years (i.e. the last payment will be made on 30 June 2010). The useful life of the vehicle is 3 years.</p> <p>There is no residual payment for this lease.</p> |
|---|--|

The following approach is suggested to solve the accounting treatment of this problem:

Step One: Determine the lease term, which is defined as 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, which option at the inception of the lease it is reasonably certain that the lessee will exercise. In this example the lease term is 3 years.

Step Two: Determine the amount of the minimum lease payments. Minimum lease payments are payments that the lessee is, or can be, required to make in terms of the lease. This will include any residual value of the leased asset guaranteed by the lessee to the lessor as well as any payment that the lessee, is or can be, required to make upon failure to renew or extend the lease at the expiration of the original lease term. It will also include finance costs. However, these payments will exclude those in respect of maintenance. In this example, as there is no residual value guaranteed in the lease conditions set out above, the minimum lease payments are R12 000 per year for three years which equal R 36 000 in total.

Step Three: Determine the fair value of the leased asset, being the amount at which the asset will be capitalised. Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. This value is normally the price stated in the lease agreement, and is usually the cash price. In this example it is the given amount of R26 000.

Step Four: Determine the discount factor. The discount factor can be determined by using a financial calculator and inputting the number of instalments (N) as 3; the present value of the lease (PV) as R26 000; the payments (PMT) as -R12 000 (negative) and the future value (FV) as R0. In this example, the discount factor has been calculated as 18,219 % (using a financial calculator).

Step Five: Determine the expected useful life of the leased asset for the municipality for depreciation purposes according to the principles of GRAP 17. For purposes of this example, the expected useful life can be assumed to be three years.

Step Six: Prepare an amortisation schedule, splitting each instalment into its capital and interest portion. This is illustrated below:

| Date | Instalment (R) | Capital (R) | Interest (R) | Balance (R) |
|------------|----------------|-------------|--------------|-------------|
| 01/07/2007 | | | | 26 000 |
| 30/06/2008 | 12 000 | 7 263 | 4 737 | 18 737 |
| 30/06/2009 | 12 000 | 8 586 | 3 414 | 10 151 |
| 30/06/2010 | 12 000 | 10 151 | 1 849 | 0 |
| Total | 36 000 | 26 000 | 10 000 | |

Step Seven: Prepare Journal entries to account for the lease and related transactions

| Date | Description | Debit (R) | Credit (R) |
|------------------------|--|----------------------|------------|
| YEAR 1 - 01/07/2007 | Asset: Motor vehicle VAT – Input Non – current liability Being recording of vehicle at inception of lease. | 22807.02 3192.98 | 26 000.00 |
| 30/06/2008 | Non current liability Finance charges Bank Being payment of annual lease payment | 7 263.00 4 737.00 | 12 000.00 |
| 30/06/2008 | Depreciation: Vehicles Accumulated depreciation: Vehicles (22 807.02 ÷ 3 years - expected life) Being annual depreciation on leased vehicle | 7 602.34 | 7 602.34 |
| YEAR 2 - 30/06/2009 | Non current liability Finance charges Bank Being payment of annual lease payment | 8 586.00 3 414.00 | 12 000.00 |

| Date | Description | Debit (R) | Credit (R) |
|------------------------|--|-----------------------|------------|
| 30/06/2009 | Depreciation: vehicles Accumulated depreciation: Vehicles Being annual depreciation on leased vehicle | 7 602.34 | 7 602.34 |
| YEAR 3 – 30/06/2010 | Non current liability Finance charges Bank Being payment of annual lease payment | 10 151.00 1 849.00 | 12 000.00 |
| 30/06/2010 | Depreciation: Vehicles Accumulated depreciation: Vehicles (22 807.02 ÷ 3 years - expected life) Being annual depreciation on leased vehicle | 7 602.34 | 7 602.34 |

Step Eight: Record transactions in financial statements

Disclosure of the above transactions in the financial statements of SA Municipality for the year ended 30 June 2009.

| SA Municipality Statement of financial position at 30 June 2009 | | | |
|---|------|-----------|-----------|
| (Extract from Balance Sheet) | Note | 2009 R | 2008 R |
| Non current liabilities | | | |
| Long term Liabilities | 5 | 0 | 10151 |
| Non current assets | | | |
| Property, plant and equipment | 7 | XXX | XXX |
| Current Liabilities | 5 | 10151 | 8586 |
| SA Municipality Statement of financial performance for the year ended 30 June 2009 | | | |
| (Extract from Income Statement) | Note | 2009 R | 2008 R |
| Depreciation | 8 | XXX | XXX |
| Interest on external borrowings | 8 | XXX | XXX |

Note 1: Accounting policies**(a) Leases:**

Leases are classified as finance leases where substantially all the risks and rewards associated with ownership of an asset are transferred to the local authority. Operating lease are those leases, which do not fall within the scope of the above definition. Operating lease rentals are expensed as they become due.

Assets subject to finance lease agreements are capitalised at their cash cost equivalent and the corresponding liabilities are raised. The cost of the assets is depreciated at appropriate rates on the straight-line basis over the estimated useful lives of the assets. Lease payments are allocated between the lease finance cost and the capital repayment using the effective interest rate method. Lease interest is expensed when incurred.

Note 5: Long –term liabilities

| | 2009 | 2008 |
|---|-------|-------|
| Capitalised lease liabilities | 10151 | 18737 |
| Less short term portions transferred to current liabilities | 10151 | 8586 |
| Long term liabilities | 0 | 10151 |

The capitalised lease liabilities are secured over the assets leased. Refer note 7. The lease liabilities are repayable in annual instalments of R12 000 on 30 June at an annual effective interest rate 18.22% per annum.

Note 7: Property, plant and equipment

| | 30 June 2009 | Cost | Accumulated depreciation | Gross carrying value |
|--------------------------------------|--------------|--------|--------------------------|----------------------|
| Leased property, plant and equipment | 22 807 | 15 205 | 7 602 | |


| | 30 June 2008 | Cost | Accumulated depreciation | Gross carrying value |
|--------------------------------------|--------------|--------|--------------------------|----------------------|
| Leased property, plant and equipment | | 22 807 | 7 602 | 15 205 |

The leased property plant and equipment is secured as set out in note 5.

Note 8: Depreciation and interest paid

Depreciation and interest paid will be added to and disclosed together with the other depreciation and interest paid of the municipality.

Example 2: Illustration of change in interest rate

| | |
|---|---|
|  | <p>Assume that SA Municipality enters into the lease agreement referred to in Example 1. However, after the payment of the second instalment on 30 June 2009, the interest rate changes to 20% per annum.</p> |
|---|---|

Firstly, it is important to note that no adjustments are made to previously recorded amounts for the financial years ended 30/06/2008 and 30/06/2009 and the journal entries for the first two years of the lease are the same as those recorded in Example 1.

The outstanding capital balance as at 30/06/2009 remains unchanged at R10 151.

The instalment and the interest portion of the instalment will increase for the year ended 30/06/2010 as a result of the increased interest rate. A financial calculator can be used to calculate the new instalment as R12 181, the interest portion as R2 030 and the capital reduction as R10 151, by inputting (N) as 1, (i) as 20; (PV) as R 10 151 and (FV) as 0.


The following journal entry will be processed in Year 3 of the finance lease (i.e. as at 30 June 2010). The journal entries for Years 1 and 2 will remain unchanged and are set out in Example 1.

| | | | |
|------------------------|--|-----------------------|-----------|
| YEAR 3 – 30/06/2010 | Non current liability Finance charges Bank Being payment of annual lease payment | 10 151.00 2 030.00 | 12 181.00 |
| 30/06/2010 | Depreciation: Vehicles Accumulated depreciation: Vehicles (22 807.02 ÷ 3 years - expected life) Being annual depreciation on leased vehicle | 7 602.34 | 7 602.34 |

Practical consideration when calculating finance lease payments, interest and capital

In practice, most finance leases will be monthly and interest rate fluctuations will occur during a month and may be frequent throughout the period of a lease. Information can be requested from the lessor on the amount of capital and interest paid during a financial year. This will assist in determining the journal entries required to accurately record finance lease transactions.

Example 3: Operating lease where payments are not spread evenly over lease period

| | |
|---|--|
|  | <p>The following details pertain to an entity that leases a Photostat machine. The lease is classified as an operating lease and the lease has the following details:</p> <p>Cash price of the machine: R 200 000</p> <p>Lease term: 01/07/2007 – 30/06/2010</p> <p>Monthly instalments: R7 000 for the first 24 months and R5 000 per month for the last 12 months.</p> |
|---|--|

The principle objective in such leases is to calculate an average operating lease payment over the whole period of the lease, which average amount will be expensed over the period of the lease. The difference between the average operating lease payment and actual lease payment is recognised as a prepayment or short-term liability until the lease period has expired.

In terms of this example, the following calculations need to be performed: -

Operating lease payments calculation: -

| | |
|---|-----------------|
| First 24 months (7 000 x 24) | R168 000 |
| Last 12 months (5 000 x 12) | R 60 000 |
| Total operating lease payments | R228 000 |
| Average monthly payment (R 228 000/36 months) | R6 333,33pm |

Calculation of operating lease expense in Year 1

| | |
|---|----------------|
| Average expense for 12 months = (R6 333, 33 x 12) to be included in the statement of financial performance | R76 000 |
| Actual payments made for 12 months = (R7 000 x 12) – Cheque payments to lessor | R84 000 |
| Prepaid expense on 30/06/2008 – to be included in the statement of financial position as a debtor | R 8 000 |
| Prepayment balance as at 30/06/08 | R 8 000 |

Calculation of operating lease expense in Year 2


| | |
|---|----------------|
| Average expense for 12 months = (R6 333, 33 x 12) to be included in the statement of financial performance | R76 000 |
| Actual payments made for 12 months = (R7 000 x 12) – Cheque payments to lessor | R84 000 |

| | |
|---|----------------|
| Additional prepaid expense on 30/06/2009 – to be included in statement of financial position | R 8 000 |
| Prepayment balance as at 30/06/09 | R16 000 |
| Calculation of operating lease expense in Year 3 | |
| Average expense for 12 months = (R6 333, 33 x 12) to be included in the statement of financial performance | R76 000 |
| Actual payments made for 12 months = (R5 000 x 12) – Cheque payments to lessor | R60 000 |
| Reduction in prepaid expense on 30/06/10 | R16 000 |
| Prepayment balance as at 30/06/10 | R0 |

The only disclosure for this specific transaction in the financial statements should be as follows: -

- Operating lease payments of R 76 000 should be disclosed as an expense/charge against operating surpluses/deficits for the years ended 30/06/2008 – 30/06/2010.
- An amount of R8 000 should be included in current assets as a deferred lease payment at 30 June 2008. This amount should not normally be disclosed as a separate line item as at 30/06/2008, but be included with receivables. An amount of R16 000 will be disclosed as a deferred lease payment (included under receivables) as at 30/06/2009.

Example 4: Recording of finance lease previously accounted for as an operating lease

| | |
|---|--|
|  | <p>SA Municipality enters into a finance lease with Company A on the first day of the financial year ended 30 June 2008 (i.e. on 1/7/2007), for the lease of a telephone system. The following conditions relate to the lease:</p> <p>Finance lease payments, payable annually in arrears on 30 June each year, are R600 000 per annum. The lease agreement is for five years (i.e. the last payment will be made on 30 June 2012). The useful life of the telephone system is 5 years.</p> <p>There is no residual payment for this lease. The interest rate on this lease is 12% per annum. The lease was dealt with in the past as an operating lease and at 30 June 2009, with the implementation of GRAP, the correcting entries to change the accounting of the transaction as a finance lease need to be performed. (For the purposes of this example VAT was excluded)</p> |
|---|--|

The following approach is suggested to solve the accounting treatment of this problem:

Step One: Identify the transactions previously incorrectly recorded as an operating lease

| Date | Description | Debit (R) | Credit (R) |
|----------------------|--|-----------|------------|
| Year 1 30/06/2008 | Operating lease Rental expense Bank Being the recording of finance lease as an operating lease at 30 June 2004. | 600 000 | 600 000 |
| Year 2 30/06/2009 | Operating lease Rental expense Bank Being the recording of finance lease as an operating lease as at 30 June 2005. | 600 000 | 600 000 |

Step Two: Determine the fair value of the leased asset, being the amount at which the asset will be capitalised. Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. This fair value (present value) can be determined by using a financial calculator and inputting the number of instalments (N) as 5; the interest rate (I/Yr) as 12%; the payments (PMT) as –R600 000 (negative) and the future value (FV) as R0. In this example, the present value is calculated as R2 162 865 (using a financial calculator).

Step Three: Prepare an amortisation schedule, splitting each instalment into its capital and interest portion. This is illustrated below:

| Date | Instalment (R) | Capital (R) | Interest (R) | Balance (R) |
|------------|----------------|-------------|--------------|-------------|
| 01/07/2007 | | | | 2 162 865 |
| 30/06/2008 | 600 000 | 340 456 | 259 543 | 1 822 410 |
| 30/06/2009 | 600 000 | 381 311 | 218 689 | 1 441 098 |

Step Four: Determine the expected useful life of the leased asset for the municipality for depreciation purposes according to the principles of GRAP 17. For purposes of this example, the expected useful life can be assumed to be five years.

Step Five: Identify the transactions that should have been recorded for the finance lease since inception

| Date | Description | Debit (R) | Credit (R) |
|------------|---|-----------|------------|
| Year 1 | | | |
| 30/06/2008 | Asset: Telephone System | 2 162 865 | |
| | Non Current liability | | 2 162 865 |
| | Being the recording of asset at inception of the lease. | | |
| | Non Current liability | 340 456 | |
| | Finance Charges | 259 543 | |
| | Bank | | 600 000 |
| | Being payment of annual lease payments | | |
| | Depreciation: Telephone System | 432 573 | |
| | Accumulated depreciation : Telephone system | | 432 573 |
| | Being annual depreciation on leased asset | | |

| Date | Description | Debit (R) | Credit (R) |
|------------|---|-----------|------------|
| Year 2 | | | |
| 30/06/2009 | Non Current liability | 381 311 | |
| | Finance Charges | 218 689 | |
| | Bank | | 600 |
| | Being payment of annual lease payments | | 000 |
| | Depreciation: Telephone System | 432 573 | |
| | Accumulated depreciation : Telephone system | | 432 573 |
| | Being annual depreciation on leased asset | | |

Step Six: Prepare correcting entries to record finance lease as at 30 June 2009

| Date | Description | Debit (R) | Credit (R) |
|------------|--|-----------|------------|
| 30/06/2009 | Asset: Telephone System (1) | 2 162 865 | |
| | Accumulated surplus (4) | 143 379 | |
| | Non – current liability (2) | | 1 441 089 |
| | Accumulated Depreciation (3) | | 865 146 |
| | Being the recording of finance lease as at 30 June 2009 that was recorded previously as an operating lease. | | |


Explanatory notes

1. Debit asset at cash cost price.
2. Credit lease liability as per outstanding amortisation model.
3. Credit Accumulated Depreciation based on the expected life span of the asset
4. Balancing figure to Accumulated Surplus

An alternative method of calculating the balancing figure shown above (4) is as follows:

| | |
|--|--------------|
| Interest that should have been recorded under a finance lease up to 30/06/2009 (R259 544 + R218 689) | = R 478 233 |
| Plus Depreciation that should have been recorded up to 30/06/2009 | = R 865 146 |
| Less Operating lease expenses recorded up to 30/06/2009 <u>200 000</u>) | = <u>(R1</u> |
| Net adjustment to Unappropriated expenditure | = R143 379 |

Example 5: Sale and leaseback by way of a finance lease agreement

| | |
|---|---|
|  | <p>SA Municipality sells some of its land and buildings on 01/07/2007 to ABC Bank and leases the buildings back in terms of a sale and leaseback arrangement. The carrying amount of the land and buildings is R350 000, the selling price is R420 000 and 36 instalments of R14 000 each are payable monthly in arrears.</p> |
|---|---|

Accounting for the above transactions in the accounting records of SA Municipality will be as follows for the year ended 30/06/2008 and is set out by way of a stepped approach:

Step One: Preparation of an amortisation schedule

| Year ended | Payments (R) | Interest (R) | Capital (R) | Balance (R) |
|------------|-----------------|-----------------|----------------|----------------|
| 2007 | | | | 420 000 |
| 2008 | 168 000 | 44 674 | 123 326 | 296 674 |
| 2009 | 168 000 | 28 691 | 139 309 | 157 365 |
| 2010 | 168 000 | 10 635 | 157 365 | 0 |

Note: The above amortisation schedule is based on financial calculator functions of a PV of R420 000, (N) of 36 months, (PMT) of R14 000 (negative) per month, a (FV) of R0 and a calculated (i) of 1,021 % per month.

Step Two: Prepare journal entries to reflect the finance lease (just the first year is shown using the information obtained from the amortisation table in Step One above)

| Date | Description | Debit (R) | Credit (R) |
|------------|---|-------------------|------------|
| 01/07/2007 | Bank Lease liability Being raising of loan finance received | 420 000 | 420 000 |
| 01/07/2007 | Land & buildings Deferred profit Assets written up to proceeds on sale and profit deferred | 70 000 | 70 000 |
| 01/07/2007 | Deferred profit Gain on sale of assets (I/S) 1/3 of deferred profit recognised (amortised over lease term) | 23 333 | 23 333 |
| 30/06/2008 | Finance charges Lease liability Bank Being repayment of principle and interest as at 30 June 2000 | 44 674 123 326 | 168 000 |

Step Three: The asset will continue to be depreciated over its expected useful life based on the book value of the asset prior to the sale and leaseback agreement and not the open market value.

Example 6: Finance lease in the financial statements of a municipality that acts as a lessor

ABC Local authority provided a car loan to its Chief Financial Officer on 1 July 2007. The details of the car loan are as follows:

| | |
|----------------|--------------------------------|
| Asset cost | R200, 000 |
| Useful life | 3 years |
| Depreciation | 33, 3% per annum straight line |
| Lease payments | R87, 596 per annum in arrears |

Revenue (Finance income) on the lease is recognised according to the lessor's net investment outstanding:

Illustration of the accounting entries:

| Description | Debit (R) | Credit (R) |
|--|--------------|---------------|
| Gross investment | 262 788 | |
| Unearned finance income | | 62 787 |
| Bank | | 200 000 |
| Payment of loan proceeds to CFO and recognition of lease payments receivable | | |
| Bank | 87,596 | |
| Gross investment | | 87,596 |
| Receipt of finance lease instalment | | |
| Unearned finance income (year 1) | 30,000 | |
| Interest received | | 30,000 |
| Recognition of finance income received | | |

Extract from the notes to the financial statements

ABC Local Authority

Notes to the financial statements for the year ended 30 June 2009

1. Accounting policy

1.4 Finance leases: basis of allocating Revenue:

Revenue (finance income) on assets leased to lessees under finance leases is allocated to reflect a constant periodic rate of return on the lessor's net investment outstanding.

3. Net surplus/ (Deficit) for the year

Interest received of R 30 000 will be added to the other interest received by the municipality and disclosed as such in the Statement of Financial Performance

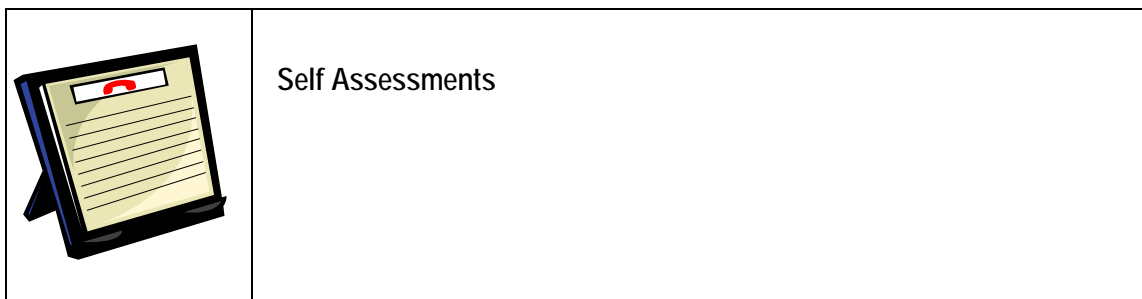
16. Finance lease : Net investment outstanding

| | Gross investment | Unearned Finance Income | Net Investment outstanding |
|--|------------------|-------------------------|----------------------------|
| Total receivable at reporting date | 175 192 | 32 787 | 142 405 |
| Receivable within one year of reporting date | 87 596 | 21 361 | 76 169 |
| Receivable thereafter | 87 596 | 11 425 | 0 |

Calculation of gross investment, unearned finance income (UFI), and Net investment outstanding:

| Date | Transaction | Instalment | Capital | Interest | Outstanding Balance |
|-----------|-------------|---------------|---------------|---------------|---------------------|
| 1/7/2008 | Balance | | | 200 000 | |
| 30/6/2009 | payment | 87 596 | 57 595 | 30 000 | 142 405 |
| 30/6/2010 | payment | 87 596 | 66 234 | 21 361 | 76 169 |
| 30/6/2011 | payment | <u>87 596</u> | <u>76 169</u> | <u>11 425</u> | 0 |
| | | 262 788 | 200 000 | 62 787 | |

| | | |
|-------------------------------|---|-----------------|
| Gross investment : 87 596 x 2 | = | R175 192 |
| UFI : 62 787 – 30 000 | = | <u>R 32 787</u> |
| Net investment | | R142 405 |



1. The classification of a lease as either an operating or finance lease is based on
 - (a) The length of the lease.
 - (b) The transfer of the risks and rewards of ownership.
 - (c) The minimum lease payments being at least 50% of the fair value.
 - (d) The economic life of the asset.

2. The accounting concept that is principally used to classify leases into operating and finance is
 - (a) Substance over form.
 - (b) Prudence.
 - (c) Neutrality.
 - (d) Completeness.

3. Which of the following situations would prima facie lead to a lease being classified as an operating lease?
 - (a) Transfer of ownership to the lessee at the end of the lease term.
 - (b) Option to purchase at a value below the fair value of the asset.
 - (c) The lease term is for a major part of the asset's life.
 - (d) The present value of the minimum lease payments is 50% of the fair value of the asset.

4. The classification of a lease is normally carried out
- (a) At the end of the lease term.
 - (b) After a “cooling off” period of one year.
 - (c) At the inception of the lease.
 - (d) When the entity deems it to be necessary.
5. Where there is a lease of land and buildings and the title to the land is not transferred, generally the lease is treated as if
- (a) The land is a finance lease; the building is a finance lease.
 - (b) The land is a finance lease; the building is an operating lease.
 - (c) The land is an operating lease; the building is a finance lease.
 - (d) The land is an operating lease; the building is an operating lease.
6. The lease of land and buildings when split causes difficulty in the allocation of the minimum lease payments. In this case the minimum lease payments should be split
- (a) According to the relative fair value of two elements.
 - (b) By the entity based on the useful life of the two elements.
 - (c) Using the sum of the digits method.
 - (d) According to any fair value method devised by the entity.
7. Which is the correct accounting treatment for an operating lease payment in the accounts of the lessee?
- (a) **Dr** Cash, **Cr** Operating lease rentals/income statement
 - (b) **Dr** Operating lease rentals/income statement, **Cr** Cash
 - (c) **Dr** Asset account, **Cr** Cash
 - (d) **Dr** Cash, **Cr** Asset account

8. Which is the correct accounting treatment for a finance lease in the accounts of a lessor?
- (a) Treat as a non-current asset equal to net investment in lease. Recognize all finance payments in income statements.
 - (b) Treat as a receivable equal to gross amount receivable on lease. Recognize finance payments in cash and by reducing debtor.
 - (c) Treat as a receivable equal to net investment in the lease. Recognize finance payment by reducing debtor and taking interest to income statement
 - (d) Treat as a receivable equal to net investment in the lease. Recognize finance payments in cash and by reduction of debtor
9. In the case of sale and leaseback transactions, if the sale is below the fair value of the assets and the loss is compensated by future lease payments, then the loss is
- (a) Recognized immediately in reserves.
 - (b) Deferred and amortized over the useful life of the asset.
 - (c) Deferred until the end of the lease term.
 - (d) Recognized immediately in the profit and loss.
10. An undertaking shall disclose the total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
- (i) Not later than one year;
 - (ii) Later than one year and not later than five years;
 - (iii) Later than five years.
- (a) (i)
 - (b) (i)-(ii)
 - (c) (i)-(iii)