OPERATING LEASES

Introduction

The South African Institute of Chartered Accountants' Accounting Practices Committee (APC) wishes to explain the requirements of IAS 17(AC 105) – *Leases*, in respect of operating leases which include fixed rental increases and highlight the International Financial Reporting Interpretations Committee (IFRIC) agenda decision on recognition of contingent rentals. .01

The process of using International Financial Reporting Standards (IFRS) implies not only the use of such standards, but also uniformity in the way in which the standards are applied. Increased global usage of international standards focuses attention on the way in which standards should be applied, which in some cases may differ from South African practice. .02

In South Africa it appears that certain entities may have recognised lease expenditure and income on a basis that is inconsistent with international practice. .03

Scope

This circular addresses fixed rental increases in relation to operating leases on all types of assets. Variations in lease payments that are linked to other factors such as inflation rates or turnover are contingent rentals, the accounting treatment of which was discussed by the IFRIC in July 2006, and the IFRIC agenda decision is set out below. .04

Accounting references

Paragraph 33 of IAS 17(AC 105) states "*Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.*" .05

Paragraph 50 of IAS 17(AC 105) states "*Lease income from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of* .06

the time pattern in which use benefit derived from the leased asset is diminished."

.07 Paragraph 9 of SIC 15(AC 415) – *Operating Leases – Incentives* states *"The underlying substance of operating leases is that the lessor and lessee exchange the use of an asset for a specified period for the consideration of a net amount of money. The accounting periods in which this net amount is recognised by either the lessor or the lessee is not affected by the form of the agreement or the timing of payments.*"

Conclusions

.08 The APC is aware that, up to now in South Africa, many lessees and lessors have recognised rental expenses and income respectively on the basis of the cash flows in the lease agreement, believing that *"another systematic basis"* was *"more representative of the time pattern of the user's benefit"*. Cash flows were considered to be an appropriate basis for recognition as it was considered that the increased cash flows arose as a result of the increased benefits arising from the leased asset. Many entities therefore selected a method other than the straight-line method. The straight-line method results in an equal impact in the income statement in each reporting period irrespective of the fact that cash flows differ. Because of the worldwide transition to IFRS, currently accepted South African accounting practices are being compared to international practices.

.09 After considerable debate, both locally and internationally, about when it is appropriate not to use the straight-line basis, it has become clear that the 'other systematic basis' as applied by South African entities is not consistent with the requirements of IAS 17(AC105) as applied internationally. IAS 17(AC 105) permits a treatment other than straight-line recognition only when another basis is more representative of the <u>time pattern</u> of the user's benefit. This is expected to be rare. The time pattern of the user's benefit is only affected by factors which impact the physical usage of the property. Straight-line recognition means that the payments over the lease term are to be aggregated and divided by the lease term in months in order to arrive at the monthly expense. The cumulative difference between the amounts recognised in the income statement and the cash flows, is recognised on the balance sheet. The effect on deferred tax should be determined with reference to IAS 12(AC 102) – *Income Taxes*.

The APC is of the opinion that the requirements of IAS 17(AC 105) in respect of the recognition of operating lease payments have not changed from the previous version of this statement, which was effective for periods beginning on or after 1 January 1999(1 March 2000). Another version of AC 105 that was in effect before that date included the following guidance in relation to the treatment for operating leases: *"The lease payments are charged against income on some systematic basis related to the benefit expected to be derived from the leased asset; this is normally achieved by charging lease payments as they are incurred"* and when it was changed it appears that entities generally continued to treat operating leases in an unchanged manner. .10

Lessees and lessors should recognise the change to the straight-line method retrospectively from the commencement of the lease term in accordance with requirements of IAS 8(AC103) – *Accounting Policies, Changes in Accounting Estimates and Errors**. .11

Contingent Rental

We requested the IFRIC to consider whether an estimate of contingent rentals payable/receivable under an operating lease should be included in the total lease payment/lease income to be recognised on a straight-line basis over the lease term. .12

In the IFRIC meeting of July 2006 this issue was discussed. The following was noted as its decision in the IFRIC Update of the same date: .13

"The IFRIC noted that, although the Standard is unclear on this issue, this has not, in general, led to contingent rentals being included in the amount to be recognised on a straight line basis over the lease term. Accordingly, the IFRIC decided not to add this issue to its agenda but to recommend to the Board that IAS 17 be amended to clarify the approach intended by the Standard."

The APC therefore advises that contingent rentals do not need to be included in the lease payments/lease income to be recognised on a straight-line basis over the lease term. .14

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* The wording in this paragraph has been amended to correct Circular 7/2005 issued in August 2005, which referred to *"inception"* of the lease and now refers to *"commencement"* of the lease.

Responsibility

SAICA members should determine the necessary action required in the context of their responsibilities as preparers, auditors or users. .14

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August 2006 **Executive President**