



**national treasury**

Department:  
National Treasury  
**REPUBLIC OF SOUTH AFRICA**

# Accounting Manual for Departments

## Leases

## Chapter Content

1	Overview .....	3
2	Key Learning Objectives .....	3
3	Scope .....	4
4	Identification of a Lease .....	4
5	Classification of Leases .....	5
5.1	General .....	5
5.2	Classification at Inception .....	5
5.3	Risks and rewards of ownership.....	6
5.4	Classification Indicators .....	7
5.5	Discussion on Specific Issues .....	13
5.5.1	Land and buildings .....	13
5.5.2	Leased vehicles .....	14
5.5.3	Cell phones and 3G modems .....	15
6	Recognition, Measurement and Recording .....	15
6.1	Finance lease in the financial statements of lessee .....	15
6.2	Finance lease in the financial statements of lessor .....	20
6.3	Operating lease in the financial statements of lessee .....	21
6.4	Operating lease in the financial statements of lessor .....	23
7	Sale and Leaseback .....	23
8	Disclosure .....	24
9	Summary of Key Principles.....	25
9.1	Identification.....	25
9.2	Classification.....	25
9.3	Recognition and measurement.....	25
9.4	Recording and measurement .....	25





## 1 Overview

The purpose of this Chapter is to provide guidance on distinguishing between operating and finance leases and to illustrate the consequential accounting requirements applicable to departments.

The Office of the Accountant-General has compiled a Modified Cash Standard (MCS) and this manual serves as an application guide to the MCS which should be used by departments in the preparation of their financial statements.

Any reference to a “Chapter” in this document refers to the relevant chapter in the MCS and / or the corresponding chapter of the Accounting Manual.

Explanation of images used in the manual:

	Definition
	Take note
	Management process and decision making
	Example


## 2 Key Learning Objectives

- Understanding the different types of leases
- Understand the accounting and disclosure requirements for each type of lease from the lessee's and lessor's perspective

### 3 Scope

There are no specific exclusions from applying the Chapter on Leases.

### 4 Identification of a Lease

	<p>A <b>lease</b> is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.</p>
---	--

As is apparent from the definition above, leases are agreements whereby a department can gain the use of an asset or grant the use of an asset for a specified period of time. A typical example would be a straightforward rental agreement; however, departments also use a lease to finance an asset without having to purchase the asset outright.


It is important to note that, in most cases, legal ownership of the leased asset will rest with the lessor, while the possession and use of the leased asset will vest in the lessee.

Two scenarios can exist:

- legal title may not transfer, but control might; and
- legal title may well transfer at the end of the agreement.

Most leases are easily identifiable based on the terms and conditions of the lease agreement. However, in some instances entities may enter into agreements that do not take the legal form of a lease, but that conveys the right to use an asset in return for a series of payments. These arrangements may comprise of one transaction, or a series of transactions, which in substance may be a lease or may contain a lease element.

A lease may for example be one element in a broader set of agreements with private sector entities to construct, own, operate and/or transfer assets in terms of a Public Private Partnership (PPP).

	<p>Refer to the Guideline on Accounting for PPPs on the PPP website (<a href="http://www.ppp.gov.za">www.ppp.gov.za</a>) for identification of a possible lease element in a PPP arrangement.</p>
---	---

Departments often enter into such agreements, particularly in relation to long-lived physical assets and infrastructure assets. For example, a department may construct an office building. It may then lease the office building to a private sector entity as part of an arrangement whereby the private sector entity agrees to:

- lease the office building for an extended period of time (with or without an option to purchase the facility);
- manage the office building and its facilities within; and
- fulfil extensive maintenance requirements.

If the arrangement contains a lease, the requirements of the MCS will be applied to the lease element and therefore the lease will need to be classified as either a finance lease or an operating lease, based on the **classification criteria** as indicated in the **Section on Classification Indicators** below.

Departments may also enter into a variety of agreements for the provision of goods and/or services, which necessarily involve the use of dedicated assets (such as computer equipment). In some of these agreements, it may not be clear whether or not a lease, as defined by this Chapter, has arisen, for example a department can enter into a hiring arrangement to hire furniture for a month or for a specific event.

The identification of leases may require professional judgment to be exercised. If the agreement contains a lease, it must be accounted for as a lease in terms of the requirements of the MCS


For the purposes of recording leases, a department should maintain a lease register that will enable it to comply with the disclosure note requirements of the MCS.


## 5 Classification of Leases

### 5.1 General

Once it has been determined that an arrangement is (or contains) a lease, it should be determined whether the lease should be classified as either a finance or an operating lease. This classification results in substantially different accounting treatments and classification of the payments made for the use of the asset.

It is common practice for contracts to be termed rental agreements. This therefore does not mean that this is excluded from being a lease. One still needs to go through the conditions of the contract to determine whether it is a finance lease or an operating lease.


	<p>A <b>finance lease</b> is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.</p> <p>An <b>operating lease</b> is a lease other than a finance lease.</p>
--	--

	<p>In terms of SCOA finance lease transactions should be funded from the department's capital budget, whereas payments in terms of operating lease agreements are funded from the current (operating) budget of the department.</p> <p>Also in terms of SCOA, a transaction that involves a once-off payment for the temporary use of a capital asset which is owned by an external party is expensed to Rental and Hiring and not to operating or finance lease payments as leases involve a series of payments.</p>
---	---

### 5.2 Classification at Inception

As the classification of a lease agreement depends on the definitions in the MCS, the circumstances surrounding the lease agreement may be different for the parties to the agreement; as a result the classification of the same lease may be different in the accounting records of the lessee and lessor.

The classification of the lease is **made at inception** of the lease and is **not changed**, unless both parties agree to change the provisions of the initial lease (other than by renewing it), and these changes would have resulted in a different classification of the lease at its inception. This amended lease is considered a new lease agreement.

	<p>Note the difference between <b>commencement date</b> and <b>inception date</b>:</p> <p>The <b>commencement date</b> is the date from which the lessee is entitled to exercise its right to use the asset.</p> <p>The <b>inception date</b> is the earlier of the date of the lease agreement and the date of commitment by the parties to the principle provisions of the lease. This is also when the lease should be classified as either a finance lease or an operating lease.</p> <p>As such, the commencement date of the lease is typically when the lessee takes possession of the leased asset. The inception date is typically the date on which the lease agreement is signed by both parties and becomes legally binding.</p>
---	--


In the case of a renewal or extension of the lease, where the lease arrangement was reassessed, the accounting for the lease should be applied from the inception of the renewal or extension period.

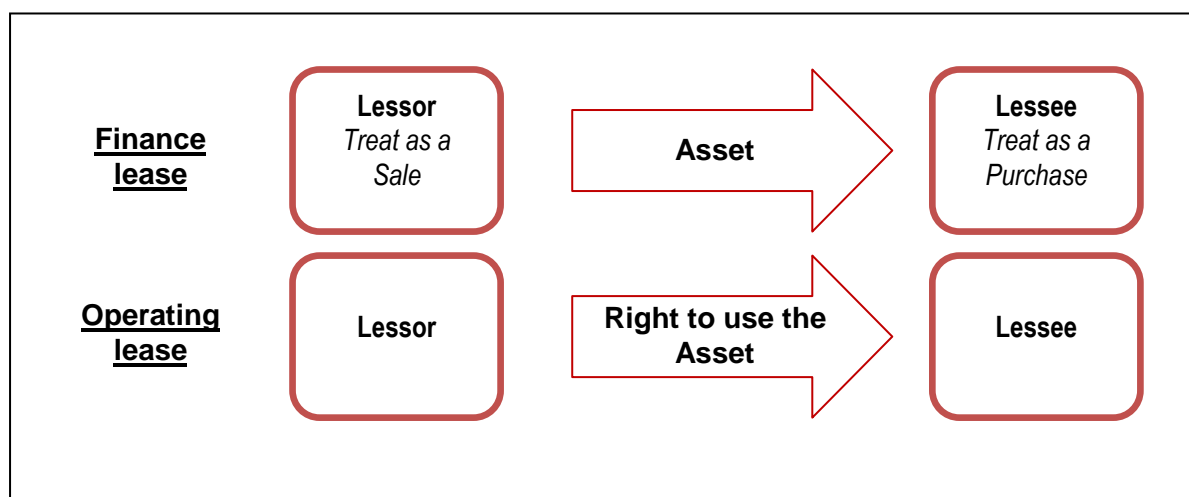
### 5.3 Risks and rewards of ownership


The classification of a lease does not depend on where the legal ownership of the leased asset lies, but rather on the extent to which the risks and rewards incidental to ownership of the asset have been transferred from the lessor to the lessee. If **substantially all of the risks and rewards** have been transferred to the lessee, it is a finance lease; otherwise it is an operating lease.

The risks and rewards that are considered to be incidental to ownership include (but are not limited to) the following:

Risks	Rewards
<ul style="list-style-type: none"> <li>Which party carries the risk of possible losses as a result of <b>idle capacity</b>, <b>technological obsolescence</b> and fluctuation of <b>asset value</b> as a result of change in economic conditions?</li> <li>Which party carries the risk of repairs and maintenance of the asset?</li> <li>Which party carries the risk of insurance cost / losses?</li> </ul>	<ul style="list-style-type: none"> <li>Deriving revenue or service potential from the use of the asset over its economic life;</li> <li>Profitable operation of an asset over its economic life; and</li> <li>Gain from the increase in value or the realisation of the residual value upon disposal.</li> </ul>

	<p>Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with legal form. Thus legal title of a leased asset may not necessary transfer to a lessee, but the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life, therefore such arrangement should be accounted for as a finance lease in accordance with the requirements of the MCS.</p>
---	---




	<p>These indicators are intended to assist as a guide in the decision-making process, but may not be conclusive. A department should therefore not follow the guidance blindly, but it is important that it considers the overall <b>substance of the lease agreement</b> for each of its leases. The classification should be based on an overall assessment of whether <b>substantially</b> all of the risks and rewards of ownership of the leased asset have been transferred to the lessee.</p>
---	--


## 5.4 Classification Indicators

A department should consider the terms of the agreement or contract and should classify the lease depending on the substance of the transaction rather than the form of the contract. This requires a department to carefully assess the classification of a lease.


The following are examples of situations that **will normally** result in a lease being classified as a finance lease:


	<p>These indicators are intended to assist as a guide in the decision-making process, but may not be conclusive. A department should therefore not follow the guidance blindly, but it is important that it considers the overall <b>substance of the lease agreement</b> for each of its leases. The classification should be based on an overall assessment of whether <b>substantially</b> all of the risks and rewards of ownership of the leased asset have been transferred to the lessee.</p>
---	--


- Ownership of the asset is transferred to the lessee when the lease term ends;
- The lessee has an option to purchase the asset at a price that is expected to be much lower than the fair value of the asset at the date the option becomes exercisable and at the time of entering the lease, it is expected that the lessee will exercise the option;

	<p>The exercise of the option is based on the expectation of the department. Therefore, if the department does not expect to exercise the option (for example, if the department has a policy of returning all leased assets at the end of the lease term, regardless of the price), this indicator will not be present - even if the price at the date that the option is expected to be exercised is significantly lower than the fair value.</p>
---	---


- The lease term is for a major part of the economic life of the asset even though title is not transferred;

	<p>The <b>lease term</b> is the <b>non-cancellable period</b> for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the <b>option to continue</b> 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.</p> <p>If the lease agreement contains a cancellation clause with no penalty to the lessee, the lease term will be from commencement date to the earliest date at which the cancellation clause is exercisable by the lessee.</p> <p>If the lease agreement contains a cancellation clause which states that the lessee will have 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 ignored in determining the lease term. This is because 100% of the lease payments will still be made.</p>
---	---


	<p><b>Difference between economic life and useful life</b></p> <p><b>Economic life</b> is either:</p> <ul style="list-style-type: none"> <li>• the period over which an asset is expected to be economically usable by one or more users; or</li> <li>• the number of production or similar units expected to be obtained from the asset by one or more users.</li> </ul> <p><b>Useful life</b> is either:</p> <ul style="list-style-type: none"> <li>• the period over which an asset is expected to be available for use by an department; or</li> <li>• the number of production or similar units expected to be obtained from the asset by a department.</li> </ul> <p>Economic life is therefore the total expected life of an asset and useful life is the expected life of the asset over which the department will use it. The useful life will therefore never be more than the economic life, but can be the same.</p>
---	--


	<p><b>Example: Classification of leases</b></p> <p>Department B leases a vehicle, with a total economic life of 5 years from Ecorental CC for a period of 4 years. 4 out of 5 years is a major part of the economic life of the vehicle, therefore the lease could be classified as a finance lease at the inception of the agreement.</p>
---	--




	<p>There is no clear cut threshold as to what will be considered to be 'a major part of the economic life of the asset', although approximately 75% is considered reasonable in terms of common practice.</p> <p>A department should follow its own process to determine the acceptable threshold that it will use in making the assessment. This threshold should be documented in its own operational policies. It should be noted, however, that this threshold should not represent an automatic cut-off point - a department should consider <b>all</b> relevant factors when assessing the classification of a lease to decide whether substantially all of the risks and rewards have been transferred.</p> <p>It should be noted that a department will need to determine the economic life and the useful life of the leased asset, in order to determine whether the asset qualifies as a finance lease or not.</p>
---	---

- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;

	<p>The minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and 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><b>Example: Calculating the present value of minimum lease payments due</b></p> <p>Department A entered into a lease agreement on 1 April 2010 to lease a machine for a period of three years. The monthly lease payment is R5,000 payable in arrears beginning 30 April 2010 and the rate implicit in the lease is 5%.</p> <p>The present value of the minimum lease payments will be calculated as follows:</p> <table border="1" data-bbox="467 1377 1058 1581"> <tr> <td>PMT</td><td>5,000</td></tr> <tr> <td>i</td><td>0.00416667% (5% / 12)</td></tr> <tr> <td>n</td><td>36 (3 x 12)</td></tr> <tr> <td>PV?</td><td>166,828</td></tr> </table> <div data-bbox="1074 1377 1391 1581" style="border: 1px solid red; border-radius: 10px; padding: 5px;"> <p>Note the lease is payable on a monthly basis, therefore the interest rate and period also needs to be monthly</p> </div> <p>This calculation can be done on a financial calculator or in MS Excel.</p>	PMT	5,000	i	0.00416667% (5% / 12)	n	36 (3 x 12)	PV?	166,828
PMT	5,000								
i	0.00416667% (5% / 12)								
n	36 (3 x 12)								
PV?	166,828								

	<p>There is no clear cut threshold to what amounts to 'at least substantially all of the fair value' of the asset when comparing this value to the present value of the minimum lease payments, although approximately 90% is considered reasonable in terms of common practice.</p> <p>A department should follow its own process to determine the acceptable threshold that it will use in making the assessment. This threshold should be documented in its own operational policies. It should be noted, however, that this threshold should not represent an automatic cut-off point - a department should consider <b>all</b> relevant factors when assessing the classification of a lease to decide whether substantially all of the risks and rewards have been transferred.</p> <p>It should be noted that an department will need to determine the present value of the minimum lease payments and the fair value of the leased asset, in order to determine whether the leased asset qualifies as a finance lease or not. If the fair value is not available, the asset will be accounted for at the present value of the minimum lease payments.</p>
---	---


- The leased asset is of such a specialised nature that only the lessee can use it without major modifications; or
- The leased asset is not easily replaceable by another asset.

The following are other indicators of situations that individually or in combination **could also** lead to a lease being classified as a finance lease (the **secondary** indicators listed in the MCS):

- If the lessee can cancel the lease, the lessee will carry any loss that will be incurred by the lessor as a result of the cancellation;
- Gains or losses due to changes in the fair value of the residual value are credited to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- At the end of the initial lease, the lessee has an option to extend the lease at a rent that is substantially lower than the market rent.

	<p><b>Example: Classification of leases</b></p> <p>Department B leases a vehicle, with a total economic life of 5 years, from Ecorental CC, for a period of 4 years. Department B has the option to continue with the lease for another year, without payment during this period. It is reasonably certain that Department B will exercise this option.</p> <p>There are two indicators that this lease agreement is a finance lease:</p> <ul style="list-style-type: none"> <li>• Department B has the ability to continue with lease for another year at a rent lower than market rent; and</li> <li>• The lease term will be five years in total, which is equivalent to the economic life of the vehicle.</li> </ul> <p>This lease will therefore be classified as a finance lease at the inception of the agreement</p>
---	--

For a lease to be classified as a finance lease it is not necessary to have all the above indicators present, it could be one or a combination of the above indicators.

	<p>It is important to note that the indicators mentioned under this section are not always conclusive. A lease can be classified as an operating lease even if one or more of these indicators are present, if it is clear from other factors that the risks and rewards of ownership are not transferred to the lessee.</p> <p>The deciding factor is the extent to which risks and rewards incidental to ownership of an asset lie with either the lessor or lessee.</p> <p>Generally, a finance lease is economically similar to a purchase of the underlying asset.</p>
---	---

### Example: Determining the classification of a lease

A department has entered into a 4 year rental agreement for a photocopier. In terms of the agreement, the department will have the right to use the photocopier for the rental period, there after the photocopier must be returned to the lessor.

The following are the main provisions of the agreement:

- The rental payment is R2,800 per month over a period of 48 months.
- The rental payments will fluctuate in accordance with changes in the prime lending rate.
- The department is responsible for the insurance of the asset, subject to conditions/restrictions imposed by the Treasury Regulations.
- The agreement states that ownership remains with the lessor, and at no time will ownership pass to the department.
- At the end of the lease term, the lease can continue on a month-to-month basis (based on the final rental amount), until notified by either party.
- If the department cancels the agreement during the term, it has to immediately pay all outstanding payments for the remainder of the rental period to the lessor.


If the department was to purchase the photocopier outright, a cash payment of R110,000 will be required. The rate implicit in the lease is 12%. The economic life of a photocopier is considered to be 5 years.


The department applies the indicators as listed above to the provisions in the lease agreement to determine whether it should be classified as an operating or a finance lease:

Standard example of situations that normally indicate finance leases	Application to rental agreement	Met (Y/N)
The lease transfers ownership of the asset to the lessee by the end of the lease term	No such provision in agreement	N
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 for it to be reasonably certain, at the inception of the lease, that the option will be exercised	No such provision in agreement	N

	The lease term is for the major part of the economic life of the asset even if title is not transferred	Lease contract is for 4 years and the economic life of the photocopier is 5 years $4/5 = 80\%$ This is considered to be a major part of the life of the asset	Y
	At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset  <div>Note the lease is payable on a monthly basis, therefore the interest rate and period also need to be monthly</div>	Using a financial calculator or MS Excel: $PV = (rate, nper, pmt)$ $PV = (12\%/12, 48, -2,800)$ $PV = 106,327$ Therefore the present value equals substantially all of the fair value of R110,000	Y
	The leased assets are of a such a specialised nature that only the lessee can use them without major modifications	The photocopier is not specialised and can be used by other entities	N
	The leased assets cannot easily be replaced by another asset	Photocopier can easily be replaced by another	N
	If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee	Department has to pay all outstanding rentals if it cancels the lease	Y
	Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease)	Not applicable to agreement	N
	The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent	Not applicable, as the department can continue renting the photocopier at the final rental amount	N
<p>It is not necessary that all criteria are met for an agreement to constitute a finance lease. If substantially all the risks and rewards of ownership have been transferred to the department, it should account for the agreement as a finance lease. The transfer of risks and rewards is demonstrated by the fact that the present value of the minimum lease payments equals substantially all of the fair value of the photocopier, that the lease is for the major part of the economic life of the asset and that the department is responsible for insuring the asset.</p> <p>The department should therefore classify the lease as a finance lease and account for it accordingly.</p> <p>The fact that the department can continue to lease the asset, after the lease period has expired, on a month-to-month basis, means that the department will have to reclassify the arrangement once the option has been exercised (i.e. at the end of the rental period), because as from then on the lease period cannot be calculated as there</p>			

	is no fixed rental period. Therefore lease classification changes from a finance lease to a month-to-month operating lease.
--	---

	<p>The interest <b>rate implicit in the lease</b> is the discount rate that, at the inception of the lease, causes the aggregate present value of:</p> <ul style="list-style-type: none"> <li>• the minimum lease payments; and</li> <li>• the unguaranteed residual value;</li> </ul> <p>to be equal to the sum of:</p> <ul style="list-style-type: none"> <li>• the fair value of the leased asset; and</li> <li>• any initial direct costs of the lessor.</li> </ul>
---	---

	<p>For SCOA classifications refer to the <b>Chapter on The Standard Chart of Accounts and Systems</b> and any related SCOA Classification Circular.</p>
--	---

## 5.5 Discussion on Specific Issues

### 5.5.1 Land and buildings

When a lease contains both a land and a building element, the two components should be assessed individually. Land usually has an indefinite economic life, which implies that the land will normally be classified as an operating lease. It is therefore possible that the rental of the building may be classified as a finance lease and the rental of the land as an operating lease.

On initial recognition, where the land and building is classified as an operating lease and a finance lease respectively, the lease payments should be allocated between the land and the building based on the fair values of each. If payments cannot be allocated, the entire lease is classified as finance lease, unless the lease contract is clearly an operating lease, e.g. where the building is leased for a significant shorter period than its economic life.

In instances where the lease payment amount that would be allocated to land is immaterial, both the land and building can be treated as a single asset for classification purposes and the economic life of the asset would be based on the economic life of the building.

Sound cash management includes avoiding prepayments for goods or services (i.e. payments in advance of the receipt of the goods or services), unless required by the contractual arrangements with the supplier. For example rental agreements may require rent to be payable monthly in advance. If a department makes monthly payments in advance, over a period of twelve months of the financial year there will be 12 payments made. Therefore in a modified cash environment departments are advised not to raise a prepayment where the amount prepaid is judged to immaterial. It is expected that should there be an increase in rent in March for the April rent, the increase will not be significant to result in a material misstatement.

In instances where in terms of the contractual arrangement the department is expected to pay for a period more than a month, for example pay two months in advance, then the department should consider materiality when raising a prepayment.

### 5.5.2 Leased vehicles

When a department leases vehicles from the relevant government garage, the lease is either classified as an operating or a finance lease. Careful consideration should be exercised in deciding whether the leases are operating or finance leases.



#### **Example: Lease of fleet vehicles from the provincial government garage (operating lease)**

A provincial department leases its fleet of vehicles from the provincial government garage. It pays the government garage a daily tariff and a kilometre tariff. The lease is classified as an operating lease.

The payment of the daily tariff (lease instalment) to the government garage will be accounted for as follows:

<i>Debit</i>	Operating lease
<i>Credit</i>	Bank account

NB: the allocation of the transaction in the infrastructure and asset segment is as follows:

**Infrastructure segment** :- “Non-infrastructure operating lease current”

**Asset segment** :- “Motor vehicle” (an account created under transport assets)

The kilometre tariff paid to the government garage will be accounted for as follows:

<i>Debit</i>	Fleet services : kilometres
<i>Credit</i>	Bank account

NB: the allocation of the transaction in the infrastructure and asset segment is as follows:

**Infrastructure segment** :- “Non-infrastructure (stand-alone) current”

**Asset segment** :- “Motor vehicle” (an account created under transport assets)



#### **Example: Lease of fleet vehicles from the provincial government garage (finance lease)**

A provincial department leases its fleet of vehicles from the provincial government garage. It pays the government garage a daily tariff and a kilometre tariff. The lease is classified as a finance lease.

The payment of the daily tariff (lease instalment) to the government garage will be accounted for as follows:

<i>Debit</i>	Finance lease – motor vehicles
<i>Credit</i>	Bank account

NB: the allocation of the transaction in the infrastructure and asset segment is as follows:

**Infrastructure segment** :- “Non-infrastructure finance lease capital”

**Asset segment** :- “Motor vehicle” (an account created under transport assets)

The kilometre tariff paid to the government garage will be accounted for as follows:	
<i>Debit</i>	Fleet services : kilometres
<i>Credit</i>	Bank account
NB: the allocation of the transaction in the infrastructure and asset segment is as follows:	
<i>Infrastructure segment</i> :- “Non-infrastructure (stand-alone) current”	
<i>Asset segment</i> :- “Motor vehicle” (an account created under transport assets)	

### 5.5.3 Cell phones and 3G modems

In practice, a cell phone (or 3G modem) contract usually results in the contract holder obtaining ownership of the phone and receiving the right to use the network for the duration of the contract.

The indicators of the transfer of risks and rewards which are **most** relevant to cell phone contracts are as follows:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

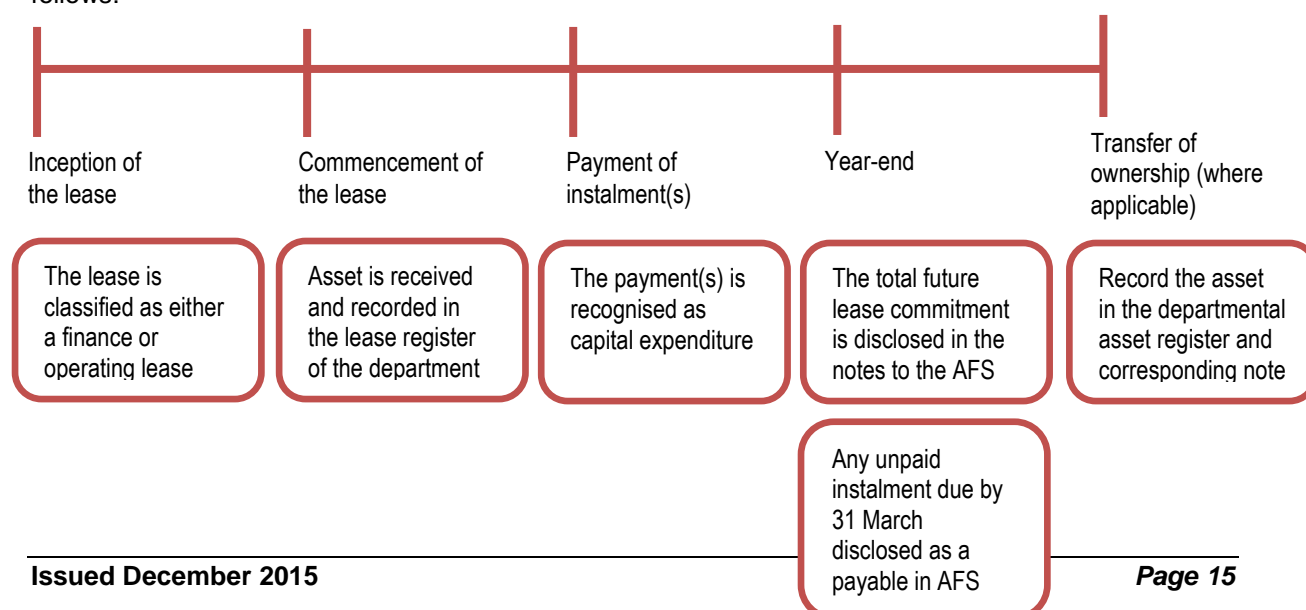
Due to the fact that cell phone contracts usually transfer ownership at the end of the contract and the phone usually only has a short economic life, these contracts will generally result in finance leases.

The specific terms of the agreements should however be considered when classifying these agreements. Also take into consideration the materiality concept, as discussed in the **Chapter on Financial Statement Presentation**, for the accounting and disclosure of cell phones and 3G modems contracts.

## 6 Recognition, Measurement and Recording

### 6.1 Finance lease in the financial statements of lessee

The events and transactions pertaining to the lease agreement are recognised and recorded as follows:



An amount owing at the end of the financial year such as the

If at the end of the lease term department takes ownership of the asset(s), it should measure the finance lease asset(s) acquired at:

- cost, being the fair value of the leased asset or; if lower,
- the sum of the minimum lease payments made, including any payments to be made to acquire ownership at the end of the lease term, excluding interest.

The present value of the future minimum lease payments is discounted at the interest rate implicit in the lease, which can usually be calculated from the information provided in the contract. If it is not possible to calculate the rate implicit in the lease, then the department can use a reasonable proxy rate such as the prime lending rate at inception of the lease.

The future minimum lease payments expected to be made should be recorded in the notes to the financial statements as secondary financial information in the following periods:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.



#### Example: Calculating the present value of minimum lease payments due

Department A entered into a lease agreement on 1 April 2010 to lease a machine for a period of 3 years. The monthly lease payment is R5,000 payable in arrears beginning 30 April 2010 and the rate implicit in the lease is 5%.

The present value of the minimum lease payments will be calculated as follows:

PMT	5,000
i	0.00416667% (5% / 12)
n	36 (3 x 12)
PV?	166,828

Note the lease is payable on a monthly basis, therefore the interest rate and period also need to be monthly

This calculation can be done on a financial calculator or in MS Excel.




#### Example: Calculating the “take-on value” of a leased asset


Department A entered into a lease agreement on 1 April 2010 to lease a machine for a period of 3 years. The monthly lease payment is R5,000 payable in arrears beginning 30 April 2010 and the rate implicit in the lease is 5%. The department will take ownership of the asset at the end of the lease term.

The present value of the minimum lease payments is R166,828 and the fair value of the asset on 31 March 2013 is R130,000.

The take-on value for the asset is thus R130,000.



	<p><b>Measurement of cell phone and 3G modem contracts</b></p> <p>In order to determine the value attributable to the handset / modem, the components of the transaction need to be identified and the consideration payable needs to be allocated to these components.</p> <p>The following is an example of components that may exist in a generic cell phone / 3G modem contract:</p> <ul style="list-style-type: none"> <li>• Sale of a cell phone / modem;</li> <li>• Finance cost relating to the sale of the cell phone / modem;</li> <li>• Use of the network; and</li> <li>• Free minutes / data bundles.</li> </ul> <p>The following methods can be used to allocate the consideration to the relevant components:</p> <ul style="list-style-type: none"> <li>• Relative fair values method; or</li> <li>• Residual value method.</li> </ul> <p>In terms of the <b>relative fair value method</b>, the total consideration is allocated to the different components based on the ratio of the fair values of the components relative to each other. In order to apply this method, the fair values of the components need to be ascertained.</p> <p>The <b>residual value method</b> requires the undelivered components (e.g., network access / free minutes) to be measured at fair value and the remainder is to be allocated to the delivered component (e.g., cell phone / modem).</p> <p>The best evidence of fair value is the price charged for an identical item sold on a standalone basis.</p>
---	---

	<p><b>Example: Initial measurement of cell phone contracts</b></p> <p>Department A signed a two year cell phone contract with Vodacom. The department pays R430 per month (excluding VAT) for 24 months and it gets 200 anytime minutes for free plus a Blackberry 9800 Torch. Should the contract be cancelled, Department A will be liable for all outstanding monthly payments.</p> <p>The phone becomes the property of Department A at the end of the contract. The cash price (at inception date of the contract) for a Blackberry 9800 Torch is R7,199. The prime lending rate at inception is 15% (this is the rate that Department A would have paid had it borrowed the money to buy the Blackberry 9800 Torch for R7,199).</p> <p><b>Step 1:</b> Determine if the contract is a finance or operating lease</p> <p>This contract is finance lease due to Department A carrying all the risk and rewards of ownership, this is demonstrated by:</p> <ul style="list-style-type: none"> <li>• The lease term is for the major part of the economic life of the asset (2 out of 2 years);</li> <li>• The present value of the minimum lease payments amounts to substantially all of the fair value (Present Value: R8,868 and Fair Value: R7,199);</li> <li>• Ownership is transferred to Department A at the end of the period;</li> </ul>
---	---

- Department A will carry all the cost involved in cancelling the contract;
- Department A will get all the rewards from using the cell phone; and
- Department A is responsible for paying insurance and thus carries all the risk should the phone be lost, stolen or breaks.

**Step 2:** Recognise the actual lease payments made by the department during the financial year as capital expenditure in the statement of financial performance in accordance with the **Chapter on Expenditure**.

**Step 3:** Record the lease commitments for the finance lease expenditure in the notes to the financial statements. This is the future minimum lease payments at financial year end, showing separately those payable:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.

**Step 4:** Determine the amount at which the cell phone would be recorded in the "capital asset" note to the financial statements:

*<only relevant when actual ownership transfers to the department>*

The MCS states that at the end of a lease term, the leased asset should be recorded at cost, being the fair value of the leased asset or, if lower, the present value of the minimum lease payments due.

The fair value is R7,199 (see above).

The present value of the minimum lease payments will be calculated as follows:

PMT	430
i	0.0125% (15% / 12)
n	24
PV?	8,868

The average rate per peak minute is R1. The present value of 200 minutes for 24 months will be calculated as follows:

PMT	200 (200 x 1)
i	0.0125% (15% / 12)
n	24
PV?	4,125

Using the fair value model, the present value of the phone is calculated as the difference between the total present value and the present value of the free minutes: R4,743 (R8,868 – R4,125).

**Step 5:** Record asset

The amount to be recorded for the cell phone in the asset register and the financial statements is R4,743. Once recorded in the asset register, the **Chapter on Capital Assets** is applied in accounting for the asset.

The initial direct costs that the lessee incurs to negotiate and arrange a lease should be added to the amount recognised as an asset.

Contingent rents expected, i.e. payments linked to a variable that is not known until payment is due, for example, rentals linked to an inflation index, rentals based on the sales the lessee achieves from the leased premises, and usage based rentals (such as leases of copier equipment in which the lease payments are fixed with an additional amount due for each copy made over a contractually specified number). As such, these portions of the lease payments are expensed in the period payment is made and excluded from the minimum lease payments.



### Example: Comprehensive example - finance lease (lessee)

Department A entered into a lease agreement on 1 April 20x0 to lease a machine for a period of three years. The **yearly** lease payment is R60,000 payable in arrears beginning 30 April 20x0 and the rate implicit in the lease is 5%. In addition, the department has to pay a contingent rent as an additional amount due for each copy made over a contractually specified number. Payments made by Department A over the three years were as follows:

	Fixed lease payment	Contingent rent
Year 1	R60 000	R1 240
Year 2	R60 000	R 960
Year 3	R60 000	R1 105

The fair value of the machine is R189,000 and the present value of the minimum lease payments due is R163,395 (pmt 60,000; i 5%; n 3).

**Step 1:** Recognise the actual lease payments made by the department during the financial year as capital expenditure in the statement of financial performance in accordance with the **Chapter on Expenditure**. I.e. in year 1, R60 000 is recognised as capital expenditure in the statement of financial performance.

Recognise the contingent rent as current expenditure in the period payment is made. i.e. R1 240, R960 and R1 105 are recognized in year 1, year 2 and year 3 respectively.

**Step 2:** Record the lease commitments for the finance lease expenditure in the notes to the financial statements. This is the future minimum lease payments at financial year end, showing separately those payable:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.

### Extract from Notes to the financial statements

Finance leases expenditure	Specialised military equipment	Land	Buildings and other fixed structures	Machinery and equipment	Total
20x1	R'000	R'000	R'000	R'000	R'000
Not later than 1 year	xx	xx	xx	60	xxx

Later than 1 year and not later than 5 years	xx	xx	xx	60	xxx
Later than 5 years	xx	xx	xx	Xxx	xxx
<b>Total lease commitments</b>	<b>xxx</b>	<b>xxx</b>	<b>xxx</b>	<b>120</b>	<b>xxx</b>

**At the end of the lease term**

**Step 3:** Determine the amount at which the asset would be recorded in the notes to the financial statements:

The MCS states that the leased asset should be recorded at cost, being the fair value of the leased asset or, if lower, the present value of the minimum lease payments (excluding interest) due.

The fair value is R189,000 (see above).

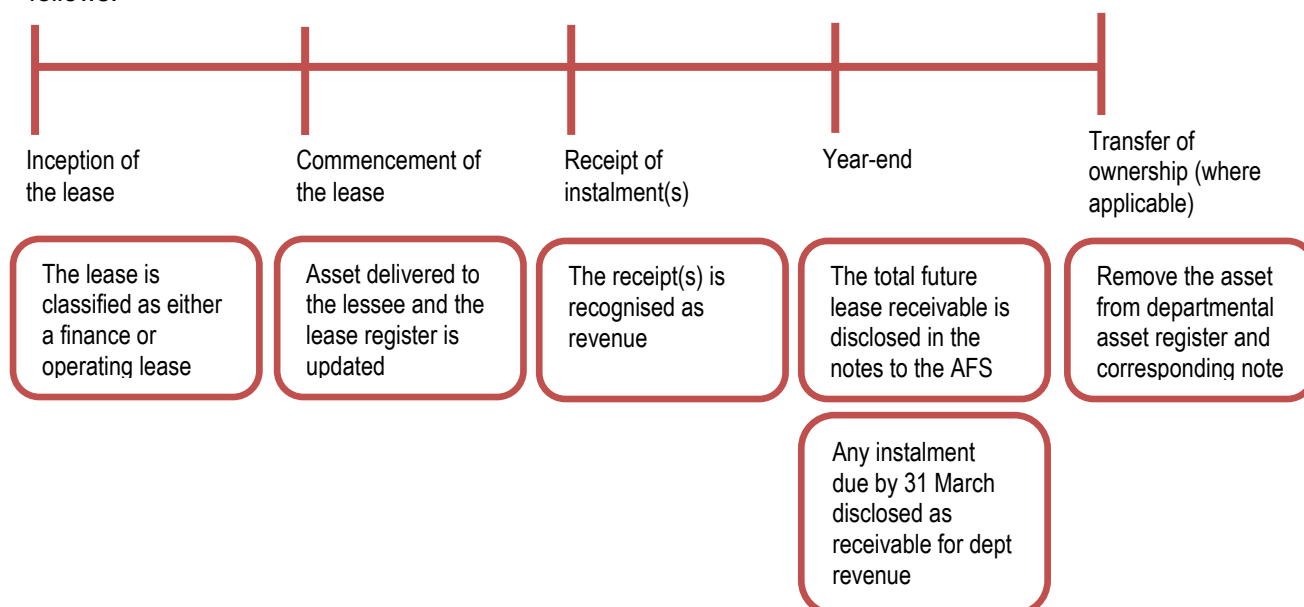
The present value of the minimum lease payments due is calculated as the sum of the minimum lease payments made, including any payments made to acquire ownership at the end of the lease term, excluding interest, which amounts to R163,395, as calculated above.

**Step 4:** Record asset

The amount to be recorded for the leased asset in the asset register and the financial statements is R163,395. Once recorded in the asset register, the **Chapter on Capital Assets** is applied in accounting for the asset.

## 6.2 Finance lease in the financial statements of lessor

The events and transactions pertaining to the lease agreement are recognised and recorded as follows:



Where the department leases out an asset it should continue to be accounted for in accordance with the **Chapter on Capital Assets**. If ownership of the leased asset is transferred to the lessee at the end of the lease term, the asset will be removed from the asset register on expiry of the lease.

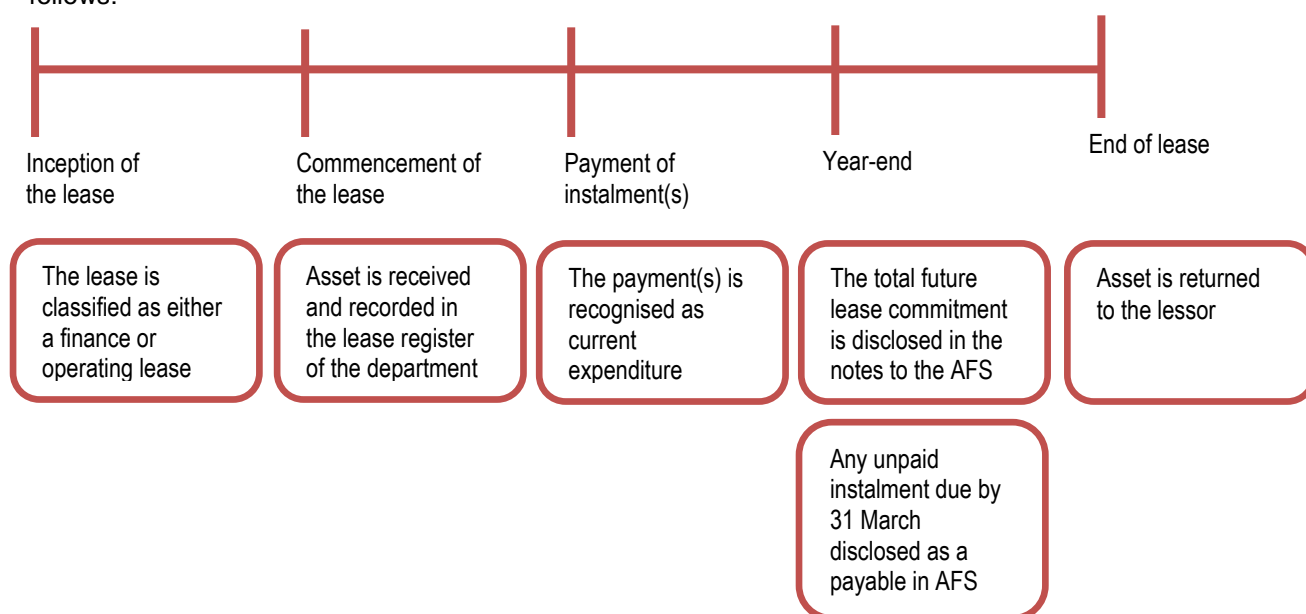
The actual lease payments received during the financial year should be recognised and measured as **revenue** in the statement of financial performance in accordance with the **Chapter on Revenue**.

The amount of lease revenue that is expected to be received should be recorded in the notes to the financial statements as secondary financial information in the following periods:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.

### 6.3 Operating lease in the financial statements of lessee

The events and transactions pertaining to the lease agreement are recognised and recorded as follows:



The lease payments under an operating lease should be recognised as **current expenditure** in the statement of financial performance in accordance with the **Chapter on Expenditure**.

The lease commitment for future operating lease expenditure should be recorded in the notes to the financial statements as secondary financial information. This is the future minimum lease payments at financial year end, showing separately those payable:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.



#### Example: Comprehensive example - operating lease (lessee)

Department Z entered into a lease agreement on 1 April 20x0 to lease equipment for a period of three years. The **monthly** lease payment is R2,000 payable in arrears beginning 30 April 20x0. In addition, the department has to pay a contingent rent as an additional amount due for each copy made over a contractually specified number.

Payments made by Department Z over the three years were as follows:

	Lease payment	Contingent rent	Total
Year 1	R24 000	R 240	R24 240
Year 2	R24 000	R270	R24 270
Year 3	R24 000	R110	R24 110

**Step 1:** Recognise the total lease payments made by the department during the financial year, including contingent rent, as current expenditure in the statement of financial performance in accordance with the **Chapter on Expenditure**. I.e. in year 1, R24 240 is recognised as current expenditure in the statement of financial performance.

**Step 2:** Record the lease commitments for the operating lease expenditure in the notes to the financial statements. This is the future minimum lease payments at financial year end, showing separately those payable:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.

**Extract from Notes to the financial statements**

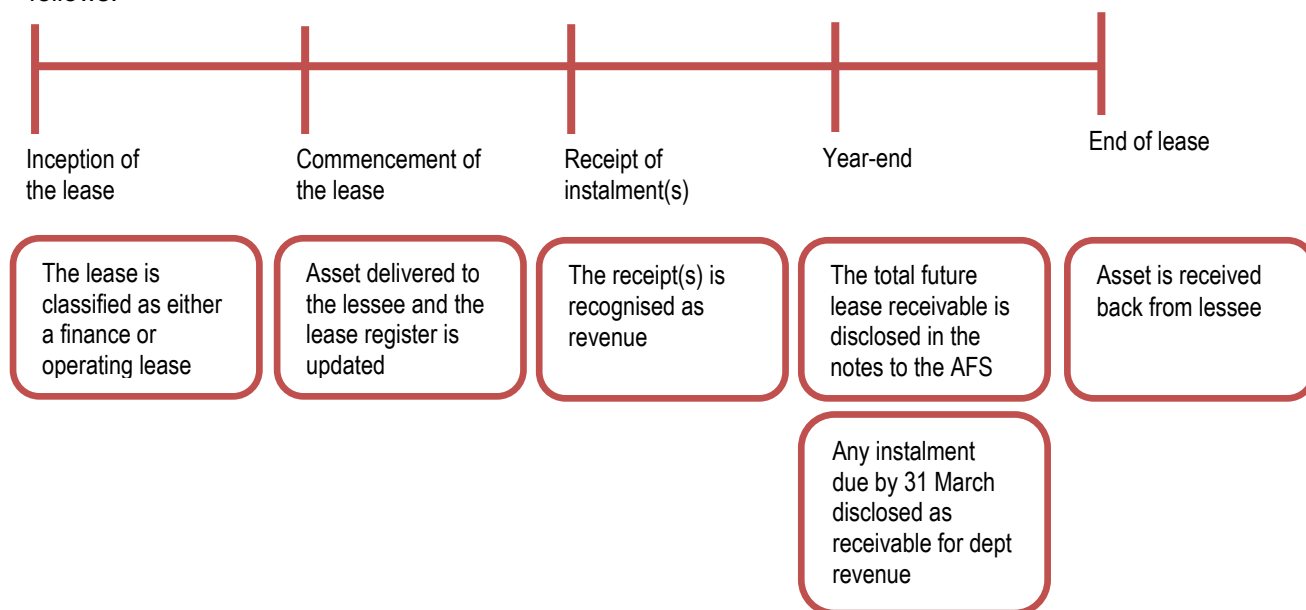
Finance leases expenditure	Specialised military equipment	Land	Buildings and other fixed structures	Machinery and equipment	Total
20x1	R'000	R'000	R'000	R'000	R'000
Not later than 1 year	xx	xx	xx	24	xxx
Later than 1 year and not later than 5 years	xx	xx	xx	24	xxx
Later than 5 years	xx	xx	xx	Xxx	xxx
<b>Total lease commitments</b>	<b>xxx</b>	<b>xxx</b>	<b>xxx</b>	<b>48</b>	<b>xxx</b>

**At the end of the lease term**

Unlike finance leases, operating lease asset will not be recorded as the capital asset of the department.

### Operating lease in the financial statements of lessor

The events and transactions pertaining to the lease agreement are recognised and recorded as follows:



Where the department leases out an asset; the underlying asset should continue to be accounted for in accordance with the **Chapter on Capital Assets**.

The actual lease payments received during the financial year should be recognised and measured as **revenue** in the statement of financial performance in accordance with the **Chapter on Revenue**.

The amount of lease revenue that is expected to be received should be recorded in the notes to the financial statements as secondary financial information in the following periods:

- not later than one year;
- later than one year and not later than five years; and
- later than five years.

## 7 Sale and Leaseback

Sometimes a department will enter into a transaction involving selling an asset and then the leasing back of the same asset from the purchaser - the department is then the lessee.

The opposite can also happen where the department acquires an asset and leases that same asset back to another party - the department is then the lessor. The sales price and lease payments are inter-linked as they are usually negotiated at the same time.


The table below shows how the lessee and lessor will account for a sale and leaseback transaction:

	Sales proceeds	Capital asset leased	Lease payments / receipts	Disclosure
Lessee	Recognised as revenue in accordance with the <b>Chapter on Revenue</b> .	Remove the asset from the asset register on the date of sale. Account for the asset	Recognise as capital expense in accordance with the <b>Chapter on</b>	The disclosure requirements for lessees apply equally to sale and leaseback

		at the end of the lease if ownership transfers back to the lessee.	<b>Expenditure.</b>	transactions. Where the department is given a reduction in the lease payments instead of actual cash from the sale of the asset, it should disclose this fact in the notes to the financial statements.
Lessor	Not applicable	Record and disclose the asset acquired in accordance with the <b>Chapter on Capital Assets</b> .  Remove the asset from the department's asset register if ownership of the leased asset is transferred to the lessee at the end of the lease term.	Account for the lease revenue in accordance with the <b>Chapter on Revenue</b> .	The disclosure requirements for lessors apply equally to sale and leaseback transactions.

## 8 Disclosure

Refer to the Specimen Annual Financial Statements for the illustrated disclosure requirements.

	<p>The MCS Chapter on Leases requires a department to furnish details of each lease agreement. There are instances where departments have numerous lease agreements. In such instances, the department can group the lease disclosure narrative according to the sub-categories of assets leased. For example, if a department has 100 photocopiers with escalation clauses ranging from 1% to 5% they may specify the escalation clause as follows:</p> <p><i>“The escalation clauses of the 100 photocopiers leased by the department range from 1% to 5%.”</i></p>
---	---



## 9 Summary of Key Principles

This chapter prescribes the criteria for distinguishing between operating and finance leases, and prescribes the disclosure requirements for leases from both the lessor's and the lessee's perspectives.

### 9.1 Identification

A lease is an agreement between two parties whereby the one party (the lessor) allows the other party (the lessee) to use its assets for an agreed period of time in return for a payment or series of payments.

A department has to assess whether an arrangement entered into with another party may constitute a lease or may contain in substance a lease element.

### 9.2 Classification

OPERATING LEASE		FINANCE LEASE
Definition	Lease other than a finance lease	Transfers substantially all the risks and rewards incidental to ownership

### 9.3 Recognition and measurement

OPERATING LEASE		FINANCE LEASE	
LESSEE	LESSOR	LESSEE	LESSOR
<ul style="list-style-type: none"> <li>Operating lease payments are recognised as <b>current expenditure</b> in accordance with the <i>Chapter on Expenditure</i>.</li> </ul>	<ul style="list-style-type: none"> <li>Operating lease receipts are recognised as <b>revenue</b> in accordance with the <i>Chapter on Revenue</i>.</li> </ul>	<ul style="list-style-type: none"> <li>Finance lease payments are recognised as <b>expenditure for capital assets</b> in accordance with the <i>Chapter on Expenditure</i>.</li> <li>All interest paid is allocated to the "finance lease" account, the separation of the interest portion was discontinued from 1 April 2012.</li> </ul>	<ul style="list-style-type: none"> <li>Finance lease receipts are recognised as <b>revenue</b> in accordance with the <i>Chapter on Revenue</i>.</li> </ul>

### 9.4 Recording and measurement

OPERATING LEASE		FINANCE LEASE	
LESSEE	LESSOR	LESSEE	LESSOR
<ul style="list-style-type: none"> <li>A lease asset is not recorded in respect of an operating lease, as the risks and rewards incidental to</li> </ul>	<ul style="list-style-type: none"> <li>The asset is continued to be accounted for in accordance with the <i>Chapter on Capital Assets</i>.</li> </ul>	<ul style="list-style-type: none"> <li>The leased asset is measured and recorded as an asset in the notes to the financial statements in</li> </ul>	<ul style="list-style-type: none"> <li>The asset is continued to be accounted for in accordance with the <i>Chapter on Capital Assets</i>.</li> </ul>

<p>ownership is not transferred to the lessee.</p> <ul style="list-style-type: none"> <li>• The lease commitment for future finance lease expenditure is recorded in the notes to the financial statements in accordance with this Chapter.</li> </ul>	<ul style="list-style-type: none"> <li>• If ownership of the leased asset transfers to the lessee at the end of the lease term, the asset is removed from the asset register on expiry of the lease.</li> <li>• The amount of lease revenue that is expected to be received is recorded in the notes to the financial statements in accordance with this Chapter.</li> </ul>	<p>accordance with this Chapter and the <b>Chapter on Capital Assets</b> at the end of the lease if ownership transfers to the lessee.</p> <ul style="list-style-type: none"> <li>• The lease commitment for future finance lease expenditure is recorded in the notes to the financial statements in accordance with this Chapter.</li> <li>• No need to disclose separately the interest portion.</li> <li>• However for a finance lease in a PPP the interest must still be shown separately in the notes to the financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>• If ownership of the leased asset transfers to the lessee at the end of the lease term, the asset is removed from the asset register on expiry of the lease.</li> <li>• The amount of lease revenue that is expected to be received is recorded in the notes to the financial statements in accordance with this Chapter.</li> </ul>
--	--	--	--