Financial Accounting Standards Board

International Accounting Standards Board

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INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**24 April 2007, London**
Project:	**Leases**
Subject:	**Scope (IASB Agenda paper 16, FASB Memo #6)**

Purpose of this memo

1. The purpose of this memo is to consider the scope of the leases project. This memo sets out two possible approaches to the project scope and discusses the advantages and disadvantages of each approach. This memo focuses on the high level issues that may be considered in deciding on the scope, but does not give a detailed analysis of which specific issues might be within the project scope.

2. In its initial project plan, the staff indicated it would first explore different accounting models, then focus on one model for a simple lease, and then consider how that accounting model could be applied to arrangements that seem similar to leases. However, in evaluating the rights and obligations in a simple lease, many questions were raised that indicated that it may be useful at the beginning stages

of the project to solicit Board member feedback on what the scope of the project should be.

3. Appendix 1 to this memo describes the scope of current lease standards and includes excerpts from: IAS 17, *Leases*, FASB Statement No. 13, *Accounting for Leases,* IFRIC Interpretation 4, *Determining whether an Arrangement contains a Lease,* and EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease".

Alternatives

4. This memo considers whether the scope of the leases project should be limited to the scope of current lease standards; that is, limit the scope of the project to the current scope of Statement 13 and IAS 17, including those arrangements that are brought into the current scope by Issue 01-8 and IFRIC 4 (see Appendix 1).

5. Alternatively, this memo considers whether the scope of the leases project should include all right-to-use arrangements (for example, licensing of certain intangible assets, which are currently outside the current scope of Statement 13 and IAS 17).

6. This memo does not discuss whether to limit the scope of the project to lessee accounting as the Boards have already decided that they will consider both lessee and lessor accounting. This memo also does not consider whether to exclude short-term or immaterial leases as that determination will inherently be part of any scope approach approved by the Boards.

7. The staff recommends phasing the leases project and limiting the scope of the first phase. Additionally, the staff recommends that the initial due process document be limited to the first phase of the project. Once that initial due process document is issued and constituent comments have been received, a decision can be made on whether to proceed toward a standard at that time.

Analysis

Scope of current lease standards

8. Appendix 1 describes the scopes of Statement 13, IAS 17, Issue 01-8, and IFRIC 4. Issue 01-8 and IFRIC 4 expand the scopes of Statement 13 and IAS 17 by including 'in-substance' lease arrangements (for example, arrangements that convey to the lessee the effective right to control the use of the underlying property, plant, and equipment [PPE] when the lessee operates or directs others to operate the PPE and the lessee takes more than a minor amount of the output from the use of the item). Statement 13 defines a *lease* as conveying the right to use PPE, whereas IAS 17 defines a *lease* as the right to use 'an asset'. To the extent that the IAS 17 definition is interpreted to include within its scope items other than PPE, such as intangible assets, more transactions would be subject to IAS 17 lease accounting than would be subject to Statement 13. However, the staff's understanding is that in practice, IAS 17 is rarely used for items other than PPE and, therefore, the current scopes of Statement 13 and IAS 17 are generally applied in a similar manner.

9. This alternative would include arrangements covered under the guidance in SIC Interpretation 27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. An entity may enter into a transaction or a series of structured transactions (an arrangement) with an unrelated party or parties (an investor) that involves the legal form of a lease. For example, an entity may lease assets to an investor and lease the same assets back, or alternatively, legally sell assets and lease the same assets back. The form of each arrangement and its terms and conditions can vary significantly. In the lease and leaseback example, it may be that the arrangement is designed to achieve a tax advantage for the investor that is shared with the entity in the form of a fee, and not to convey the right to use an asset. SIC 27 provides guidance when an arrangement takes the legal form of a lease but does not contain a right to use an asset and addresses (a) how to determine whether a series of transactions is linked and should be accounted for as one transaction, (b) whether the arrangement meets the definition of a lease under IAS 17, and (c) how that arrangement should be accounted for.

10. An advantage of this limited-scope alternative is that practice is already familiar with this scope and, therefore, this alternative may be easier to understand and implement for constituents. This alternative would capture substantially all contracts that are considered leases under current guidance including those 'in-substance' lease arrangements covered under Issue 01-8 and IFRIC 4. Therefore, determining the specific arrangements that would be included in the scope of this project would not be as difficult as a scope that includes all right-to-use arrangements (recognizing that the scopes of Statement 13 and IAS 17 are written differently and will need to be considered as the project converges those two scopes).

11. A disadvantage of this alternative is that it does not address the fundamental question of what a lease contract is and how it differs from other contracts.

12. Another consideration, under either alternative, is the potential impact of a change in lease accounting guidance on investment property now covered by IAS 40, *Investment Property*. IAS 40 relies on the distinction in IAS 17 between finance leases and operating leases to determine whether property meets the definition of investment property, and only property that is leased out under an operating lease meets the definition of investment property. The staff note that under a right-of-use model, IAS 40 would have to be amended to eliminate the distinction between operating leases and finance leases. Therefore, as a result of this project, the scope of IAS 40 will be need to be reconsidered.

All right-to-use arrangements

13. A scope that includes all right-to-use arrangements would result in a fundamental reconsideration of how to account for all contracts that provide a right to use. An advantage of this alternative is that it would ensure that contracts with similar characteristics would be accounted for consistently. This alternative would help define the distinction between such things as executory contracts, service contracts, maintenance contracts, and 'lease contracts' as defined in current lease accounting literature.

14. The main disadvantage of this alternative is that it may take a substantial amount of time and effort to develop. Some constituents have expressed concerns that

entities are not recognizing a substantial amount of lease obligations that meet the definition of liabilities under both the IASB's *Framework for the Preparation and Presentation of Financial Statements* and FASB Concepts Statement No. 6, *Elements of Financial Statements*. These constituents may prefer that the issue with the accounting for leases, as currently defined, be addressed initially; accounting for other right-to-use contracts, which could take a significant amount of additional time and effort, would be addressed at a later stage. The following is an illustrative list of additional questions that would need to be considered and resolved if this alternative is adopted (note that the list is not meant to be all-inclusive).

a. What is the difference between a service contract and a lease?

b. What is the difference between an executory contract and a lease?

c. Is the lease of a pro-rata share of an asset in the scope of this project (for example, a fractional use of an airplane)?

d. Is a lease for a non-consecutive time period (for example, lease an asset every Wednesday for the next five years) in the scope of this project?

e. How should a lease be defined; for example, by availability of the leased item or by the output that the leased item provides?

f. Does the scope include leases of intangible assets such as royalty arrangements, mineral rights, or software? If so, how would a right-of-use model apply to these types of arrangements?

Staff recommendation

15. The staff thinks that all arrangements that provide one party the right to use an item of another party should be accounted for similarly. However, the staff is concerned that the scope of the leases project could become so broad that it may take significantly longer than originally anticipated to complete and that timely guidance will not be provided to address constituent concerns about the current accounting for leases. Therefore, the staff recommends that the project be phased so that the first phase would have a limited scope and subsequent phases could address the more broad issue of accounting for all right-to-use arrangements.

16. The staff recommends that the first phase of the project limit the scope to that of the current lease standards. This approach would accomplish the initial objective

of the project. That initial objective is to comprehensively reconsider the guidance in Statement 13 and IAS 17, together with their subsequent amendments and interpretations to ensure that investors and other users of financial statements are provided with useful, transparent, and complete information about leasing arrangements in the financial statements.

17. Therefore, the staff recommend that the initial due process document address only the first phase of the leases project; that is, the scope of the initial due process document be limited to the scope in current accounting standards. The staff consider that the first phase can address the most significant issues and concerns of constituents without the need to resolve every potential question or issue that may arise if the scope extends to all right-to-use arrangements. In addition, by limiting the scope of the first phase of the project, the staff thinks the project will move more quickly; attempting to address all right-to-use arrangements will require a detailed analysis of a significant number of arrangements, consideration of what aspects of these are economically similar or different, and application and extension of the basic model to these arrangements. After the initial due process document has been issued and constituent comments have been received, the decision can then be made as to whether a standard should be issued based on the limited scope, or whether the scope should be reconsidered at that time. The initial due process document could include a specific question for constituents to consider regarding the scope of a standard.

Question for Board members

18. Which approach do you prefer for the scope of the leases project and why?

APPENDIX 1—SCOPE IN CURRENT STANDARDS

IAS 17

Definition of lease

1. The term *lease* is used to cover a wide range of arrangements between contracting parties. IAS 17 defines a lease as "…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."

Scope

2. Paragraphs 2 and 3 of IAS 17 state the following:

> This Standard shall be applied in accounting for all leases other than:
>
> (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and
>
> (b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
>
> However, this Standard shall not be applied as the basis of measurement for:
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> (a) property held by lessees that is accounted for as investment property (*see IAS 40* Investment Property);
>
> (b) investment property provided by lessors under operating leases (*see IAS 40*);
>
> (c) biological assets held by lessees under finance leases (*see IAS 41* Agriculture); or
>
> (d) biological assets provided by lessors under operating leases (*see IAS 41*).
>
> This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Statement 13

3. Statement 13 defines leasing in terms of the scope of the document and provides the following definition of a lease in paragraph 1:

> …an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel. This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. This Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights. [Footnote reference omitted.]

IFRIC 4

4. IFRIC 4 provides guidance for determining whether an arrangement is, or contains, a lease that should be accounted for in accordance with IAS 17. IFRIC 4 states that that determination should be made based on the "substance of the arrangement" and requires an assessment of whether (a) fulfillment of the arrangement is dependent on the use of a specific asset or assets and (b) the arrangement conveys a right to use the asset.

5. For example, in determining whether fulfillment of the arrangement is dependent on the use of a specific asset, if a supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfillment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease. However, a warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly does not preclude lease treatment.

6. An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. IFRIC 4 also provides guidance for (a) assessing or reassessing whether an arrangement is, or contains, a lease, (b) separating payments for the lease from other payments, and (c) examples of arrangements that contain (and do not contain) a lease.

Issue 01-8

7. Issue 01-8 provides guidance for the evaluation of whether an arrangement contains a lease within the scope of Statement 13 and, similar to IFRIC 4, states that the evaluation should be based on the substance of the arrangement. Issue 01-8 provides guidance for determining the substance of the arrangement. The model in Issue 01-8 for determining whether an arrangement contains a lease is based on whether:

    a. The arrangement involves the use of property, plant, or equipment

    b. The property, plant, or equipment in the arrangement is either explicitly or implicitly identified

    c. The arrangement conveys to the purchaser/lessee the "right to use" the specified property, plant, or equipment.

8. As with IFRIC 4, Issue 01-8 also contains guidance for (a) assessing and reassessing the arrangement, (b) accounting for multiple element arrangements that contain a lease, and (c) provides examples to illustrate the application of that Issue.