Project **Leases**

Topic **In-substance purchases/sales**

Objective

1. Some board members have expressed concerns about the treatment of leases that are in-substance purchases/sales of the leased item. They have asked the staff to carry out additional analysis to determine the following:
   - (a) whether leases that are in-substance purchases/sales should be excluded from the scope of a new lease accounting standard
   - (b) whether there should be different accounting for leases that are in-substance purchases/sales.
2. This paper has the following sections:
   - (a) identification of the item that is purchased/sold
   - (b) a discussion of what is meant by the phrase in-substance purchase/sale
   - (c) an explanation of why it matters whether an in-substance purchase/sale is included or excluded from the scope of the new leases standard
   - (d) recommendations and questions.
3. In this paper the staff recommend the following:
   - (a) Lease contracts that are purchases/sales of the leased item should be excluded from the scope of the new leases standard.
   - (b) When determining whether a lease transaction is in effect a purchase/sale of the leased item, the reporting entity should consider

applicable revenue recognition standards to determine whether a purchase/sale has taken place.

4. The final section of this paper discusses whether some transactions that have sales-type features but are not in fact sales should be accounted for differently within the leases standard.

5. The appendix to this paper summarises some of the feedback received from constituents on these issues.

The nature of the item that is purchased/sold

6. When discussing in-substance purchases/sales, it is important to identify what is being purchased/sold. In a normal lease contract the lessee obtains control of a right-of-use asset. It does not obtain control of the underlying leased item. For example, in a five-year lease of a machine, the lessee obtains control of the right to use the machine for 5 years. It does not obtain control of the machine itself.

7. However in a purchase/sale transaction the lessee presumably obtains control of the underlying leased item (that is the machine in the above example).

What are in-substance purchases/sales?

8. The staff think that any new leases standard should set out the accounting requirements for transactions where an entity obtains a right to use an item. Transactions where an entity obtains the leased item itself should be accounted for as a purchase/sale of the leased item.

9. Consequently, the staff recommend identifying those transactions that are purchases/sales of the leased item. The staff think that the phrase in-substance purchase/sale in this context is potentially misleading. What we are trying to do is identify those transactions that are called leases but are actually purchases/sales of the leased item.

10. There are two ways in which transactions that are purchases/sales could be identified:

    (a) Cross refer to applicable revenue recognition standards to determine whether a transaction qualifies for revenue recognition. If revenue would be recognised on transfer of the leased item to the customer, it would be accounted for as a purchase/sale of the leased item rather than as a lease.

    (b) Define within the leases standard those transactions that should be accounted for as purchases/sales of the leased item rather than leases.

Cross refer to applicable revenue recognition standards

11. The main advantage of cross referring to applicable revenue recognition standards is that it avoids the need to develop new rules for leases. It ensures that revenue is recognised consistently with other economically similar transactions that are legally structured as purchase/sales rather than leases.

12. Current thinking in the revenue recognition project would suggest that revenue should be recognised when control of a good or service is transferred from the seller to the buyer. Applying this to the leases project would suggest that a purchase/sale exists when a lessor transfers control of the leased item to the lessee.

13. The staff note that a final standard on revenue recognition is due at about the same time as a final standard on leases. It is possible (although unlikely) that the leases standard could be finalised before the revenue recognition standard is completed. Consequently, cross referring to applicable standards could mean cross referring to existing revenue recognition guidance. Existing revenue recognition standards are not converged so it is possible that different transactions would be accounted for as purchases/sales under US GAAP and IFRS. Thus, the boards may not find this approach attractive if a new converged revenue recognition standard has not been finalised. However, the staff note

under this approach convergence would eventually be achieved when the new standard on revenue recognition is issued.

Define those transactions that should be accounted for as purchases or sales within the leases standard

14. Applying revenue recognition standards to lease contracts may not be straight-forward. Therefore, the boards may wish to define within the leases standard those transactions that should be accounted for as purchases or sales. For example, the boards may wish to treat some leases that include purchase options as a sale of the underlying leased item. However, without additional guidance, a contract of this type could be viewed as the sale of two things: a right-of-use asset and a purchase option.

15. In addition the boards may wish to define those contracts that should be excluded from the scope of the leases standard more widely than would be suggested by the control-based approach in the revenue recognition standard. For example, some board members may want to exclude leases that are for a major part of the economic life of the asset or leases of specialised equipment.

16. If the boards want to adopt this approach, the staff will develop detailed criteria to identify those contracts that should be outside the scope. For example, the boards could decide to exclude from the new standard:

    (a) Only those leases where title transfers automatically

    (b) Leases where title is expected to transfer (e.g. on exercise of a bargain purchase option)

    (c) Leases where substantially all the risks and rewards of ownership transfer (i.e. the existing finance lease/operating lease distinction).

17. The staff note that any attempt to define those leases to be excluded from the scope of the leases standard would inevitably introduce complexity into a new standard. If the criteria for excluding a transaction from the scope of the standard were different from the revenue recognition criteria, similar

transactions could be accounted for differently leading to structuring opportunities.

Implications of including or excluding in-substance purchases/sales from the scope of the new leases standard

18. The implications of excluding or including in-substance purchases/sales from the scope of the new leases standard are discussed below.

Lessees

19. If an in-substance purchase transaction is excluded from the scope of the leases standard, the transaction would be treated by the lessee as a purchase and a financing of the leased item. That is, the lessee would recognise the leased item and an obligation to pay for that item.

20. If an in-substance purchase is included in the scope of the leases standard the accounting would be as follows (assuming the boards reconfirm their tentative decisions):

    (a) The obligation to pay rentals will initially be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate. This measurement is a reasonable approximation to the fair value of the obligation to pay rentals.

    (b) The obligation to pay rentals will be measured subsequently on an amortised cost basis.

    (c) The right-of-use asset will initially be measured at cost.

    (d) The right-of-use asset will be measured subsequently on an amortised cost basis and will be amortised over the shorter of the lease term and the economic life of the leased item. For leases of items in which it is expected the lessee will obtain title at the end of the lease term, the right-of-use asset will be amortised over the economic life of the leased item (the same period as for a purchased asset).

21. Consequently, the accounting proposed in the leases discussion paper (DP) for a lessee should result in accounting that is similar to that required for assets that are purchased. During discussions before publication of the DP, the boards noted that attempting to define what is meant by an in-substance purchase may be difficult. As a result, the boards tentatively decided to include in-substance purchases in the scope of a new lessee accounting standard.

22. It should be noted that in-substance purchases are included in the existing lease guidance. For example, the lease of an item where title automatically transfers to the lessee at the end of the lease term is included in the scope of IAS 17 and Statement 13.

23. Although the accounting proposed in the leases DP is similar to purchase accounting, it is not identical. For example:

Area	**Lease accounting**	**Purchase accounting**
Acquisition costs	Acquisition costs would be excluded from the initial measurement of the right-of-use asset.	Acquisition costs may be included in the initial measurement of the recognised asset.
Liability	Subsequent measurement of the liability will be on an amortised cost basis only.	It may be possible to elect to fair value the liability.
Options	Payments during optional periods may be included in the obligation to pay rentals.	Optional payments would be excluded from the liability.
Presentation	The right-of-use asset will be presented separately but adjacent to similar assets that are owned.	The asset would be presented as PP&E or as an intangible depending on its nature.

24. These differences could result in economically similar transactions being accounted for differently, which could reduce comparability for users of financial statements.

Lessors

25. If an in-substance sale is outside the scope of a new lessor accounting standard, the transaction would be accounted for as an ordinary sales transaction (the seller would derecognise the asset and recognise revenue in accordance with applicable revenue recognition standards).

26. Including in-substance sales within the scope of a new lessor standard could result in very different accounting depending on which accounting model the boards adopt for lessors (the derecognition approach or the performance obligation approach).

The derecognition approach

27. Under the derecognition approach, the lessor is viewed as having transferred a portion of the leased item to the lessee in exchange for a right to receive payments over the lease term. Consequently, under this approach the lessor:

    (a) recognises a right to receive rental payments

    (b) derecognises a portion of the leased item

    (c) has an asset for its residual rights in the leased item at the end of the lease term

    (d) may recognise revenue at the start of the lease.

28. Under this approach, the accounting for an in-substance sale transaction that is within the scope of the leases standard would be similar to the accounting for an in substance sale transaction that is outside the scope of the leases standard. That is, in both cases the lessor would derecognise the leased item and recognise revenue at the start of the lease.

The performance obligation approach

29. Under the performance obligation approach, the lessor is viewed as having granted the lessee the right to use its economic resource (the leased item) in exchange for a right to receive rentals from the lessee. The lessor does not lose

control of the leased item and thus continues to recognise the whole of the leased item. However, the lessor is committed to allowing the lessee to use the leased item over the lease term. Consequently, under this approach the lessor:

(a) recognises a receivable for its right to receive payments under the lease contract

(b) recognises a performance obligation

(c) does not recognise any revenue at the start of the lease

(d) does not derecognise any of the leased item.

30. Thus, if the performance obligation approach to lessor accounting is adopted, including in-substance sales within the scope of the new lessor accounting standard could result in economically similar transactions being accounted for differently. For example, the required accounting for a lease that transfers title of the leased item to the lessee upon payment of the final rental would very different from the accounting required for a sale of the same item where payment is deferred[1].

Recommendations and questions

31. The staff think that lease contracts that are purchases/sales of the underlying leased item should be accounted for consistently with other purchases/sales. Consequently, the staff recommend that lease contracts that are purchases/sales of the leased item should be excluded from the scope of the leases standard.

Question 1
The staff recommend that lease contracts that are purchases/sales should be excluded from the scope of the new leases standard. Do the boards agree?

[1] It is possible that there may not even be a difference in when title to the asset transfers. In a sales transaction the seller could retain title to the asset until the final payment is made.

32. The staff think that any attempt to define within the leases standard those transactions that are purchases/sales:

    (a) Will increase the complexity of the new standard

    (b) Could result in economically similar transactions being accounted for differently

    (c) Could lead to inconsistencies with a new revenue recognition standard.

33. Thus, the staff recommend that the leases standard require entities to refer to applicable revenue recognition standards to determine whether revenue should be recognised and hence whether a purchase/sale has occurred.

34. The staff acknowledge that it is possible that the guidance in a new revenue recognition standard may not be sufficient to determine when control of the leased item has passed to the lessee. In which case we may need to reconsider this issue. However, the staff think that any guidance should try to apply the principles in the revenue recognition standards to a lease rather than developing new boundaries.

Question 2
The staff recommend that the leases standard require entities to refer to applicable revenue recognition standards to determine whether revenue should be recognised and hence whether a purchase/sale has occurred. Do the boards agree? If you disagree please indicate how you would define those contracts that should be excluded from the scope of the leases standard

Different treatments for transactions that are not purchases/sales

35. The boards could decide that some transactions that have purchase/sale features but are not in fact purchases/sales should be accounted for differently within the leases standard. For example, the boards could decide to do the following:

(a) Require linked subsequent measurement of the right-of-use asset and the obligation to pay rentals for transactions that are not in-substance purchases/sales (the linked approach).

(b) Present assets acquired in some leases differently (for example, present them as owned rather than as leased assets).

(c) Present depreciation of the right-of-use asset differently (for example, as rental expense).

(d) Require additional disclosures to allow users to differentiate between leases that are similar to outright purchases and those that are not.

36. The staff also note that, in developing the lessor accounting model, it may be necessary to require different treatments for some transactions that have purchase/sales features. For example, the boards may permit derecognition of the leased item or revenue recognition in some situations.

37. Each of these issues will be discussed in more detail at future meetings. However, the staff note that requiring different accounting within the leases standard for transactions that have purchase/sales features would:

(a) Increase the complexity of the new standard because those transactions that would be accounted for differently would need to be defined.

(b) Provide opportunities to structure transactions to achieve a particular result

(c) Reduce comparability as similar leases could be accounted for differently.

38. Consequently, (with the possible exceptions of lessor accounting and disclosures) the staff is unlikely to recommend developing different accounting models within the leases standard for transactions that have purchase/sale features but are not in fact purchases/sales.

39. At this meeting we would like board members to indicate:

(a) When you might require different accounting models within the leases standard for transactions that have purchase/sale features but are not in fact purchases/sales

(b) How you would define those leases that should be accounted for differently.

Question 3
The staff would like board members to indicate: (a) If there are situations when you would require different accounting models within the leases standard for transactions that have purchase/sale features but are not in fact purchases/sales (b) How you would define those leases that should be accounted for differently.

Appendix – Feedback from constituents

A1. Feedback on the issue of in-substance purchases and sales has been received both from respondents to the discussion paper and members of the leases working group.

Feedback from respondents to the discussion paper

A2. The discussion paper did not include a specific question on the subject of in-substance purchases/sales. However, a number of respondents commented on the issue.

A3. Some respondents noted that leases that transfer title to the lessee do not give rise to a right-of-use; instead they result in a purchase/sale of the underlying leased item. Consequently, they would exclude such leases from the scope of the leases standard.

A4. Other respondents think that in-substance purchases/sales should be included in the scope of the leases standard. They note that the accounting required under the proposed approach would be similar to the accounting required for an outright purchase and that any attempt to differentiate between an in-substance purchase/sale and other transactions would increase complexity.

A5. Some respondents support retaining the existing accounting requirements for leases. They think that finance (capital) leases are in substance purchases/sales and that they should be accounted for as a purchase/sale of the underlying leased item. They view all other leases as executory contracts that do not give rise to assets and liabilities. Consequently, these respondents support retaining the requirement to classify leases as finance leases or operating leases although some would modify the existing classification requirements to make classification more principles-based.

A6. Some respondents (particularly those in the leasing industry) think that the subsequent measurement of the right-of-use asset and the obligation to pay rentals should be linked for leases that are *not* in-substance purchases/sales (the linked approach). In-substance purchases/sale should be accounted for as a purchase/sale of the underlying leased item.

A7. Some respondents think that the derecognition approach to lessor accounting should be applied to leases that are in-substance purchases/sales of the leased item. The performance obligation approach to lessor accounting would be applied to all other leases.

Feedback from working group members

A8. The issue of in-substance purchases/sales was discussed at the September 2009 working group meeting. The following comments were made at the working group meeting:

(a) Attempting to distinguish between in-substance purchases and other leases would reintroduce a classification requirement which would increase the complexity of the proposals.

(b) Distinguishing between in-substance purchases and other leases is more important for lessor accounting. The real concern is when the transaction gives rise to revenue.

(c) Some working group members reiterated their support for a linked approach to subsequent measurement of leases that are not in-substance purchases/sales.

(d) Some working group members stated that a legal or tax analysis of lease contracts should be carried out to help differentiate between in-substance purchases/sales.

A9. After the working group meeting, the staff circulated a questionnaire to working group members. It included the following three questions:

(a) Should in-substance purchases/sales be within the scope of the leases project?

(b) Should the boards attempt to define in-substance purchases/sales? If so, how?

(c) Should in-substance purchases/sales have different accounting treatment from other right-of-use leases?

A10. Most working group members who responded to the questionnaire think that in-substance purchases/sales should be within the scope of the leases standard. Some noted that the accounting proposed in the discussion papers for lessees would result in similar accounting whether an in-substance purchase was inside or outside the scope of the leases standard.

A11. One working group members thinks that only those transactions that are sales of the underlying leased item (that is, transactions where title to the leased item passes to the lessee) should be outside the scope of the leases standard.

A12. Working group members were split on whether in-substance purchases should be defined. Some think that defining in-substance purchases is an unnecessary complication. Many of these respondents note that requiring different accounting for leases that are in-substance purchases could cause similar problems to the existing standards

A13. Other working group members think that the accounting for leases that are in-substance purchases should be different from the accounting for other leases. Consequently, they support defining in-substance purchases. Some think that the distinction is important for lessor accounting only whilst others (particularly those who support the linked approach to subsequent measurement) think the distinction is important for both lessees and lessors.

A14. Some working group members would define in-substance purchases as those leases that transfer title of the leased item to the lessee. Others would expand the definition to include those leases where the lessee obtains substantially all the risks and rewards of the leased item. Some suggest a control-based approach to defining those leases.