Project **Leases**

Topic **Scope – Purchase or sale of the underlying asset**

Background and purpose of paper

1. At their October 2009 joint meeting, the boards tentatively decided to exclude contracts that represent the purchase or sale of the underlying asset from the scope of the proposed new leases requirements.

2. At a subsequent meeting in January 2010, the boards tentatively decided that:

   (a) Transactions that transfer control of the underlying asset are, in fact, purchases or sales of the underlying asset, and should be excluded from the scope of the proposed new requirements for leases.

   (b) The proposed new requirements for leases should provide indicators to help reporting entities determine whether control of the underlying asset has been transferred/obtained.

   (c) Management of the entity would exercise judgement and consider all relevant facts and circumstances when determining whether control of the underlying asset has been transferred/obtained.

3. The boards also tentatively decided that control of the underlying asset has generally been transferred/obtained when:

   (a) The contract automatically transfers title of the underlying asset

   (b) The contracts include a bargain purchase option. An option would only be considered a bargain purchase option if at the start of the contract, it is reasonably certain the option will be exercised (for example, £1 options).

4. The boards instructed the staff to provide additional analysis on the definition of control, how control would be assessed, and other possible indicators of control in the context of a lease contract.

5. Rather than providing additional analysis of the control definition, this paper recommends a different approach. We recommend replacing the control definition and indicators of control with an overall principle and explanatory paragraphs.

6. It should be noted that the accounting proposed for lessees is very similar (but not identical) to purchase accounting. However, the accounting proposed for lessors is very different to sales accounting. Consequently, this is a much more significant issue for lessors than for lessees. Agenda paper 10B/42 from October 2009 summarises these accounting differences.

7. Throughout this paper, the staff have assumed that assessment of whether a transaction is a purchase or sale of the underlying asset will be made on signing of the contract and will not be subsequently reassessed (unless the terms of the contract change).

Proposed approach

8. At the January 2010 joint meeting, the staff proposed the following definition of control:

> Control of an underlying asset is an entity's present ability to direct the use of and receive the benefit from that underlying asset.

9. This definition is consistent with the definition of control used in the revenue recognition project. However, board members expressed the following concerns about this definition:

   (a) A lessee may not have a *present* ability to control the underlying asset. For example, in a contract that includes a bargain purchase option, it can be argued that the lessee does not control the underlying asset until the purchase option is exercised.

(b) The definition makes no reference to who receives benefits from the underlying asset after the end of the contract (that is, who has an interest in the residual).

(c) The definition refers only to benefits, and ignores any exposure to risks (either during the contract term or after the end of the contract) that either party may have.

10. Consequently, the boards asked the staff to provide additional analysis on this definition of control.

11. However, the staff are concerned that developing a different definition of control from the one used in the revenue recognition project would be confusing for constituents.

12. Consequently, we are not recommending a different definition of control. Instead, we think the new leases requirements should state the following principle:

> Contracts that are purchases or sales of the underlying asset are not lease contracts and should not be accounted for in accordance with these requirements.

13. This principle should be expanded using the following explanatory paragraphs:

> A **seller/lessor** shall not apply these requirements to contracts that will transfer all [significant] benefits associated with the underlying asset after the end of the contract. This is because contracts of this type are sales of the underlying asset.
>
> A **buyer/lessee** shall not apply these requirements to contracts under which the buyer/lessee will obtain all [significant] benefits associated with the underlying asset after the end of the contract. This is because contracts of this type are purchases of the underlying asset.

14. In addition, the new requirements should provide examples of transactions that would generally be considered to be purchases or sales of the underlying asset.

15. The following sections discuss the explanatory paragraphs and examples in more detail.

How this approach addresses the boards' concerns

16. This approach emphasises that this issue is a question of scope rather than a question about who controls the underlying asset. The basic idea is that sales and purchases are not leases and should not be accounted for as such. This is stated in the overall principle.

17. The explanatory paragraphs address the following concerns raised by board members:

    (a) They remove the reference to a present ability to control the benefits associated with the underlying asset. Instead, the explanatory paragraphs refer to who will obtain the benefits associated with the underlying asset. This helps clarify that contracts where title to the underlying asset will pass to the buyer/lessee at some point in the future may be purchases or sales of the underlying asset.

    (b) They explicitly refer to the interest in the leased asset after the end of the contract (the residual).

Should the explanatory paragraphs refer to 'risks'?

18. The proposed explanatory paragraphs refer only to the benefits associated with the underlying asset. They do not refer to risks. This is consistent with the boards' definitions of an asset. It is also consistent with the current thinking about control in the revenue recognition, consolidation and derecognition projects.

19. The staff note that an entity could have sold an asset but still be exposed to risks associated with the underlying asset after the end of the contract. For example:

    (a) the seller/lessor could retain an obligation to ensure that the asset is disposed of in an environmentally-friendly way at the end of its life (as is the case with many outright sales of electrical goods within the EU). However, this represents a separate liability of the seller/lessor and does not necessarily indicate that the seller/lessor has not sold the underlying asset. The staff note that this would normally be treated as a separate performance obligation under the proposed approach to revenue recognition.

(b) the seller/lessor could provide a warranty that the asset continues to operate for a period of time. This also represents a separate liability of the seller/lessor and does not necessarily indicate that the lessor has not sold the underlying asset. The staff note that this warranty obligation would also normally be treated as a separate performance obligation under the proposed approach to revenue recognition.

20. The staff note that a residual guarantee provided by the buyer/lessee to the seller/lessor exposes the seller/lessee to the risks associated with the underlying asset at the end of the contract. However, in this situation the lessor will still have retained all of the benefits associated with the underlying asset after the end of the contract. Consequently, the existence of a residual value guarantee does not necessarily mean that the underlying asset has been purchased/sold (whether or not the explanatory paragraphs refer to risks).

Should the explanatory paragraphs refer to 'significant' benefits?

21. Some staff think that if the benefits associated with the underlying asset are not significant at the end of the contract, then who obtains them is not relevant to determining whether the asset has been purchased or sold. Consequently, they propose that the explanatory paragraphs include reference to 'significant'. For example, if the term of a lease contract will cover the expected useful life of an asset (and the scrap value of the asset is not expected to be significant), the seller/lessor will have transferred all significant benefits associated with the underlying asset after the end of the contract. This would be reflected in the

price charged by the seller/lessor, which is likely to be similar to the price charged for an outright sale of the asset.

22. Staff who support including ‘significant’ in the explanatory paragraphs do not advocate including a definition of what was meant by ‘significant’. Instead what is or (is not) considered significant would be left to the judgment of preparers.

23. However other staff think that if the seller/lessor has not transferred all of the benefits associated with the underlying asset after the end of the contract, it has not have sold the underlying asset. Similarly, if the buyer/lessee does not obtain all the benefits associated with the underlying asset, it will not have purchased the underlying asset. In addition they note that:

    (a) The phrase ‘significant’ is subjective and will be open to interpretation, thereby reducing consistency.

    (b) Including the phrase ‘significant’ could create structuring opportunities for reporting entities.

    (c) Including the phrase ‘significant’ would make the explanatory paragraphs difficult to apply.

24. Some staff think that if the explanatory paragraphs do not include reference to ‘significant’ benefits, then who is expected to obtain title to the underlying asset after the end of the contract will become the most important factor in determining whether the underlying asset has been sold/purchased. Other staff disagree and note that all relevant facts and circumstances would need to be considered.

Questions for the boards

25. The staff recommend that the new leases requirements should include the following principle:

> Contracts that are purchases or sales of the underlying asset are not lease contracts and should not be accounted for in accordance with these requirements.

26. In addition, the staff recommend that this principle should be expanded using the following explanatory paragraphs:

> A **seller/lessor** shall not apply these requirements to contracts that will transfer all [significant] benefits associated with the underlying asset after the end of the contract. This is because contracts of this type are sales of the underlying asset.
>
> A **buyer/lessee** shall not apply these requirements to contracts under which the buyer/lessee will obtain all [significant] benefits associated with the underlying asset after the end of the contract. This is because contracts of this type are purchases of the underlying asset.

Question 1
Do the boards support this approach? If you do not support this approach what alternative approach would you recommend and why?

Question 2
The staff do **not** think that the explanatory paragraphs should include reference to **risks** as well as benefits? Do the boards agree? Why or why not?

Question 3
Should the explanatory paragraphs include reference to **significant** benefits? Why or why not?

Examples of transactions that would generally be considered to be purchases or sales of the underlying asset

27. The Appendix to this paper analyses some transactions in light of the proposed principle and explanatory paragraphs. The staff note these examples are not the only situations in which the underlying asset will have been purchased or sold. The new leases requirements should emphasise this point.

28. In summary, the staff recommend that the proposed exposure draft on leases include the following examples of transactions that would generally be considered to be purchases or sales on the underlying asset:

Explanatory paragraphs do not refer to *significant* benefits	**Explanatory paragraphs refer to *significant* benefits**
• Contracts that automatically transfer title. • Contracts that include a bargain purchase option. An option would only be considered a bargain if, at the start of the contract, it is reasonably certain the option will be exercised. • Contracts where the return the lessor receives is fixed (that is, contracts where the return the lessor receives is a lender's return).	• Contracts that automatically transfers title. • Contracts that includes a bargain purchase option. An option would only be considered a bargain if, at the start of the contract, it is reasonably certain the option will be exercised. • Contracts where the return that the lessor receives is fixed (that is, contracts where the return the lessor receives is a lender's return). • Contracts that cover the whole of the expected useful life of the asset. • Contracts that are expected to cover the whole of the useful life of the asset because of options to renew at a bargain price. An option would only be considered a bargain if at the start of the contract, it is reasonably certain the option will be exercised.

29. The staff note that the first two indicators in both columns could be replaced by a single indicator, namely:

> Contracts where it is reasonably certain at the start of the contract that title to the underlying asset will transfer.

30. Similarly, the final two indicators in the second column could be replaced by:

> Contracts where it is reasonably certain at the start of the contract that the contract will cover the expected useful life of the asset.

Questions for the boards

Question 4
Do you support the proposed examples described in paragraph 28? If not what examples would you recommend and why?

Question 5
Would you support simplifying the indicators as described in paragraphs 29 and 30?

Long-term leases of land

31. In some jurisdictions it is common for land to be provided by lessors to lessees under very long leases (eg 99 years, 125 years, 999 years). Lessees in arrangements of this type are in an economically similar position to entities that have purchased the land out-right. Indeed the price paid by the lessee will usually be similar to the price paid for an out-right purchase (and will often be paid up-front). Similarly, lessors are in a similar position to entities who have sold the land.

32. However, in contracts of this type the lessor retains the benefits associated with the underlying asset after the end of the contract and although the present value of those benefits may not be significant, they may be significant at the end of the contract. Consequently, it could be argued that the lessor has not sold the land (even if ‘significant’ is included in the proposed explanatory paragraphs).

33. This is unlikely to be an issue for lessees – they will recognise a right-of-use asset and an obligation to pay rentals (if they have not fully prepaid the lease). However, if transactions of this type are not treated as sales the lessor will retain the leased land in their financial statements and recognise a performance obligation that will be released to income over the term of the contract (99 years, 125 years or even 999 years).

34. Those staff who think that the explanatory paragraphs should include reference to **significant** benefits also think that in very long leases of land, the lessor has in effect sold the land and the financial statements should reflect this. Those staff think that (as long as the explanatory paragraphs include reference to **significant)** the new leases requirements should simply clarify that some long-term leases of land, are purchases/sales of the land. Consequently, they should not be accounted for in accordance with the requirements for leases.

35. Other staff think that long term leases of land are not sales/purchases of the underlying land because they do not transfer all the benefits associated with the land. However, they think that in some cases it would be inappropriate to account for very long term leases of land under the new leases requirements. Consequently, they would recommend a scope exclusion for very long leases of land (eg 50 years or more). If the boards support this approach, we will bring to a future meeting proposals regarding what constitutes a very long lease.

Question 6
Do the boards think that very long leases of land should be accounted for as purchases/sales of the underlying land? Why or why not? If you think that very long leases of land should be accounted for as purchases/sales of the underlying land, how should this be achieved: (a) Clarification within the standard that some very long leases of land are sales of the underlying land (this will only work if the explanatory paragraphs refer to **significant** benefits) (b) A specific scope exclusion for long term leases of land with a term of greater the a specified number of years

(c) Some other approach?

Appendix – Examples of transactions that would generally be considered to be purchases or sales of the underlying asset

A1. This appendix analyses a number of transactions using the proposed principle and explanatory paragraphs in this paper.

Indicator	**Definitions do not refer to *significant* benefits**	**Definitions refer to *significant* benefits**	**Comments**
	Contract is a purchase/sale?	**Contract is a purchase/sale?**	
Contract automatically transfers title.	Yes	Yes	Buyer/lessee will obtain all benefits associated with the underlying asset after the end of the contract because they will obtain title to the underlying asset. Seller/lessor is expected to transfer all benefits associated with the underlying asset after the end of the contract, because title will transfer to the buyer/lessee.
Contract includes a bargain purchase option: an option would only be considered a bargain if, at the start of the contract, it was reasonably certain to be exercised.	Yes	Yes	Buyer/lessee will obtain all benefits associated with the underlying asset after the end of the contract, because it is reasonably certain to obtain title to the underlying asset. Seller/lessor will transfer all benefits associated with the underlying asset after the end of the contract, because title is reasonably certain to transfer to the buyer/lessee.

Indicator	**Definitions do not refer to *significant* benefits**	**Definitions refer to *significant* benefits**	**Comments**
	Contract is a purchase/sale?	**Contract is a purchase/sale?**	
Contract includes a non-bargain purchase option	No	No	The buyer/lessee may not obtain all [significant] benefits associated with the underlying asset after the end of the contract because it is not reasonably certain they will obtain title to the underlying asset. The seller/lessor may not transfer all [significant] benefits associated with the underlying asset after the end of the contract, because it is not reasonably certain that title will transfer to the buyer/lessee.
Contracts that cover the whole of the expected useful life of the asset	No	Yes	If a contract covers the whole of the expected useful life of the underlying asset, it is unlikely that there will be any *significant* benefits associated with the underlying asset after the end of the contract (unless the scrap value of the asset is significant). However, benefits may still exist.

Indicator	**Definitions do not refer to *significant* benefits**	**Definitions refer to *significant* benefits**	**Comments**
	Contract is a purchase/sale?	**Contract is a purchase/sale?**	
Contracts that are expected to cover the whole of the useful life of the asset because of options to renew at a bargain price Contract includes a bargain purchase option: an option would only be considered a bargain if, at the start of the contract, it was reasonably certain to be exercised.	No	Yes	If a contract is expected to cover the whole of the expected useful life of the underlying asset, it is unlikely that there will be any *significant* benefits associated with the underlying asset after the end of the contract (unless the scrap value of the asset is significant). However, benefits may still exist.

Indicator	Definitions do not refer to *significant* benefits	Definitions refer to *significant* benefits	Comments
	Contract is a purchase/sale?	**Contract is a purchase/sale?**	
The contract payments equal or are expected to equal the fair value of the underlying asset.	No	No	This will not always indicate that the seller/lessor has transferred all [significant] benefits. In some leases, the lessee may be willing to pay in excess of the fair value of the underlying asset because leasing is more convenient (eg some short-term equipment leases).
The underlying asset is a specialised asset (ie it can only be used by the current lessee).	No	No	This will not always indicate that the seller/lessor has transferred all [significant] benefits. If the underlying asset is specialised, it is likely that the lessor and lessee will look to protect their positions by including purchase options or options to extend the lease. If these are not present (or they are not bargain options), the lessee may not in fact have purchased the underlying asset.
The lessee provides the lessor with a residual value guarantee.	No	No	The seller/lessor has limited its exposure to falls in value of the underlying asset, but has retained the benefits associated with the asset at the end of the contract. The buyer/lessee is exposed to falls in value of the underlying asset, but has not obtained the benefits associated with the asset at the end of the contract.