Project **Leases**

Topic **Definition of a lease**

Introduction and purpose of this paper

1. This paper discusses the staff's proposed definition of a lease, which is:

   A lease is a contract in which the lessor conveys the right to use a specified asset, usually for a stated period of time, in return for a payment.

2. This paper does not deal with how separate contracts are linked with, or considered part of, a single arrangement or vice versa. That will be discussed at a later meeting.

3. IASB Agenda paper 2A/FASB Memorandum 64 illustrates the proposed definition of a lease for different scenarios.

Structure of the paper

4. This paper is structured as follows:

   (a) Background information that comprises:

      (i) the boards' preliminary views, together with comments from respondents; and

      (ii) a brief explanation on the definition of a lease and guidance in existing literature.

   (b) Staff analyses and recommendations on the common and different themes or elements of the boards' existing definitions of a lease:

(i) Is a lease only for property, plant and equipment?

(ii) A lease is a type of agreement (or contract as proposed in this paper).

(iii) A lease conveys the right to use a specified asset.

(iv) Is a lease only for an agreed period of time?

(v) Is payment a necessary element in the definition of a lease?

Background

Boards' preliminary views and comments from respondents

5. The boards did not reach preliminary views on a converged definition of a lease. However, the boards' preliminary view in the Leases Discussion Paper (DP) *Leases: Preliminary Views* is that the scope of the proposed new leases requirements should be based on the scope of the current leases requirements.

6. The boards also agreed that the proposed new leases requirements would incorporate the requirements of US Accounting Standards Codification (ASC) Section 840-10-15 (formerly EITF Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease*) and IFRIC 4 *Determining whether an Arrangement contains a Lease*.

7. A number of respondents to the DP noted that in the light of the proposed new leases model, in which there will be a single model to account for leases, it is important that the proposed new leases requirements should make the distinction between a lease and a service contract. This is because a service recipient would normally treat a service contract as an executory contract, while a lessee recognises the assets and liabilities from a lease contract. This tension is not so acute under existing requirements because, while an entity is required to split between a lease and a service contract, in practice most of the lease contracts that are affected are now currently classified as operating leases. In an operating

lease, a lessee only recognises rental expense over the lease term, which is similar to how a service contract is accounted for.

8. These respondents also requested that the boards should clarify and improve IFRIC 4 and ASC section 840-10-15, because they have found some of the words used not to be helpful. (The staff analysis will discuss this issue further.)

9. Other respondents also added that that unless the boundary between a lease contract and a contract for services is better defined, opportunities to obtain off-balance-sheet financing will remain because entities will attempt to structure leases as contracts for services.

What is in existing literature?

10. Under current requirements, leases are defined as follows:

> A lease 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. (IAS 17 *Leases* paragraph 4)
>
> A lease is an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. (FASB ASC Master Glossary, former FAS 13 *Leases* paragraph 1)

11. These definitions have also been interpreted by the boards in IFRIC 4 and ASC Section 840-10-15.

12. IFRIC 4 and paragraphs 840-10-15-6 and 840-10-15-10 state that there are two factors to consider to determine whether an arrangement is, or contains, a lease:

    (a) The fulfilment of the arrangement is dependent on the use of a specified asset (or assets) [property, plant and equipment under existing US GAAP].

    (b) The arrangement conveys to the purchaser (the lessee) the right to use the underlying asset.

Staff Analyses and Recommendations

13. Both the IASB's and the FASB's definitions have the following common themes:

    (a) A lease is an agreement.

    (b) The lessor conveys the right to use an asset.

14. Both definitions also have some differences:

    (a) The IASB's definition is broader because it applies to the right to use all assets (which includes intangible assets) while the FASB's definition focuses on the right to use property, plant and equipment.

    (b) The IASB's definition states that the lessee has to pay the lessor for the right to use an asset but the FASB's definition does not explicitly state that.

    (c) The IASB's definition states that a lease is for an agreed period of time but the FASB's definition states that a lease is *usually* for a stated period of time.

15. The following paragraphs analyse the common themes and the differences in the definition of a lease in more detail.

Is a lease only for property, plant and equipment?

16. The FASB's definition of a lease is limited to leases of property, plant and equipment.

17. The IASB's definition of a lease is broader because it is not limited only to property, plant and equipment.

18. In December 2009, the boards tentatively decided that the proposed new leases requirements should exclude leases of intangible and biological assets. Consequently, the boards tentatively decided that the scope of the proposed new leases requirements would be limited to property, plant and equipment.

19. There are two ways to deal with this issue:

    (a) define a lease as one that is limited to property, plant and equipment; or

    (b) define a lease broadly to encompass other assets, but to specify the scope of the proposed new leases requirements so as to exclude other types of leases with the result that the proposed new leases requirements would be limited to property, plant and equipment.

20. We recommend that the definition of a lease should not be limited to property, plant and equipment, because it acknowledges the existence of other types of leases. Moreover, for IASB constituents, having a broad definition would assist preparers who want to apply the principles in the leases requirements to other types of leases not within the scope of the proposed new leases requirements.

Recommendation and Question 1
We recommend that the definition of a lease should not be limited to property, plant and equipment. Do the boards agree?

A lease is a type of agreement

21. Both the IASB and the FASB definitions of a lease state that a lease is a type of agreement.

22. Dictionary meanings of a lease state that a lease is a type of contract.

> A lease is a contract by which one conveys real estate, equipment, or facilities for a specified term and for a specified rent … (http://www.merriam-webster.com/dictionary/lease)

> A lease is a contract by which one party conveys land, property, services, etc. to another for a specified time, in return for payment. (http://www.askoxford.com/concise_oed/lease?view=uk)

23. However, we prefer using the term *contract* instead of *agreement*. Our reasons are:

    (a) it is consistent with the terminology used in the revenue recognition and insurance projects. Both of those projects explain that a contract is not only limited to a written contract or legal form, which is what the term *agreement* is currently trying to convey in the existing definitions of a lease. If the boards agree with the staff proposals, the basis for conclusions should explain that practice should not be different because the term *contract* is intended to mean the same as the term *agreement* as it is currently used.

    (b) it is consistent with how a lease is defined in English dictionaries.

    (c) it is more precise. The English dictionary defines agreement to also include 'accordance in opinion or feeling[1]' and 'consistency or conformity between two things' and we do not think that a lease incorporates those meanings.

Recommendation and Question 2
We recommend that a lease is defined as a type of contract. Do the boards agree?

[1] http://www.askoxford.com/concise_oed/agreement?view=uk and http://www.merriam-webster.com/dictionary/agreement

A lease conveys the right to use a specified asset

24. The definitions of a lease in both US GAAP and IFRSs state that an agreement (contract) is a lease when the right to use an asset (property, plant and equipment under US GAAP) is conveyed. We think that this is the essential factor that distinguishes a lease from other types of contracts.

25. However, the concept of the 'right to use an asset' is still quite broad and thus not useful in some circumstances. For example, how does one differentiate between a) an arranged chauffeured car from home to the office and b) renting a car to get to the office? Some may consider the former to be a type of service contract and the latter to be a type of a lease contract. Others may view both of those transactions as service contracts. What are the criteria to differentiate between a service contract and a lease contract?

26. As noted earlier, ASC section 840-10-15 and IFRIC 4 provide additional guidance on when a contract contains a lease, and they both attempt to answer the question above.

27. IFRIC 4 and paragraphs 840-10-15-6 and 840-10-15-10 state that there are two factors to determine when a lessor conveys the right to use an asset (or when an arrangement contains a lease):

    (a) The fulfilment of the contract is dependent on the use of a specified asset (or assets) [property, plant and equipment under existing US GAAP].

    (b) The arrangement conveys to the purchaser (the lessee) the right to control of the use of the underlying asset.

28. The following paragraphs discuss whether and/or how the guidance above should be adopted in the proposed new leases requirements.

Does the right to use an asset have to be for a specified asset or assets?

29. IFRIC 4 and ASC section 840-10-15 state that one of the factors to determine whether a contract contains a lease is that fulfilling the contract is dependent on

a specified asset. In the proposed new leases model, that specified asset would be the underlying asset.

30. Identifying the underlying asset could be explicit or implicit.

> The identification of property, plant, or equipment in the arrangement need not be explicit; it may be implicit. Property, plant, or equipment has been implicitly specified if, for example, the owner-seller owns or leases only one asset with which to fulfill its obligation to the purchaser and it is not economically feasible or practicable for the owner-seller to perform its obligation through the use of alternative property, plant, or equipment. (paragraph 840-10-15-5)

This guidance is also similar in paragraph 8 of IFRIC 4.

31. Paragraph 7 of IFRIC 4 also states:

> If the 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. 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 a lease treatment.

This guidance is also contained in paragraphs 840-10-15-11 to 840-10-15-13.

32. Under the guidance above, an arrangement is a lease if the lessee has contracted to use a specified underlying asset, which would also be the case if the lessor provided a faulty asset and is obliged to replace the underlying asset (ie warranty clauses). An arrangement would not be considered a lease in situations in which the lessor is free to provide goods or services with another similar asset that is not specified in the arrangement.

33. We also suggest clarifying that a 'specified asset' occurs in situations in which a lessor can substitute the underlying asset but in practice rarely does or in which it is quite difficult for the lessor to substitute the underlying asset. For example, it may not be practical to substitute another asset when leasing a building if the lessee has made extensive changes to the underlying asset (the building) to suit the company's image and brand.

34. In regard to the phrase in italics from paragraphs IFRIC 4.8 or 840-10-15-5:

> Property, plant, or equipment has been implicitly specified if, for example, *the owner-seller owns or leases only one asset* with which to fulfill its obligation to the purchaser and it is not economically feasible or practicable for the owner-seller to perform its obligation through the use of alternative property, plant, or equipment. [emphasis added]

We have found that this could sometimes create problems in practice. Sometimes it may be obvious when the lessor only has one underlying asset to lease, eg a steelworks company leasing electricity from a power plant that is next to it. In other cases, it may not be so obvious. For example, a lessee has hired a company to clean its office. That cleaning company may only have one vacuum cleaner when it provides cleaning services, but that does not necessarily mean that the cleaning arrangement is a lease. The phrase 'the owner-seller owns or leases only one asset' is useful, but it needs to be clarified that just because a lessor has one asset, that does not necessarily mean that the asset is implicitly specified.

Staff recommendation

35. We recommend that the definition of a lease should state that a lessor conveys the right to use a specified asset. That retains what is in existing guidance: that there is a lease because the contract depends on the lessee acquiring a specified asset (or assets) to use for the duration of the agreement.

Recommendation and Question 3
We recommend that for a lease to exist, the lessor must convey the right to use a specified asset. Do you agree?

When does a lease convey the right to use the underlying asset?

36. The second factor to determine whether an arrangement (contract) contains a lease is if the arrangement (contract) conveys to the lessee the right to use the underlying asset.

37. The current converged guidance in ASC Topic 840 and IFRIC 4 states that an arrangement conveys the right to use the underlying asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. That guidance further states that the right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

    a) the purchaser (lessee) has the ability or right to operate the asset [property, plant and equipment (PPE)][2] or direct others to operate the asset (PPE) in a manner it determines while obtaining or controlling more than an insignificant (minor)[3] amount of the output or other utility of the asset (PPE).

    b) The purchaser has the ability or right to control the physical access to the underlying asset (PPE) while obtaining or controlling more than an insignificant (minor) amount of the output or other utility of the asset (PPE).

    c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant (minor) amount of the output or other utility that will be produced or generated by the asset (PPE) during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

38. The IFRIC and EITF's reasons for those conditions can be found in the Appendix to this paper. In summary:

    (a) The first two conditions consider the purchaser's ability to control physically the use of the underlying asset either through operations or physical access.

    (b) The third condition (c) assumes that the lessee has the ability to control the use of the underlying asset when it is able to restrict the access of others to the output from the underlying asset. In addition, by paying a price per unit of output, the lessee is paying for a product or service rather than paying for the right to use the underlying asset.

[2] Existing US GAAP is only applicable to property, plant and equipment
[3] Existing US GAAP refers to this as 'minor' while IFRSs use the word 'insignificant'.

(c) The IFRIC also noted that many take-or-pay contracts may be recognised as leases, because the lessee is paying for the time that the underlying asset is made available for use rather than paying for the basis of actual use or output.

39. The boards could carry forward the existing converged guidance under paragraph 840-10-15-6 and paragraph 9 of IFRIC 4, which some staff members recommend. However, other staff members think that:

(a) rewriting the guidance could help clarify the intentions of the boards; and

(b) that 'paying a price per unit of output or utility of the underlying asset' in condition (c) in paragraphs 9 of IFRIC 4 and 840-10-15-6 is not relevant to whether a lease exists.

Consequently, we propose three options.

Options	Description	Implications
1	Carry forward existing converged guidance	No change in existing requirements
2	Update conditions without pricing requirements in condition (c)	More arrangements would be treated as a lease
3	Update conditions but require pricing to be a factor in determining whether a lease exists	Some arrangements that are now considered leases may not be considered a lease

Option 1 – carry forward existing converged guidance

40. Option 1 retains the current conditions as written in paragraph 840-10-15-6 and paragraph 9 of IFRIC 4 to determine when the lease conveys the right to use the underlying asset. These conditions help to determine when the arrangement conveys the right to control the use of the underlying asset.

41. Option 1 has the following advantages:

    (a) all arrangements currently accounted for as leases would continue to be accounted for as leases;

    (b) this option carries forward the notion that the right of use can be conveyed without having physical access to the underlying asset (by excluding others' access to the underlying asset);

    (c) this option carries forward the notion that the payments must be for something other than goods or services;

    (d) this option is familiar to constituents and therefore it would be easier for constituents to understand and implement;

    (e) the guidance is already converged;

    (f) although its application may be difficult at times, in most situations it is clear whether a lease contract is within the scope of the existing leases guidance; and

    (g) this option is consistent with the boards' preliminary views in the Leases DP.

42. Option 1 carries forward the notion that an arrangement conveys the right to use an underlying asset if the arrangement conveys to the purchaser (lessee) the right to use the underlying asset through its contractual ability to exclude others' use of the underlying asset. For example, if the purchaser (lessee) obtains, or has the right to obtain, all or substantially all of the output of the underlying asset, then the purchaser (lessee) has excluded others' use of the underlying asset.

43. The notion that a right to use an underlying asset (a lease) is conveyed through limiting others' access to the underlying asset was noted in the deliberations that led to EITF 01-8, and in the basis for conclusions of IFRIC 4. This notion, and the notion that paying a price other than a fixed price per unit of output or a price equal to the current market price per unit output as of the time of delivery represents payments for something other than the output, are the foundations of condition (c) currently in paragraphs 9 of IFRIC 4 and ASC 840-10-15-6. The importance of both notions is evident in their respective basis of conclusions summarised in paragraph 38 above and quoted in the Appendix to this paper.

44. Paragraph BC35 of IFRIC 4 addresses concerns of respondents to the exposure draft that led to the issuance of IFRIC 4. These respondents were troubled by the fact that in some circumstances, a purchaser's right to acquire the output from an asset, without the ability to physically control the asset, could be considered a lease. In its response, the IFRIC reaffirmed its view that a purchaser that is taking substantially all of the output from an asset has the ability to restrict the access of others to the output from that asset. The purchaser therefore has a right of use because it controls access to the economic benefits to be derived from the asset.

45. Staff who support option 1 think that removing the pricing condition currently in condition (c), as suggested by option 2, would greatly expand the scope of the proposed lease requirements so as to include arrangements that are currently excluded from the scope of the existing lease guidance. As a result of altering the principles of IFRIC 4 and paragraph ASC 840-10-15-6, arrangements for goods or services would be accounted for as leases under option 2.

Option 2 – Delete the pricing requirements in condition (c) and rewrite the conditions in IFRIC 4 and ASC 840-10-15-6

46. Supporters of option 2 would extract the principles underpinning the conditions in paragraphs ASC 840-10-15-6 and IFRIC 4.9 rather than carrying forward the exact same wording. In addition, option 2 would delete the pricing requirements in condition (c).

47. Firstly, some staff and respondents think that the conditions as written in paragraphs ASC 840-10-15-6 and IFRIC 4.9 to determine when the lease conveys the right to control the use of the underlying asset are confusing. For example, a respondent noted:

> … the application of these interpretations is often very difficult because they focus on "outputs" to assess the "right to use" specific assets. This has been further complicated because many of the arrangements considered when these interpretations were initially issued have evolved since that time. For example, in evaluating whether a power purchase or sale arrangement contains a lease, one must currently understand the "outputs" of the facility. When the interpretations were initially issued, the "output" from a power plant was generally limited to electricity or possibly steam or other by-products. Within the last few years, the structure of many power purchase and sale contracts has changed to include many intangible elements (such as capacity credits and renewable energy credits) which have raised questions as to whether these items represent an output of a power plant for the purposes of applying lease accounting. While these deliverables are not tangible, they are intangible attributes associated with the power plant that are often retained by the owner or marketed or used by a party other than the purchaser of the electricity. (CL120)

48. Second, some staff have found an inconsistency when applying these conditions, particularly in regards to pricing requirements in condition (c). To illustrate the confusion where similar arrangements are accounted for differently under the existing requirements, here are three examples:

> Example 1
>
> A utility company has built a power plant next to Manufacturing Company B's plant (the plant is outside Co B's premises). Because of safety reasons, only the utility company's employees are allowed to operate and maintain that plant. Co B has agreed to acquire all of the power generated from that power plant for a fixed fee of CU[4]1000 per month.

Assessment: Co B has acquired a lease under existing requirements because it meets condition (c). Co B is taking all of the output of the plant and is not paying per unit of the power generated by the power plant.

[4] CU = currency units

> Example 2 (similar to example 1 but Co C pays per unit of output)
>
> A utility company has built a power plant next to Manufacturing Company C's plant (the plant is outside Co C's premises). Because of safety reasons, only the utility company's employees are allowed to operate and maintain that plant. Co C has agreed to acquire all of the power generated from that power plant but will pay CU1 for each kW produced.

***Assessment*:** Co C has not acquired a lease under existing requirements because it does not meet any of the conditions in paragraphs IFRIC 4.9 or 840-10-15-6. In particular, Co C is paying per unit of output and not a fixed price.

> Example 3 (the plant is inside the premises of the manufacturing company)
>
> A utility company has built a power plant in Manufacturing Company D's premises. Because of safety reasons, only the utility company's employees are allowed to operate and maintain that plant. Because the plant is in Co D's premises, the utility company employees must seek Co D's permission to enter the premises. Co D has agreed to acquire all of the power generated from that power plant but will pay CU1 for each kW produced.

***Assessment*:** Co D has acquired a lease under existing requirements because it meets condition (b) – the purchaser has the ability or right to control the physical access to the power plant.

49. Supporters of option 2 think that the boards need to resolve these inconsistencies in applying the pricing requirements in condition (c). They disagree with the argument that if the lessee is paying per output, this indicates that the lessee is purchasing a product or a service, rather than paying for the right to use the asset. They think that pricing arrangement is a measurement issue and should be removed from the principles to determine if an arrangement contains a lease.

Proposed principle for option 2

50. The proposed principle to determine when the lease conveys the right to use the underlying asset is– ***when the purchaser (lessee) enters into a contract, the supplier (lessor) has made available to the purchaser (lessee) the use of the underlying asset***.

51. Indicators of when the supplier (lessor) has made available to the purchaser (lessee) the use of the underlying asset is when the lessee has acquired:

(a) the ability to operate the underlying asset, or to direct others to operate the asset, in a manner that it determines, while obtaining more than an insignificant amount of the output or other utility of the underlying asset; or

(b) the physical access to the underlying asset or can exclude others from using the underlying asset during the term of the contract, while obtaining more than an insignificant amount of the output or other utility of the underlying asset; or

(c) the ability to restrict others from accessing the use of the underlying asset, by obtaining or controlling all but an insignificant amount of the output or other utility of the underlying asset.

52. Implications in applying this principle to the examples in paragraph 48 above are:

Example	*Basic features in example*	*Implications option 2*
1	• Power plant outside premises • Co B acquires all of the power generated • Co B pays a fixed fee	Yes, lease
2	Same as example 1, but purchaser pays per unit of output	Yes, lease
3	Same as example 2 but power plant is within the purchaser’s premises	Yes, lease

Option 3: If paying per unit of output is crucial

53. If the boards think that whether one is paying per unit of output is a crucial difference between a lease and other types of contracts, option 3 suggests that that concept should be more explicit.

54. The proposed principle under option 3 to determine when the lease conveys the right to use the underlying asset is– ***when the purchaser (lessee) enters into a contract, the supplier (lessor) has made available to the purchaser (lessee) the use of the underlying asset***.

55. Under option 3, indicators of when the lessor has made available to the lessee the use of the underlying asset are when the lessee:

    (a) is not paying per unit of output or utility for the use of the underlying asset for the duration of the arrangement; *and*

    (b) has acquired:

        (i) the ability to operate the underlying asset or direct others to operate the asset in a manner it determines, while obtaining more than an insignificant amount of the output or other utility of the underlying asset; or

        (ii) the physical access to the underlying asset or can exclude others from using the underlying asset during the term of the contract, while obtaining more than an insignificant amount of the output or other utility of the underlying asset; or

        (iii) the ability to restrict others from accessing the use of the underlying asset, by obtaining or controlling all but an insignificant amount of the output or other utility of the underlying asset.

56. Option 3 can cause structuring opportunities. Some types of transactions that are now accounted for as leases may not be classified as leases under this option. For example, if Company A leases a photocopy machine that is located within Company A's premises, and Company A only pays for each photocopy, that arrangement is now considered a lease under existing requirements; but if the boards view that paying per unit of output is crucial, this type of transaction may no longer be considered a lease.

57. Implications in applying this principle to the examples in paragraph 48 above are:

Examples	*Basic features in example*	*Implications option 3*
1	• Power plant outside premises • Co B acquires all of the power generated • Co B pays a fixed fee	Yes, lease
2	Same as example 1, but purchaser pays per unit of output	No, not a lease
3	Same as example 2, but power plant is within the purchaser's premises	No, not a lease

Staff recommendation

58. Some staff members prefer option 1, to carry forward the current guidance as written, for the reasons outlined above in paragraph 41. Supporters of option 1 note the reasons outlined in both the IFRIC and EITF's bases of conclusions for including the pricing notion in paragraph 9 (c) of IFRIC 4 and paragraph 840-10-15-10. The interpretative guidance includes conditions on physical control of the underlying asset, operational control of the underlying asset, and the ability to control the underlying asset through taking substantially all of the output if the payments are for something other than goods or services. Condition (c) contains both an output measure, and a pricing mechanism, to determine if an arrangement meets the definition of a lease. The IFRIC and EITF determined that a purchaser (lessee) could control the right to use an underlying asset through its contractual ability to exclude others' use of the asset. However, this ability only meets the definition of a lease if the payments in the arrangement are for something other then goods or services (ie, the pricing is neither contractually fixed per unit of output nor equal to the current market price per unit of output).

59. Other staff members prefer option 2, to reword and reconsider the conditions that are currently in paragraph 9 of IFRIC 4 and paragraph 840-10-15-10. Supporters for option 2 acknowledge that more types of arrangements may be considered a lease and this is beyond the boards' preliminary decisions to have the scope of the new leases requirements to be the same as the scope of the existing lease requirements. However they continue to support option 2 because they think that the pricing requirement in condition (c) is not relevant to whether a lease exists.

60. No staff member supports option 3.

Question 4
Which option do you prefer? 1) Option 1 – no change in paragraphs IFRIC 4.9 or 840-10-15-6 2) Option 2 – update the conditions without pricing requirements in condition (c) 3) Option 3 – update the conditions but require pricing to be a condition of a lease If the boards do not agree with any of the options presented, please provide guidance on an option that they do support.

Is a lease only for an agreed period of time?

61. US GAAP's definition of a lease does not explicitly require that a lease has to be for an agreed period of time; it states that a lease is 'usually for a stated period of time'. By contrast, the IASB's definition requires that a lease be for an agreed period of time.

62. A respondent highlighted that a lease does not need to be contractually agreed for a period of time.

> Specifically, IAS 17, *Leases*, 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." Questions have arisen as to whether an agreement needs to

> be for a contractually agreed upon period of time to be considered a lease. For example, there are agreements that convey to a party the right to use an asset but the time period is not specified. The FASB Statement No.13, *Leases*, definition is different in this respect because it states that a lease is "…**usually** for a stated period of time [Emphasis added]." We believe the IASB should use the Statement 13 definition that includes the word "usually" in the new leases standard. (CL120)

63. We agree with this respondent because there are some leases with no specified time period, such as leases of retirement villages (ie senior citizens renting a home in a retirement village until they are deceased). Consequently, we propose that the definition of a lease should state that a lease is usually for a stated period of time.

Recommendation and Question 5
We recommend that the definition of a lease state that a lease is usually for a stated period of time. Do you agree?

Is payment a necessary element in the definition of a lease?

64. The IASB's definition of a lease explicitly states that a lessee has to pay the lessor (in return for a payment or series of payments). Although the FASB's definition does not explicitly mention payment, ASC section 840-10-15 does state that the lessee is a purchaser, which indicates some form of consideration by the lessee. Consequently, the difference is not as big as it seems.

65. Explicitly stating in the definition of a lease that a lessee has to pay the lessor is more straightforward, and is consistent with how a lease is defined in English dictionaries.

Non-exchange transactions

66. Some may hold the view that if a lease is defined so that a lessee has to pay the lessor, the definition could exclude possible grants of leases. For example, a lessee receives a right-of-use asset (possibly offices in a government-owned building) as a government grant.

67. However, we recommend that the definition of a lease should explicitly state that a lessee has to pay the lessor, because:

    (a) it is consistent with how most of our constituents (and the boards) view what a lease is. We also reviewed the definition of a lease used by the International Public Sector Accounting Standards Board (IPSASB) and found that its definition of a lease is also limited to where a lessee has to pay a lessor.

    (b) the boards have developed the leases model based on an exchange transaction (and a cost model). However in US GAAP and in IFRSs, most non-exchange transactions are normally accounted for at fair value.

    (c) it is consistent with what is in plain English (ie in the English dictionary).

Recommendation and Question 6
We recommend that the definition of a lease should explicitly state that a lessee has to pay the lessor in exchange for the right-of-use asset. Do you agree?

Summary of staff recommendation
A lease is a contract in which the lessor conveys the right to use a specified asset, usually for a stated period of time, in return for a payment.

Appendix A:

Extracts from IFRIC's and EITF's bases for conclusions explaining the three conditions in paragraphs IFRIC 4.9 and 840-10-15-6

A1. The lessee has the ability to control physically the use of the underlying asset either through operations or physical access.

> The first two criteria consider the purchaser's ability to control physically the use of the underlying asset, either through operations or access, while obtaining or controlling more than an insignificant amount of the output of the asset. For example, a purchaser's ability to operate the asset may be evidenced by its ability to hire, fire or replace the operator of the asset or its ability to specify significant operating policies and procedures in the arrangement (as opposed to a right to monitor the supplier's activities) with the supplier having no ability to change such policies and procedures. [BC30 in IFRIC 4]

> …. The Task Force agreed that an arrangement conveys the right to use property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to physically control the use of the underlying property, plant, or equipment, either through operations or access, while obtaining or controlling more than a minor amount of the output of the property, plant, or equipment. [B12 in EITF 01-08]

A2. The lessee has the ability to control the use of the underlying asset when it is able to restrict the access of others to the output from the underlying asset.

> … the IFRIC reaffirmed its view that a purchaser that is taking substantially all of the output from an asset has the ability to restrict the access of others to the output from that asset. The purchaser therefore has a right of use because it controls access to the economic benefits to be derived from the asset. The IFRIC therefore did not agree that the absence of the ability to control physically the way in which the underlying asset is used precludes the existence of a right of use (although, as noted above, such an ability may indicate that a right of use has been conveyed). [BC35 in IFRIC 4]

> … Similarly, the purchaser (lessee) may obtain the right to use property, plant, or equipment through its contractual ability to exclude others' use of the property, plant, or equipment (for example, by obtaining or having the right to obtain all or substantially all of the output of the property, plant, or equipment). [B12 in EITF 01-8]

A3. By paying a price per output, the lessee is paying for a product or service rather than paying for the right to use the underlying asset.

> In adopting the approach from Issue 01-8, the IFRIC has specified that an arrangement for all or substantially all of the output from a specific asset does not convey the right to use the asset if the price that the purchaser will pay is contractually fixed per unit of output or equal to the current market price per unit of output as of the time of delivery of the output. This is because in such cases the purchaser is paying for a product or service rather than paying for the right to use the asset. In D3, the IFRIC proposed making a similar distinction by the combination of the second and third criteria (see paragraph BC15(b) and (c) above). [BC37 in IFRIC 4]

> Task Force members generally agreed that the *right to use* property, plant, or equipment is conveyed in arrangements in which the purchaser has the right or ability to take all or substantially all of the output or other utility that will be produced or generated by the property, plant, or equipment (or, said another way, when other parties will not take more than a minor amount of the output) if the arrangement's pricing contains an element that is designed to recover some or all of the supplier's capital investment in such property, plant, or equipment irrespective of the quantity of output taken by the purchaser. In such arrangements, the purchaser's rights under the arrangement essentially restrict others' ability to use, or to obtain the benefits of, the property, plant, or equipment, even though the property, plant, or equipment may be physically in the possession of, or operated by, the supplier or a third party. The Task Force noted that some arrangements that provide that the purchaser (lessee) will take all or substantially all of the output from specific property, plant, or equipment may not convey the *right to use* the property, plant, or equipment if the purchaser is essentially paying for a product or service rather than paying for a *right to use* specific property, plant, or equipment. If the price that the purchaser will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the purchaser is paying for a product or service rather than paying for the *right to use* the property, plant, or equipment. [B13 in EITF 01-08]

A4. Many take-or-pay contracts may be recognised as leases because the lessee is paying for the time that the underlying asset is made available for use rather than paying for the basis of actual use or output.

The IFRIC noted that its Interpretation could result in take-or-pay arrangements, in which purchasers are committed to purchase substantially all of the output from specific assets, being determined to contain leases. This is because in such arrangements the purchaser makes payments for the time that the underlying asset is made available for use rather than on the basis of actual use or output (resulting in the arrangement's pricing being neither fixed per unit of output nor equal to the current market price per unit of output). In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier regardless of whether the purchaser uses the underlying asset or obtains the output from that asset. Payments are therefore made for the right to use that asset. The IFRIC agreed that the overall effect of such a take-or-pay arrangement is similar to that of a lease plus contracts for related services and supplies (such as contracts for the operation of the asset and the purchase of inputs). [BC38 in IFRIC 4]

The effect of clarifying *right to use* in the manner provided for by the consensus may result in many take-or-pay arrangements being recognized as leases. That is because the purchaser makes payments for the time that the property, plant, or equipment is made available for use rather than on the basis of actual use or output (resulting in the arrangement's pricing being neither fixed per unit of output nor indexed to market prices). In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier irrespective of whether the purchaser actually uses the property, plant, or equipment or obtains the output from the property, plant, or equipment. In such arrangements, the purchaser is paying for the *right to use* the property, plant, or equipment. [B15 in EITF 01-08]