Project **Leases**

Topic **Definition of a lease: illustrative examples**

Purpose

1. This paper applies options 1, 2 and 3 from the proposed definition of a lease paper (IASB Agenda Paper 2/ FASB Memorandum 60) to different examples to show the differences in outcome.
2. For each example please assume that each arrangement would fulfil the specified asset criteria. In other words, the fulfilment of the contract is dependent on the use of a specific asset (or assets).

Example 1: Renting a photocopy machine but payment based on output

Company A rents a photocopy machine for three years from Supplier B and will pay CU[1]1 for each photocopy made. The contract is non-cancellable. The expected life of the machine is for 10 years. The photocopy machine is in Company A's premises.

Assessment:

3. Under option 1 Company A *has* leased a photocopy machine. During the three years, Company A has the ability or right to operate the photocopy machine in a

[1] CU = currency units

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manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the machine.

4. Under option 2, Company A *has* leased a photocopy machine. During the three years, Company A has purchased the availability to use the photocopy machine. Company A has the ability to operate the photocopy machine in a manner that it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the machine.

5. Under option 3, Company A has *not* leased a photocopy machine because it is paying per unit of output or utility for the use of the underlying asset for the duration of the arrangement.

Example 2: Production company enters into an arrangement to supply a minimum quantity of gas for a specified period of time with a fixed capacity charge[2]

> A production company (the purchaser) enters into an arrangement with a third party to supply a minimum quantity of a specialty gas needed in its production process for a specified period of time. The supplier designs and constructs a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:
>
> 1. The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
>
> 2. The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.

[2] This is the first example in IFRIC 4 and EITF 01-8 to illustrate when an arrangement contains a lease.

> 3. The supplier is responsible for repairs, maintenance, and capital expenditures.
>
> 4. The supplier must stand ready to deliver a minimum quantity of gas each month.
>
> 5. On a monthly basis, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which comprise approximately 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
>
> 6. In the event that the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Assessment:

6. The arrangement *contains* a lease under option 1. The purchaser has obtained the *right to use* the facility because:

   (a) the fact that the facility is designed to meet only the purchaser's needs and the fact that the supplier has no plans to expand or modify the facility – it is remote that one or more parties other than the purchaser will take more than a minor amount of the facilities output, and

   (b) the price the purchaser will pay 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.

7. The arrangement *contains* a lease under option 2. The purchaser has purchased the availability to use the facility by obtaining the ability to restrict others from accessing the use of the facility because it is obtaining all but an insignificant amount of the supply gas of the facility.

8. The arrangement *contains* a lease under option 3. The purchaser has purchased the availability to use the facility because:

(a) it is not paying per unit of supply gas from the facility during the arrangement; and

(b) it has obtained the ability to restrict others from accessing the use of the facility because it is obtaining or controlling more than an insignificant amount of the output of the facility.

Example 3: Production company enters into an arrangement to supply a minimum quantity of gas for a specified period of time (not a fixed capacity charge)

9. Similar to example 2 except that the purchaser will pay a contractually fixed price per unit of output.

> A production company (the purchaser) enters into an arrangement with a third party to supply a minimum quantity of a specialty gas needed in its production process for a specified period of time. The supplier designs and constructs a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:
>
> 1. The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
>
> 2. The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
>
> 3. The supplier is responsible for repairs, maintenance, and capital expenditures.
>
> 4. The supplier must stand ready to deliver a minimum quantity of gas each month.
>
> 5. The purchaser will pay a contractually fixed per unit of output based on actual production taken.

Assessment:

10. The arrangement does *not* contain a lease under option 1. The purchaser has not obtained the *right to use* the facility because (a) the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and (b) the likelihood that parties other than the purchaser will take more than a minor amount of the gas produced from the facility is remote, but the purchaser is paying a fixed price per unit of output indicating it is not purchasing anything other than a good or service.

11. The arrangement *contains* a lease under option 2. The purchaser has purchased the availability to use the facility by obtaining the ability to restrict others from accessing the use of the facility because it is obtaining all but an insignificant amount of the supply gas of the facility.

12. The arrangement does *not* contain a lease under option 3. This is because the purchaser is paying a contractually fixed per unit of output based on actual production taken.

Example 4: Cereal manufacturing company enters into an arrangement to supply wheat for a specified period of time

A cereal manufacturing company (the purchaser) enters into an arrangement with a third party to supply wheat for a specified period of time. The supplier only produces two crops: wheat in the months October – June, and corn in the months July – October. The supplier maintains ownership and control over all significant aspects of the land. The arrangement provides for the following:

1. The supplier's land is explicitly identified in the arrangement, but the supplier has the right to fulfil the arrangement by shipping the component parts from other land owned by the supplier. However, to do so for any extended period of time would be uneconomical.

2. The supplier is responsible for repairs, maintenance, and capital expenditures of the land.

3. The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity

> taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still only pay for the actual quantity taken.
>
> 4. The supplier has the right to sell wheat to other customers and has a history of doing so (by selling wheat directly to the market) but it is not expected that parties other than the purchaser will take more than a minor amount of the component parts produced on the supplier's land.

Assessment:

13. Under option 1 the arrangement does *not* contain a lease. It is because the purchaser has not obtained the right to use the land because (a) the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and (b) the likelihood that parties other than the purchaser will take more than a minor amount of the wheat produced on the land is remote, but the purchaser is paying a fixed price per unit of output indicating they are not purchasing other than a good or service.

14. Under option 2 the arrangement *contains* a lease. This is because the purchaser has purchased the availability to use the land by acquiring the ability to restrict others from accessing the use of the land by obtaining all but an insignificant amount of the crops produced by the land.

15. Under option 3 the arrangement does *not* contain a lease because the cereal manufacturing company is paying per unit for the crops during the arrangement.

Example 5: Auto manufacturing company enters into an arrangement to supply a specific component part of its manufactured product for a specified period of time

> Auto Manufacturing A (the purchaser) enters into an arrangement with four third party suppliers to supply specific tyres for a specified period of time. The purchaser has entered into arrangements with each supplier to obtain all the output for a period of three months during the year at a contractually fixed price per unit. For example, supplier 1 supplies tyres for the months of January – March, supplier 2 supplies tyres for the months April – May, etc. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

> 1. Each supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfil the arrangement by shipping the tyres from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomical.
>
> 2. The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
>
> 3. The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still only pay for the actual quantity taken.
>
> 4. Outside of the time periods required to supply the purchaser, the suppliers have the right to sell the tyres to other customers and has a history of doing so. However, during the time periods required to supply the purchaser, it is not expected that other parties will take more than a minor amount of the tyres produced at the supplier's plant.

Assessment:

16. Under option 1 the arrangement does *not* contain a lease. The purchaser has not obtained the right to use the plant because (a) the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and (b) the likelihood that parties other than the purchaser will take more than a minor amount of the tyres produced at the plant is not more than remote, but the purchaser is paying a contractually fixed rate per unit indicating they are not purchasing anything other than a good or service.

17. Under option 2 Auto manufacturing A *has* four lease contracts, one for each supplier. During their respective three months (ie when Auto manufacturing A buys tyres from Supplier 1 in January to March) Auto manufacturing A has purchased the availability to use each supplier’s facility by obtaining the ability to restrict others from accessing the use of the underlying by taking all of the tyres supplied.

18. Under option 3 the arrangement does *not* contain a lease. It is because the purchaser is paying for each tyre.