Project **Leases**

Topic **Scope - Purchases and sales of the underlying asset**

Purpose

1. At the October 2009 joint meeting the boards tentatively decided to exclude from the scope of the proposed new leases guidance contracts that represent the purchase (lessee) or sale (lessor) of the underlying asset.

2. The purpose of this paper is to develop criteria to determine when a transaction is in fact a purchase or sale of the underlying asset and should be excluded from the scope of the leases guidance. To put it in another way: we are trying to identify when it is appropriate for the lessor to derecognise, and the lessee to recognise, the underlying asset. There is very little guidance in either US GAAP or IFRS on when to recognise or derecognise a non-financial asset, and it is not our intention to develop a general non-financial asset recognition/derecognition model. Instead we are attempting to develop criteria that can be used on lease contracts.

3. Throughout this paper, we are trying to identify whether the whole of the *underlying asset* has been purchased or sold. We are not trying to identify whether a right-of use-asset has been purchased or sold. In a lease of a motor vehicle, for example, the underlying asset is the motor vehicle: not the right to use the motor vehicle.

4. 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.

5. This paper is structured as follows:

    (a) Summary of staff recommendations

    (b) A discussion of the principle that should be used to determine whether a transaction is in fact a purchase or sale of the underlying asset

    (c) A discussion of when control of the underlying asset is obtained or transferred in a lease transaction.

6. The final section of this paper discusses how to account for leases that include purchase options that are not bargain purchase options.

Staff recommendations

7. In this paper, the staff recommend that:

    (a) Transactions that transfer control of the underlying asset should be excluded from the scope of the leases standard.

    (b) Control of the underlying asset should be defined as the reporting entity's present ability to direct the use of, and receive the benefit from, the underlying asset.

    (c) Whether an entity has transferred/obtained control of the underlying asset should be considered from the perspective of the reporting entity.

    (d) Management of an entity must exercise judgement and consider all relevant facts and circumstances when determining whether control of the underlying asset has been transferred/obtained. Situations where control of the underlying asset has normally been transferred/obtained include:

        (i) Contracts where title to the underlying asset transfers to the lessee automatically at the end of the lease

        (ii) Contracts that include a bargain purchase option.

(e) In addition, some staff think that control of the underlying asset has normally been transferred/obtained in the following situations:

   (i) Contracts that cover the whole of the expected useful life of the underlying asset

   (ii) Contracts that are expected to cover the whole of the expected useful life of the underlying asset because they include options to renew the lease at a bargain price

   (iii) Contracts where the return that the lessor receives is fixed.

8. The final section of this paper discusses how to account for leases that include purchase options that are not bargain purchase options. We recommend that these options should be accounted for in the same way as options to extend or terminate the lease.

When is a lease transaction a purchase or sale of the underlying asset?

9. The staff have identified two separate principles that could be used to determine whether a lease contract is in fact a purchase or sale of the underlying asset. These are:

   (a) The contract transfers substantially all the risks and rewards of the underlying asset.

   (b) The contract transfers control of the underlying asset.

10. The first of these principles is the same as the principle used in the existing standards to classify leases as finance (capital) leases or operating leases. This is no accident. The classification requirements in the existing standards were designed to differentiate between transactions that are in substance purchases of the underlying asset (finance/capital leases) and those transactions that are not.

11. Whether or not a lease transaction transfers substantially all the risks and rewards of ownership of the underlying asset is determined under US GAAP by applying a series of rules/tests to the transaction. These are summarised in the

Appendix to this paper. Under IFRS, whether a transaction transfers substantially all the risks and rewards of ownership depends upon the substance of the contract. IAS 17 includes guidance that is very similar to the rules in US GAAP to help an entity determine whether the lease transfers substantially all the risks and rewards of ownership. This guidance is also summarised in the Appendix.

12. The advantages and disadvantages of using a risk and rewards principle to determine whether a lease contract is in fact a purchase or a sale are summarised in the following table.

Advantages	**Disadvantages**
• Familiar concept for users and preparers • No need to develop completely new guidance • Consistent with some aspects of existing guidance on revenue recognition	• Has often proved difficult to apply • Existing guidance has provided opportunities for structuring. However, the incentive for structuring by the lessee is now much less. Whether a transaction is accounted for as a purchase or as a lease, the lessee will recognise assets and liabilities • Inconsistent with proposed guidance on revenue recognition, consolidation and the IASB's derecognition ED. which is controls-based • Existing standards are similar but not identical – a converged approach would need to be developed

13. A control-based principle is consistent with the boards' definitions of an asset. Under both the IASB's *Framework* and the FASB's Concepts Statements, an

entity must control an economic resource or benefit for it to meet the definition of an asset.

14. The advantages and disadvantages of using a control principle to determine whether a lease contract is in fact a purchase or sale are summarised in the following table.

Advantages	**Disadvantages**
• Consistent with the definition of an asset • Consistent with the proposed guidance on revenue recognition, consolidation and the IASB's derecognition ED, which is controls-based	• Less familiar to users and preparers in the context of leases • May be difficult to apply

Staff analysis and recommendation

15. The staff recommend using a control principle to determine whether a lease contract is in fact a purchase or sale of the underlying asset. That is, if a contract transfers control of the underlying asset, it is in fact a purchase or sale and should be excluded from the scope of the leases guidance.

16. We recommend using a control principle because:

(a) It is consistent with the boards' definitions of an asset. An analysis of risks and rewards will often help an entity to determine whether an entity controls a resource. However, it does not always indicate that an entity controls that resource.

(b) It is consistent with the boards' proposed approach to revenue recognition, consolidation, and the IASB's proposed approach to derecognition, which is controls-based.

(c) Using a principle that is consistent with that proposed for revenue recognition will ensure that lessors will treat transactions as a sale of the underlying asset only when those transactions would qualify for revenue recognition. This reduces structuring opportunities.

(d) It avoids the 'baggage' associated with the existing risk-and-rewards-based principle. The existing guidance (and interpretations of the guidance) will need to be reconciled to arrive at a converged position. Consequently, although a risk and rewards approach will be familiar to users and preparers, it is likely that it will not be exactly the same as the existing requirements.

Question 1
The staff recommend using a control principle to determine whether a lease contract is in fact a purchase or sale of the underlying asset. That is, if a contract transfers control of the underlying asset, it is in fact a purchase or sale, and should therefore be excluded from the scope of the leases standard. Do the boards agree?

When is control of the underlying asset transferred in a lease contract?

17. The boards are developing guidance on control in their consolidation, derecognition and revenue recognition projects.

18. The definition of control used in the consolidation project attempts to identify whether the reporting entity has the power to direct the activities of another entity. Consequently, it is difficult to apply this definition of control to an asset in isolation (the underlying asset).

19. The IASB's exposure draft on derecognition of financial instruments proposed a control-based approach to derecognition that could be applied to lease contracts. However, the boards have not reached a converged view on this model. Consequently, the staff have not examined this model in detail.

20. The revenue recognition team have proposed the following definition of control of a good or service:

> Control of a good or service is an entity's present ability to direct the use of and receive the benefit from that good or service.

21. The staff think that it is important that a lessor should only treat a contract as a sale of the underlying asset in situations where the revenue recognition team would also view the transaction as a sale of the underlying asset. If this were not the case, there is a risk that:

    (a) The lessor would be prohibited from recognising revenue for transactions that would give rise to revenue under the revenue recognition standard.

    (b) Some transactions would fall outside the scope of the leases guidance but would not qualify for sales treatment (ie they would not result in the lessor recognising revenue).

22. Consequently, we propose to use the same definition of control as that used in the revenue recognition project. That is, control of the underlying asset is an entity's present ability to direct the use of and receive the benefit from that underlying asset.

23. In addition the revenue recognition team recommended that the management of an entity must exercise judgement and consider all relevant facts and circumstances when determining whether control of a promised asset (the underlying asset) has been transferred. We think that this should also be included in the leases guidance.

Question 2
The staff recommend that: (a) the boards use the same definition of control as that used in the revenue recognition project. That is, control of the underlying asset is an entity's present ability to direct the use of and receive the benefit from that underlying asset (b) the boards state that the management of an entity must exercise judgement and consider all relevant facts and circumstances when determining whether control of a promised asset (the underlying asset) has been transferred. Do the boards agree?

24. Conceptually whether an entity has obtained or surrendered control of an asset should be considered from the perspective of the reporting entity. However, in the revenue recognition project, the boards propose that control should be assessed from the perspective of the customer (the lessee). One of the main reasons for adopting this approach was that in service contracts it is very easy to conclude that the entity is transferring services to the customer simply because the entity is *doing* something. However, the key test under the revenue recognition model should be whether the customer is *receiving* something. This problem does not apply when trying to determine whether control of the underlying asset is being transferred. If the transaction is a purchase/sale, one reporting entity is transferring a good (the underlying asset) to the other reporting entity, not a service.

25. In addition, there may be some situations where the involvement of a third party means that the lessor has transferred control of the underlying asset but the lessee has not thereby obtained control. Consequently, the staff recommend that the question as to whether control of the underlying asset has been transferred or obtained should be determined from the perspective of the reporting entity.

Question 3
The staff recommend that the question of whether control of the underlying asset has been transferred or obtained should be determined from the perspective of the reporting entity. Do the boards agree?

26. The revenue recognition project has also developed a number of indicators that a customer has obtained control of the promised asset. These indicators are still a work in progress. However, the following table summarises the indicators proposed in September 2009 and how they could be applied to a lease contract:

Indicator	Comments
The customer has an unconditional obligation to pay for the underlying asset.	This may or may not be the case in a lease contract.
The customer has legal title to the underlying asset.	The lessee will not have legal title to the asset during the lease term, but it may transfer automatically at the end of the lease or upon exercise of a purchase option.
The customer can sell the underlying asset to (or exchange the asset with) a third party.	The lessee will not have this ability during the lease term (but it may acquire it if title transfers).
The customer has physical possession of the underlying asset.	The lessee will normally have physical possession of the asset during the lease term.
The customer has the practical ability to take possession of the underlying asset.	The lessee normally has physical possession of the asset during the lease term and may be able to obtain title to the asset if the lease includes a purchase option.
The customer specifies the design o function of the underlying asset.	This may be the case in some specialised leases.
The customer has continuing managerial involvement with the underlying asset.	The lessee does not have continuing managerial involvement after the end of the lease term (unless there is a purchase option).
The customer can secure or settle debt with the underlying asset.	The lessee normally cannot secure or settle debt with the asset (but it may acquire it if title transfers).

27. As can be seen from the table it is difficult to apply these general indicators to a lease contract, because they produce conflicting results. In addition, the fact that we have not adopted a components-based approach to leases complicates the analysis. To be consistent with our overall approach to leases, we may need to

consider the interaction of purchase options, extension options and residual value guarantees with the right-of-use asset to determine if control of the underlying asset is transferred to the lessee. This is different to the approach proposed in the revenue recognition project where, in general, the components of a contract are considered separately.

28. Consequently, the staff think that the indicators proposed by the revenue recognition team will be inadequate for determining whether control of an underlying asset has been obtained/transferred. The staff therefore think that the leases guidaance should provide indicators to help reporting entities determine whether control has been obtained/transferred.

29. The staff think that control of the underlying asset is normally obtained/transferred in the following situations:

    (a) Contracts where title to the underlying asset transfers to the lessee automatically at the end of the lease

    (b) Contracts that include a bargain purchase option.

30. Each of these situations is discussed below.

Contracts where title to the underlying asset transfers to the lessee automatically at the end of the lease

31. Contracts that automatically transfer the title of the underlying asset to the lessee at the end of the lease clearly transfer control of the underlying asset to the lessee. The lessee directs the use of, and receives the benefit from, the whole of the underlying asset for the whole of its life. The lessee's rights over the underlying asset are restricted during the lease term (it cannot sell the asset, or secure debt against the asset). However, these restrictions are really only there to protect the lessor, and are similar to those imposed by a lender who has a security interest over an asset. Once title is transferred, the lessee's rights are unrestricted.

Contracts that include a bargain purchase option

32. It can be argued that until a purchase option is exercised the lessee does not have a present right to direct the use of or receive the benefits from the underlying asset. This is undoubtedly true if you look at the components of the lease separately. The lessee controls a right-of-use asset together with a purchase option, not the underlying asset. However, the boards have tentatively decided not to adopt a components approach. To be consistent with this decision, it is necessary to consider the effect of the right-of-use asset and of the option to purchase together.

33. A lessee that has the option to buy the underlying asset for a bargain price is in an economically-similar position to a lessee that will automatically obtain title to the underlying asset. By exercising its bargain purchase option, the lessee can direct the use of, and receive the benefits from, the whole of the underlying asset for the whole of its life. That is, the lessee can use the asset and restrict others' access to the asset during the lease term and, once the option is exercised, the lessee has unrestricted rights over the underlying asset.

34. The staff considered whether to extend this indicator to include all leases that have purchase options (ie to include fixed price purchase options and market value purchase options). If the lessee has a purchase option, the lessee is able to restrict others' access to the underlying asset. However, unless the exercise price is a bargain price, it is less clear that the lessee can receive the benefits from the underlying asset after the end of the lease term. Consequently, we decided to restrict this indicator to bargain purchase options.

Staff recommendations

Question 3
The staff think that the leases guidance should provide indicators to help reporting entities determine whether control has transferred to the lessee. Do the boards agree?

Question 4
The staff think that control of the underlying asset is normally obtained/transferred in the following situations: (a) Leases where title to the underlying asset transfers to the lessee automatically at the end of the lease (b)Leases that include a bargain purchase option Do the boards agree?

35. In addition, some staff think that control of the underlying asset is also normally obtained/transferred in the following situations

    (a) Contracts that cover the whole of the expected useful life of the underlying asset

    (b) Contracts that are expected to cover the whole of the expected useful life of the underlying asset because they include options to renew the lease at a bargain price

    (c) Contracts where the return that the lessor receives is fixed.

36. Each of these situations is discussed below.

Contracts that cover the whole of the expected useful life of the underlying asset

37. Some staff think that if a lease covers the whole of the expected useful life of the underlying asset, the lessee will have the right to direct the use of, and receive the benefit from, the underlying asset for the whole of its life. The lessee will be able to restrict others from using the asset (including the lessor). In addition, it is likely that the lessee will have, in effect, paid for the underlying asset. The lessee will be unable to sell the asset or secure debt on it, but overall it is the lessee, rather than the lessor, that has the ability to direct the use of, or receive the benefit from, the whole of the underlying asset for the whole of its life.

38. However, other staff think that the lessee does not obtain control of the underlying asset because the lessor retains title to the underlying asset and can

consequently direct the use of and receive the benefit from the underlying asset after the end of the lease term.

Contracts that are expected to cover the whole of the expected useful life of the underlying asset because they include options to renew the lease at a bargain price

39. Lessees who have a bargain-priced option to lease the asset for the whole of its expected useful life are in an economically-similar position to lessees who are leasing the asset for the whole of its expected useful life. Consequently, some staff think that the lessee can direct the use of, and receive the benefit from, the whole of the underlying asset for the whole of its life. However, other staff disagree for the reasons set out in paragraph 38.

Contracts where the return the lessor receives is fixed

40. In some leases, the lessor may be unable to receive the benefits from the underlying asset because its return is fixed at the start of the lease. For example, in some leases, the lessee will be required to sell the leased item at the end of the lease as an agent for the lessor (for tax reasons, the lessee never obtains title). Any shortfall in sales proceeds below an agreed amount would be paid to the lessor by the lessee. Any excess above the agreed amount would be retained by the lessee. In leases of this type, the return earned by the lessor is fixed. It cannot use the leased item during the lease term, it cannot obtain possession of the item after the lease term (it will be sold by the lessee), and it cannot obtain benefits from changes in the asset's value during the term of the lease. The lessor could sell the underlying asset during the lease term, but the sale proceeds would reflect the fact that the return from underlying asset is fixed. Consequently, some staff think that the lessor can neither direct the use of, nor receive the benefits from, the underlying asset; it has surrendered control of the underlying asset.

Recommendation

Question 5
Some staff think that control of the underlying asset is also normally obtained/transferred in the following situations: (a) Contracts that cover the whole of the expected useful life of the underlying asset (b) Contracts that are expected to cover the whole of the expected useful life of the underlying asset because they include options to renew the lease at a bargain price (c) Contracts where the return the lessor receives is fixed. Do the boards agree?

Other indicators considered but rejected

41. The following table summarises some other indicators of control that the staff considered but rejected:

Indicator	**Reason for rejection**
The lease payments equal or are expected to equal the fair value of the underlying asset.	This will not always indicate that the lessee has obtained control of the underlying asset. 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).	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 control the underlying asset.

The lessee provides the lessor with a residual value guarantee.	A residual value guarantee protects the lessor's minimum return from the lease. but does not necessarily mean that the lessee has obtained control of the underlying asset.

Leases that include purchase options

42. Although the staff recommend that contracts that include bargain purchase options should be excluded from the scope of the leases standard, contracts that include non-bargain purchase options will be within the scope of the leases standard. This section of the paper discusses how to account for contracts that include non-bargain purchase options.

43. Purchase options can be viewed as the ultimate renewal option. Providing a purchase option is no different from providing renewals that extend over the entire economic life of the leased item. Consequently for the purposes of the DP, the boards tentatively concluded that the accounting requirements for purchase options by lessees should be the same as for options to extend or terminate the lease.

44. Most respondents to the DP agreed that purchase options should be accounted for in the same way as options to extend or terminate the lease.

> Requiring purchase options to be accounted for separately from options to extend or terminate a lease introduces a distinction between economically similar arrangements which would add unnecessary complexity to lessee accounting and may provide opportunities for structuring arrangements to achieve desired accounting. (CL #139)

45. However, as discussed in November, some of those respondents do not agree with the proposed accounting for options to extend or terminate the lease.

46. The staff continue to view purchase options as the ultimate renewal option. Consequently, we recommend that purchase options should be accounted for in the same way as options to extend or terminate the lease.

47. For the lessee this means that:

    (a) Purchase options would not be recognised as separate assets.

    (b) At the start of the lease, the lessee must determine whether it is likely that the purchase option will be exercised. If it is determined that the most likely outcome is that that a purchase option will be exercised, the obligation to pay rentals would include the exercise price of the purchase option.

    (c) In deciding the most likely outcome, the lessee should consider all relevant factors.

    (d) Whether a purchase option will be exercised should be reconsidered at each reporting date based on new facts and circumstances.

    (e) Changes in the obligation to pay rentals arising from reassessing whether a purchase option will be exercised should result in a change in the carrying amount of the right-of-use asset.

48. For the lessor this means that:

    (a) Purchase options would not be recognised separately.

    (b) At the start of the lease, the lessor must determine whether it is likely that the purchase option will be exercised. If it is determined that the most likely outcome is that that a purchase option will be exercised, the lessor's receivable would include the exercise price of the purchase option.

    (c) In deciding the most likely outcome, the lessor should consider all relevant factors.

    (d) Whether a purchase option will be exercised should be reconsidered at each reporting date based on new facts and circumstances.

    (e) Any change in the lease receivable resulting from a reassessment of whether a purchase option will be exercised should be recorded as an adjustment to the performance obligation.

Question 6
The staff recommend that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do the boards agree?

Appendix – Risk and rewards guidance in existing leases standards

A1. This appendix summarises the guidance in the existing standards that is used to differentiate between contracts that transfer substantially all the risks and rewards of the underlying asset (finance/capital leases) and those that do not (operating leases).

US GAAP

A2. Under US GAAP a lease is classified as a capital lease if:

(a) The lease transfers ownership of the property to the lessee by the end of the lease term.

(b) The lease contains a bargain purchase option.

(c) The lease term is equal to 75 per cent or more of the estimated life of the leased property (subject to some restrictions).

(d) The present value of the minimum lease payments equals or exceeds 90 per cent of the fair value of the leased property. (Note: this condition has been simplified).

IFRS

A3. The following are examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease:

(a) The lease transfers ownership of the property to the lessee by the end of the lease term.

(b) The lessee has an option to purchase the asset that is priced such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

(c) The lease is for the major part of the economic life of the asset even if title is not transferred.

(d) The present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset.

(e) The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

A4. The following are indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease:

(a) If the lessee can cancel the lease, the lessor’s losses are borne by the lessee.

(b) Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee.

(c) The lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent.