Staff Paper

Project **Leases**

Topic **Definition of a lease**

This paper will also be discussed at the IASB/FASB joint meeting in the week commencing 11 April 2011

Introduction and background

1. At the 17 February 2011 joint board meeting, the boards discussed the definition of a lease and the application guidance in the *Leases* Exposure Draft (ED) relating to that definition. The ED defines a lease as follows:

> A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

2. At that meeting, the boards expressed support for an approach clarifying that 'specified asset' should focus on an asset of a particular specification and that 'the right to control the use of an asset' should be amended to be consistent with the concept of control applied in other projects (eg revenue recognition).

3. The boards also discussed an alternative approach to clarify some aspects of the guidance in the ED relating to the definition of a lease.

4. The boards directed the staff to seek input through targeted outreach on both approaches discussed at the February 2011 meeting. The purpose of the targeted outreach wass to:

   (a) obtain a better understanding of the implications of any proposed changes to the ED; and

(b) test whether proposed changes to the guidance in the ED would provide a better basis on which to determine whether a contract is, or contains, a lease.

5. The targeted outreach paper included the preliminary draft guidance for both approaches set out in Appendix C to this paper (the boards preferred approach at the February 2011 joint board meeting) and Appendix D to this paper (the alternative approach discussed at that February joint board meeting). The targeted outreach paper noted that each appendix was not necessarily an integrated package of changes but that pieces of each appendix could be mixed in the final guidance on the definition of a lease.

6. This paper summarises the feedback received from the targeted outreach, and includes the staff analysis and recommendations regarding the definition of a lease.

7. Appendices A and B to this paper set out preliminary draft guidance for the definition of a lease reflecting the staff recommendations in this paper:

   (a) Approach A set out in Appendix A retains the proposals regarding specified asset in the ED but proposes changing the guidance regarding 'the right to control the use' of a specified asset to be more consistent with how control is described in other standards.

   (b) Approach B set out in Appendix B retains the proposals in the ED with minimal changes to address some practice concerns.

8. A further agenda paper includes some examples illustrating the application of the staff recommendations in this paper to some contracts highlighted in comment letters, at workshops or roundtable meetings or during the targeted outreach meetings. [This paper is being prepared and will be sent to board members later this week for discussion at next week's joint board meeting.]

9. The staff will also discuss the definition of a lease at the leases working group meeting on Monday 11 April 2011.

Staff recommendations

10. The staff recommend that:

    (a) the definition of a lease proposed in the ED (and set out in paragraph 1 of this paper) is retained.

    (b) within the definition of a lease:

    (i) a 'specified asset' is interpreted as an identifiable asset. Therefore if the supplier has substantive rights to substitute alternative assets for the specified asset, the contract does not contain a lease. However, some staff recommend that a 'specified asset' is interpreted as an asset of a particular specification.

    (ii) a physically-distinct portion of a larger asset can be a specified asset; a capacity portion of a larger asset that is not physically-distinct cannot.

    (c) regarding the 'right to control the use' of a specified asset:

    (i) some staff recommend that the control concept applied within the definition of a lease should be more consistent with how it is applied in other forthcoming or established standards. Therefore, a customer has the right to control the use of a specified asset if it has the ability to direct the use, and receive benefits from use, of that asset.

    (ii) other staff recommend that the control concept applied within the definition of a lease proposed in the ED (which is based on current guidance in IFRSs and US GAAP) be retained with minimal changes to address some practice concerns.

    (d) the final leases standard includes some application examples to help distinguish a service contract from one that contains a lease.

Overview of the targeted outreach

11. During March 2011, the staff met with a geographically diverse group of constituents, including preparers, accounting firms, working group members and others. A range of industries were represented, including retail, financial services, real estate, transportation, power and utilities, oil and gas, telecommunications, technology, outsourcing, shipping, airlines, health care and hospitality.

12. Some of those participating had, in comment letters or previous outreach, identified a number of examples for which it was difficult to determine whether the contract contains a lease when applying the proposals in the ED. These examples included, but were not limited to, transportation contracts (including time charterparty contracts in the shipping industry and wet leases in the aircraft industry) [1], IT outsourcing contracts, photocopying contracts, drilling rig contracts in the oil and gas industry, dark and lit fibre arrangements in the telecommunications industry, and power purchase agreements in the utilities industry (including those for which renewable energy credits are involved or pricing is stated in the contract but varies over time).

13. The main discussion points regarding the definition of a lease during the outreach were:

    (a) Should the definition of a lease refer to a specific or specified asset, meaning an asset that is uniquely identified or identifiable, or to an asset of a particular specification? As a consequence, how do rights to substitute an asset affect whether that asset is a specified asset?

    (b) Can both a physically distinct portion (eg a floor of a building) and a non-physically distinct portion (eg a capacity portion of a pipeline) of a larger asset be the subject of a lease?

[1] Time charterparty and wet lease arrangements provide the customer with a ship or airplane together with captain/pilot and crew for a period of time. Refer to agenda paper x for an example of a time charterparty arrangement.

(c) When does a customer have the right to control the use of a specified asset?

(d) Should the final leases standard address assets that are incidental to the delivery of services?

Summary of targeted outreach feedback regarding the definition of a lease

Overall comments

14. Overall, participants generally did not support widening the definition of ‘specified asset’ either to mean an asset of a particular specification or such that it would capture a non-physically distinct portion of a larger asset (as proposed in paragraphs C2-C5 of Appendix C to this paper).

15. Preparers and working group members were generally supportive of aligning the ‘right to control the use of an asset’ with the control concept applied in other projects (as proposed in paragraphs C8-C11 of Appendix C to this paper). The accounting firms had mixed views on control. Some supported aligning the control concept with other projects. Others had concerns about moving away from the current requirements and did not see the benefit in doing so at this time.

16. Preparers and working group members generally liked the idea of including guidance on assets that are incidental to the delivery of specified services (as proposed in paragraphs C6-C7 of Appendix C to this paper). However, most participants requested further information on how to apply the guidance and which contracts the guidance was intended to capture. There were also concerns about the guidance being used to avoid lease accounting.

17. A number of preparers requested that, regardless of the approach followed, the boards should be clear about which contracts are or are not intended to be leases for consistent application.

Specified asset—identifiable asset versus asset of a particular specification

18. Most outreach participants did not support changing ‘specified asset’ to mean an asset of a particular specification. They think that current guidance on the specified asset criterion works well. For some, being able to identify *an* asset (rather than one of a number of assets of a particular specification) is fundamental to the definition of a lease. They argued that it is necessary to know what the asset is in order to assess whether the customer has the right to control the use of *that* asset. In addition, if the boards decide that some leases are accounted for differently from others (either from the lessee’s or lessor’s perspective), they think that it is necessary to be able to identify *the* asset to enable the lessor or lessee to practically apply the indicators to determine the appropriate accounting for individual lease contracts, and to determine which asset to derecognise (if the lessor applies a derecognition-based approach).

19. Some supported the retention of a narrower interpretation of ‘specified asset’ for practical reasons. They agreed that ‘specified asset’ in theory should focus on an asset of a particular specification. However, they were concerned about the unintended consequences of widening the definition to the extent that it might scope in contracts that they perceived to be service contracts (eg some outsourcing contracts). Some preparers were unsure how to apply the specification guidance for the ‘asset of a particular specification’ approach, having tried to apply the preliminary draft guidance to some of their contracts.

20. Others supported widening the definition of a lease so that an asset of a particular specification could be the subject of a lease. They think that a right to use a particular *type* of asset is also a lease. They acknowledged that this approach would require more judgement but thought that the proposals would be operational.

21. Participants agreed that rights to substitute an asset are important. If a supplier has the substantive right to substitute an asset, a customer would not control the use of that asset. Many think that clear guidance around the substance of substitution rights wwould help identify the specified asset and avoid structuring concerns about defining a specified asset as a uniquely identifiable asset.

Specified asset—portions of a larger asset

22. Most participants welcomed clarification on portions of a larger asset and whether such a portion could be the subject of a lease, noting that it would aide consistent application and, thus, comparability among preparers. The lack of clarity regarding a portion of an underlying physical asset could create problems in identifying the unit of account and applying other accounting guidance.

23. Most did not support including the use of a non-physically distinct portion of an asset within the scope of the leases standard. Some argued that including capacity and non-physical portions of assets makes the definition too wide, implying that virtually every transaction could be considered to contain a lease.

24. Many also think that including a non-physically distinct portion would be overly complex to apply without significant benefits. This is because a contract for capacity would often not be a lease in any event because a customer is unlikely to be able to control the use of the capacity portion of a larger asset. Participants saw no point in widening the application of ‘specified asset’ and narrowing ‘control’ so that more contracts would have to be put through an assessment without necessarily changing the accounting that would result.

The right to control the use of a specified asset

25. Participants agreed that control is essential to defining a lease, and also noted that there is a link between the asset being specified and the right to control the use of that asset, ie the more specified the asset, the more likely it is that the customer controls the use of the asset.

26. Most participants (in particular preparers and working group members) supported aligning the ‘right to control the use of an asset’ with the control concept applied in the boards’ other projects. Those supporting this approach agreed that control should include both ‘power’ and ‘benefits’ elements. A number of preparers had also applied the proposed words to some contracts and expressed the view that the proposals could be applied from a practical perspective.

27. However, some participants asked for additional clarification about how to assess whether a customer has the 'ability to direct the use' of an asset, and how the indicators of control listed in the guidance were linked to the 'ability to direct the use'. In particular, some thought it would be important to distinguish between specifying the output or benefit from an underlying asset, and directing the use or operation of that underlying asset itself. There was some support for including 'exclusivity' in the guidance on the definition of a lease.

28. Some noted that the boards' revenue recognition control model extends well to leases when viewing the proposals from the lessor's perspective. However, they questioned whether that model could or should be applied for a lessee. Those participants recommended retaining the control approach proposed in the ED, arguing that it is easier to apply and, in their view, a better way to define 'control of the use of an asset' than aligning with other control concepts. Those participants had concerns about moving away from the proposals in the ED that were carried forward from current IFRSs and US GAAP. They proposed retaining the current guidance with minimal change because practice in applying that guidance is well established and there could be unintended consequences of making any significant changes to the definition.

29. Some participants supported changing the reference to 'output or other utility' to 'economic benefits from use'. However, some asked for clarification of whether income tax or other non-cash benefits were intended to be included as part of those economic benefits. Others preferred to retain 'output and other utility', nothing that for particular contracts, the asset may not create economic benefits directly or, in fact, ever generate cash flows (eg drilling of an oil well for which it is unknown whether the well will produce oil).

30. Some suggested that control should consider asset risk, ie who has the operational risk associated with the variability of the output or other utility of the asset. They think that if a customer has less than a majority of the exposure to the asset itself, then the contract is for services and the customer is only buying output of the asset.

Incidental asset

31. Participants generally welcomed guidance on incidental asset, although some were concerned about the extent to which the guidance might be used to try to avoid lease accounting.

32. A number of participants asked the boards to provide further application guidance or examples to help determine the types of transactions intended to be captured. For example, did the boards intend the guidance to capture photocopying contracts, outsourcing contracts, time charter arrangements or aircraft wet lease arrangements? Without such guidance, it is unclear how ‘incidental’ and ‘insignificant’ should be interpreted. Some commented that further clarification is needed to differentiate between situations when the service is supporting the asset and when the asset is supporting the service.

33. Some also suggested that the ‘incidental asset’ guidance could be embedded within either the ‘specified asset’ or the ‘right to control the use’ section of the definition.

Staff analysis

34. As discussed at the February 2011 meeting, the staff think that a lease should be defined as a contract that conveys the right to use an asset for a period of time in exchange for consideration. The feedback received from respondents to the ED, and through other outreach activities (including the targeted outreach in March 2011), confirmed that it is appropriate to determine whether a contract contains a lease by assessing whether a contract conveys the *right to control the use* of a *specified asset*.

35. This paper discusses the staff recommendations regarding the definition of a lease without repeating arguments for or against other approaches that were discussed in the February 2011 board papers. For further background information on the definition of a lease, and the feedback received during the comment period, you should refer to agenda papers 5C, 5D and 5E (FASB

memos 132, 133 and 134) from the joint meeting of week beginning 14 February 2011.

Specified asset

36. On the basis of the feedback received from the targeted outreach as well as from respondents to the ED and through other outreach, a majority of the staff recommends that a 'specified asset' is defined as an asset that is uniquely identified or identifiable for the following reasons:

    (a) Those staff think it is appropriate to define a lease as a contract that conveys the right to use a 'specified' or 'identifiable' asset, rather than any one of a number of assets of the same specification. If a customer recognises a right to use an asset, that asset should be identifiable. Similarly, if a supplier derecognises a right to use an asset (if using a derecognition approach), the asset being derecognised needs to be identifiable.

        For example, one preparer cited a contract for the transportation of coal via the use of towboats for a period of three years. The contract explicitly identifies seven towboats, which the supplier holds at his premises and operates when the customer requires coal to be transported. The supplier has substantive rights to substitute the towboats at any time for a towboat of at least the same horsepower. In practice, the supplier substitutes the towboats from time to time, and often the supplier uses a towboat with greater horsepower than the towboats listed in the contract to transport the customer's coal. The towboats listed in the contract can be used by the supplier for other purposes. In our view, the terms of the contract indicate that the contract is a contract for transportation services, rather than a right to use seven towboats because it is appears that the supplier controls the use of the towboats and not the customer.

(b) The targeted outreach identified that, if the boards were to widen the definition of a lease in this way, further application guidance would be required to make the requirements operational.

(c) This recommendation is in line with the proposals in the ED and current requirements in IFRSs and US GAAP, which generally work well in practice. With the exception of some comments on substitution rights noted in paragraph 37 below, comments received both during the comment period and in more recent outreach meetings did not identify any issues in applying this aspect of the definition of a lease.

37. This recommendation regarding 'specified asset' means a supplier's right to substitute alternative assets for the specified asset would result in the contract being considered a service, assuming that the rights to substitute are substantive and are not exercisable only when the specified asset is not operating properly. There were a number of concerns raised in comment letters about the guidance in the ED on substitution rights—the ED had proposed that an asset would be implicitly specified if a supplier has a right to substitute an asset but rarely does so in practice. We were informed by many respondents that 'rarely does so in practice' would be very difficult to make operational. Those words were removed from the targeted outreach paper.

38. Nonetheless, it is important to ensure that substitution rights that lack substance cannot be used as a means of avoiding lease accounting. Therefore, the guidance recommended in Appendices A and B to this paper proposes that a supplier's right to substitute would be substantive only when:

(a) it is practically and economically feasible or rational for the supplier to substitute the asset; and

(b) the supplier can substitute the asset at any time without requiring the customer's consent.

39. Paragraphs A2-A4 and B2-B4 of Appendices A and B to this paper include preliminary draft guidance reflecting the majority staff recommendation on 'specified assets' (both appendices include the same guidance).

40. Other staff recommend that a 'specified asset' is defined as an asset of a particular specification. This approach would say that if fulfilment of a contract depends on providing an asset of a particular specification, then that contract would contain a lease if the contract also conveys the right to control the use of an asset of that particular specification. The principle behind this approach is that the customer receives the same benefits from use of other similar or equivalent assets because it has the right to use an asset of the same functionality throughout the lease term.

41. Those staff members think that if the customer's right to use an asset of the same functionality throughout the lease term is not disrupted by the supplier providing a similar or equivalent type of asset, the benefit the customer receives from that right to use the asset would not be affected, regardless of which asset is used to fulfil the arrangement.

42. This approach was included in the targeted outreach—paragraphs C2-C4 of Appendix C to this paper include preliminary draft guidance defining a 'specified asset' as an asset of a particular specification.

Question 1 – Specified asset
Do the boards think that a 'specified asset' should be defined as an identifiable asset (paragraphs 36-39 of this paper) or as an asset of a particular specification (paragraphs 40-42 of this paper)?

A portion of a larger asset

43. On the basis of the feedback received from the targeted outreach as well as from respondents to the ED and through other outreach, we recommend that only physically-distinct portions of a larger asset can be a specified asset. Participants at the targeted outreach welcomed the clarification because this aides consistent application and comparability.

44. Although we acknowledge that, in theory, a non-physically distinct portion of a larger asset could be the subject of a lease, we agree with those who suggested that in most cases, a customer could not control the use of a non-physically

distinct portion of a larger asset. This is because decisions about the use of the asset are typically taken at the larger asset level. In addition, it might be difficult to assess whether the customer has rights to substantially all of the economic benefits from use of that portion of the larger asset. For example, if a customer contracts to use 20 per cent of the capacity of a pipeline to transport gas for a period of time, in practice, that customer would use all of the capacity of the pipeline on some days, and none on others. It is not the case that the customer has exclusive use of 20 per cent of the pipeline throughout the term of the contract. The customer's benefit from use of the pipeline may be affected by the use of the pipeline by other customers.

45. We think that widening the definition to possibly capture non-physically distinct portions of a larger asset would add a lot of complexity when assessing whether a contract contains a lease. It might force preparers to consider whether they have the right to use assets used in delivering any services received. One participant at the targeted outreach meetings mentioned, as an example, that such an approach might make an entity question whether it has the right to use a portion of the computers used by its auditors when performing audit services.

46. This approach means that, for example, contracts for capacity portions of a pipeline are unlikely to contain a lease. In contrast, capacity portions of a larger asset in the telecommunications industry might be physically distinct and therefore, could be specified assets if the contract explicitly or implicitly identifies that portion. For example, strands within a fibre-optic cable, and wavelengths within one strand, can be identified and physically distinct in that a customer can have the exclusive use of one stand within the cable, or one wavelength within the strand.

47. Paragraphs A5 and B5 of Appendices A and B to this paper include preliminary draft guidance reflecting the staff recommendation on portions on a larger asset (both appendices include the same guidance).

Question 2 – Specified asset—portions of a larger asset

Do the Boards agree with the staff recommendation that a physically-distinct portion of a larger asset can be a specified asset, but a capacity portion of a larger asset that is not physically-distinct cannot? If not, why not, and what would you propose?

Right to control the use of a specified asset

48. As noted in paragraphs 25-30 of this paper, most participants at the targeted outreach were supportive of an approach regarding the right to control the use of a specified asset that was more consistent with the control concept applied in other standards or proposed standards (as proposed in paragraphs C8-C11 of Appendix C to this paper). Such a change is likely to narrow the definition of lease to some extent by excluding, for example, some power contracts in the utilities industry. In other cases, it may not change the conclusions reached using the current requirements but might provide a clearer basis as to why a contract either does or does not contain a lease.

49. Participants were attracted to the approach mainly for the following reasons:

    (a) Some think that it is a more appropriate basis on which to assess whether a contract contains a lease and will lead to more consistent application with similar transactions. For example, consistency in how control is applied with the revenue recognition standard would lead to more consistent answers when applied by lessors who either lease or sell particular goods and services.

    (b) Those from the utilities industry are of the view that it will result in more appropriate conclusions when applied to power purchase contracts. In their view, some contracts are deemed to contain a lease according to current requirements even though they do not think that the customer has the right to use the underlying assets. Rather, those contracts are for the purchase of power.

50. Nonetheless, many asked for additional clarification of how that approach should be applied in particular situations, and other participants were concerned

about the consequences of moving away from current requirements. Preparers from the shipping and airline industries remain concerned that aircraft wet leases and ship time charter arrangements would be considered to contain leases when, in their view, those contracts are for services.

51. The following paragraphs describe the two approaches to the 'right to control the use' of a specified asset that were discussed by the boards in February 2011 and at targeted outreach meetings.

52. **Approach A:** Some staff support an approach that aligns more closely the application of control in the definition of a lease to how it is applied in the forthcoming revenue recognition standard, and the consolidation standards, for the reasons cited in paragraph 49 of this paper. Those staff also think that **Approach A**:

    (a) addresses some concerns raised that the proposed scope of the ED was too wide and would capture contracts that are service arrangements.

    (b) provides a clearer principle in determining whether a contract contain a lease or is for services. For example, we understand that practice has developed such that some contracts are structured to ensure that they do not meet the current control requirements when entities to a contract think that the contract is for services (for example, by ensuring that a customer obtains a large proportion of the output of an asset but just below what might be considered to be 'all but an insignificant amount' or by ensuring that the price is interpreted as a fixed price).

53. Appendix A to this paper sets out preliminary draft guidance for **Approach A** in paragraphs A6-A12. To address comments made by participants at the targeted outreach meetings, the preliminary draft guidance has been expanded to add some clarity about how to assess whether the customer has the ability to direct the use of an asset.

54. If the boards support **Approach A**, we would continue to seek input on the drafting of the guidance. We would also recommend including a number of application examples in the final leases standard.

55. **Approach B:** Other staff support retaining the proposals regarding the right to control the use of an asset in the ED, with minimal changes to address some practice concerns identified in the comment letters and through outreach, for the following reasons:

    (a) Although most participants at the targeted outreach preferred the direction of **Approach A**, some of those supporting **Approach A** also noted that the changes proposed in the outreach paper regarding **Approach B** were an improvement to the current requirements and the proposals in the ED. For example, participants generally supported the changes proposing the removal of the reference to ‘fixed price’ and ‘current market price’.

    (b) Moving to a new approach does not necessarily answer all of the questions and concerns raised by respondents to the ED. Those contracts that are more difficult to assess according to the current requirements may remain difficult to assess when applying a new approach. In addition, the new approach may create unintended consequences and would create additional implementation costs because of the need to apply the new guidance to all contracts, even though the conclusion of whether the contract does, or does not, contain a lease may not change.

    (c) Those staff note the concerns raised by some at the targeted outreach of making what they would view as substantial changes to the definition of a lease in this respect. In addition, **Approach A** is likely to scope out some take-or-pay contracts in the utilities industry that EITF 01-8 and IFRIC 4 were written to address.

56. Appendix B to this paper sets out preliminary draft guidance for **Approach B** in paragraphs B6 and B7. Staff supporting **Approach B** also recommend that a number of application examples are included in the final leases standard.

Question 3– Right to control the use of a specified asset

> 3. Do you think that the control concept applied within the definition of a lease should be consistent with how it is applied in other forthcoming or established standards (eg the forthcoming revenue recognition standard)? Therefore, a customer has the right to control the use of a specified asset if it has the ability to direct the use, and receive benefits from use, of that asset. [Paragraphs A6-A10 of Appendix A to this paper]
>
> Or, do you think that the control concept proposed in the ED (which is based on current guidance in IFRSs and US GAAP) should be retained with minimal changes to address some practice concerns? [Paragraphs B6-B7 of Appendix B to this paper]
>
> 4. Do you agree that the final leases standard should include some application examples to help distinguish a service contract from one that contains a lease?

Assets that are incidental to the delivery of services

57. Although most participants at the targeted outreach were supportive of including some guidance regarding assets that are incidental to the delivery of services, it is clear that, if such a concept were to be included, further clarification of its intended application would be required.

58. The tentative decisions of the boards in February 2011 regarding incidental assets defined such assets in two ways (as proposed in paragraphs C6 and C7 of Appendix C to this paper). The first was that an incidental asset represented an insignificant proportion of the overall contract; the second was that an incidental asset is a mechanism to facilitate the provision of a specified service requested by the customer such that the use of the asset was an inseparable part of the overall service.

59. Feedback received suggests that defining ‘incidental’ to mean ‘insignificant’ would possibly raise more questions than it answers. Insignificant compared to what? Insignificant in terms of the value of the overall services from the supplier’s perspective or in terms of the value received by the customer? Is

there a percentage at which the value becomes significant? For this reason, we do not recommend referring to assets that are ‘insignificant’ within the definition of a lease because we do not think it is a good basis on which to determine whether a contract contains a lease.

60. The second definition of incidental asset was trying to capture situations in which the asset may be specified but, nonetheless, the customer does not obtain a right to use the asset at commencement of the contract because the use of that asset is not separable or distinguishable from the overall service being provided.

61. Staff supporting **Approach A** regarding the right to control the use of an asset think that it would be helpful to retain this inseparable concept within the definition of a lease. However they would propose removing any reference to assets that are ‘incidental’ because that term has different meanings for different people.

62. Instead, they propose embedding the concept of an asset being separable within the section addressing the right to control the use of an asset. Paragraphs A11 and A12 of Appendix A to this paper set out preliminary draft guidance in this respect.

63. The wording proposed in those paragraphs is similar to that discussed in the revenue recognition project regarding separate performance obligations. In the revenue recognition project, the boards’ relevant tentative decisions can be summarised as follows:

    (a) a seller should account for a bundle of promised goods or services as one performance obligation if the seller provides a service of integrating those goods or services into a single item that the seller provides to the customer. [If this criterion is satisfied the seller need not consider the criteria in (b).]

    (b) a seller should account for a good as a separate performance obligation if the good is distinct. A good is distinct if either:

        (i) the entity regularly sells the good separately, or

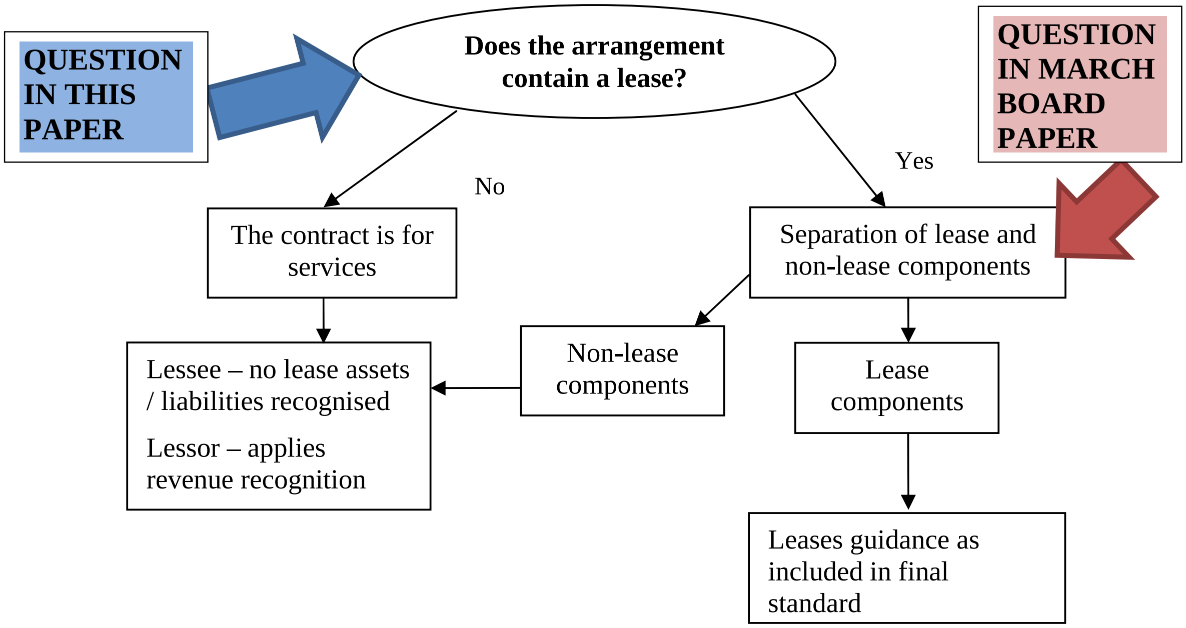
(ii) the customer can use the good either on its own or together with resources that are readily available to the customer.

64. We think that including the concept of an asset being 'separable' is appropriate within the definition of a lease and would be consistent with the approach regarding separate performance obligations in the revenue recognition project for the following reasons:

(a) If the use of an asset is separable from other services provided in a contract, the contract contains at least two separate components—(a) at the date of commencement of the contract, the customer receives the right to use an asset, which could be used on its own or together with other resources; (b) over the term of the contract, the customer may then receive the other services embedded within the contract. For example, the right to use a photocopier is often separable from the services included within such a contract. Therefore such a contract would contain a lease if the photocopier is explicitly or implicitly identified in the contract. This is consistent with the revenue recognition project because if goods are separable (or 'distinct' as used in the revenue recognition project) from any services that are included in the same contract, the customer is deemed to obtain the goods, often in advance of the services. In that case, the seller would recognise revenue for the sale of that good in advance of recognising revenue for the delivery of services over time.

(b) If the use of an asset is an inseparable part of the overall services provided, the customer effectively does not receive anything at the date of commencement of the contract. Rather, the customer receives services over the term of the contract that require the use of the asset. Therefore, in this case, it is appropriate that the customer does not recognise a right-of-use asset at the date of commencement. Similarly from the supplier's perspective, the supplier has not delivered anything to the customer at the date of commencement. The supplier will provide services over the term of the contract that require the supplier to use its own asset to deliver the services. Therefore, in this case, it is appropriate that the supplier does not recognise revenue or derecognise some or all of the underlying asset at the date of commencement. For example, a construction of a building that requires the use of specialised equipment would generally not contain a lease of that equipment if the constructor directs the use of that equipment, which is an inseparable part of the overall delivery of construction services to the customer.

65. It is important to remember that the discussion about separability in this paper is different from the discussion about bundled contracts that the boards discussed, and made tentative decisions about, at the March 2011 joint board meeting as shown in the following diagram. This is because, according to the proposals in this paper, the concept of separability would be used to help decide whether an entire contract is a service arrangement or contains a lease (step 1 in analysing a contract). The boards' tentative decisions in March 2011 relate to step 2 in the analysis—if it is concluded that a contract contains a lease, how should a lessee and lessor treat non-lease components within that contract? However, if the boards were to agree with the proposal in this paper, then assuming that a contract does contain a lease, there are likely to be relatively few contracts for which it would not be possible to separate the lease component from any non-lease components as discussed in March 2011.



66. If the boards support **Approach A** regarding the right to control the use of an asset, the staff recommend including the guidance on separable assets as part of guidance on the definition of a lease (paragraphs A11 and A12 of Appendix A to this paper). We believe that it provides more consistency with the approach developed in the revenue recognition standard and therefore will lead to more consistent accounting by sellers/lessors for lease contracts and revenue contracts.

67. Some of those staff supporting **Approach B** regarding the right to control the use of an asset also recommend including the guidance on separable assets as part of the guidance on the definition of a lease.

68. Other staff supporting **Approach B** regarding the right to control the use of an asset recommend *not* including any guidance on assets that are incidental to or separable from the overall service being provided. This is because they view **Approach B** as one that proposes a minimal amount of change to the proposals in the ED (and to current guidance) regarding the definition of a lease.

Question 4 – Guidance on separable assets
Do you think that the description of the 'right to control the use' of a specified asset should include guidance on separable assets? [Paragraphs A11-A12 of Appendix A to this paper]

Appendix A: preliminary draft guidance relating to the definition of a lease (Approach A in this paper)

The preliminary draft guidance included in this appendix has been prepared by the staff to help the boards reach decisions regarding the definition of a lease. The boards have not yet made decisions about the views reflected in this appendix, and, therefore, the guidance is subject to change. This appendix reflects the following:

- *defining a specified asset as an identifiable asset—paragraphs A2-A4 below,*
- *clarifies that physically distinct portions of a larger asset can be specified assets, and that non-physically portions are not specified assets—paragraph A5 below, and*
- *revises the description of control to be consistent with the revenue recognition project and includes guidance on separable assets —paragraphs A6-A12 below.*

[Note: the guidance proposed in paragraphs A1-A5 is exactly the same as is proposed in paragraphs B1-B5 of Appendix B.]

Definition of a Lease

A1. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:

(a) the fulfilment of the contract depends on the use of a specified asset or assets (the underlying asset) (paragraphs A2-A5); and

(b) the contract conveys the right to control the use of a specified asset or assets for a period of time (paragraphs A6-A12).

Fulfilment of the contract depends on the use of a specified asset

A2. In assessing whether fulfilment of the contract depends on the use of a specified asset, a customer and supplier shall consider whether the underlying asset is explicitly or implicitly identified. An asset is implicitly identified if it would not be practically and economically feasible for the supplier to substitute alternative assets in place of the underlying asset during the lease term. For example, in a contract that conveys the right to use an aircraft, it may not be practical to substitute another aircraft if extensive changes have been made to the underlying asset (the aircraft) to suit the customer's image, brand and requirements.

A3. A contract is not the subject of a lease if fulfilment of the contract is not dependent on the use of the specified asset. For example, if a supplier of a specified quantity of goods or services has the right and current ability to deliver those goods or services using assets not identified in the contract (ie if the supplier has a substantive right to substitute the underlying asset), the underlying asset is not specified and the contract does not contain a lease. A supplier's right to substitute the underlying asset is substantive if (a) it is practically and economically feasible for the supplier to substitute the asset and (b) the supplier can substitute the asset at any time without requiring the customer's consent.

A4. However, a supplier's right or obligation to substitute other assets only when the specified asset is not operating properly does not prevent the customer from controlling the use of the asset. In addition, a supplier's right or obligation to substitute other assets for any reason on or after a specified date does not prevent the customer from controlling the use of the asset before the date of substitution.

A5. The underlying asset can be a physically distinct portion of a larger asset (eg a floor of a building) if that portion is explicitly or implicitly specified. A capacity portion of a larger asset that is not physically distinct (eg 50 per cent capacity of a pipeline) is not a specified asset.

Contract conveys the right to control the use of a specified asset

A6. A contract conveys the right to control the use of the underlying asset if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term.

A7. A customer's ability to receive the benefit from use of a specified asset refers to its present right to obtain substantially all of the potential economic benefits from use of that asset throughout the lease term. The customer can obtain economic benefits from use of a specified asset directly or indirectly in many ways such as by using, consuming or holding the asset, or sub-leasing the right to use the asset. The economic benefits from use of a specified asset include those that arise directly from the use of the asset (eg renewable energy credits; secondary physical output), and exclude income tax benefits (eg capital allowances).

A8. When assessing whether a customer has the ability to direct the use of a specified asset, a customer and supplier shall consider all available evidence. The ability to direct the use of a specified asset can be evidenced by having the ability to make decisions about using the specified asset that significantly affect the benefit received by the customer from that use throughout the lease term. Examples of decisions that significantly affect the benefit received by the customer include, but are not limited to:

(a) determining how, when, and in what manner the specified asset is used; or

(b) determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer.

A9. If a customer can specify the output or benefit from use of the asset, but is unable to make decisions about the input or process that result in that output, the ability to specify the output would not, in and of itself, be determinative that the customer has the ability to direct the use of the asset. For example, a customer's ability to specify the quantity and timing of delivery of goods would not, in and of itself, be determinative that the customer has the ability to direct the use of the assets used to make the goods, even if the customer obtains substantially all of the goods produced by those assets. In contrast, if the supplier operates an asset according to the instructions of the customer, the customer has the ability to direct the use of that asset.

A10. The following may indicate that the customer has obtained the right to control the use of a specified asset. However, when considered in isolation, none of these indicators would be determinative that the customer has that right:

(a) The customer controls physical access to the specified asset.

(b) The design of the asset is customer-specific and the customer has been involved in designing the specified asset.

(c) The customer has rights to obtain substantially all of the economic benefits from use of the specified asset throughout the lease term.

A11. For some contracts, the supplier directs the use of the asset used to perform services requested by the customer. In such cases, if the asset is explicitly or implicitly identified, the customer and supplier shall assess whether:

(a) the use of the asset is an inseparable part of the services requested by the customer. In that case, the contract is for services because the customer has not obtained the right to control the use of the asset; or

(b) the asset is separable from the services provided. In that case, the customer has obtained the right to control the use of the asset and has outsourced the direction of that use to the supplier.

A12. Any one of the following indicates that the asset is separable:

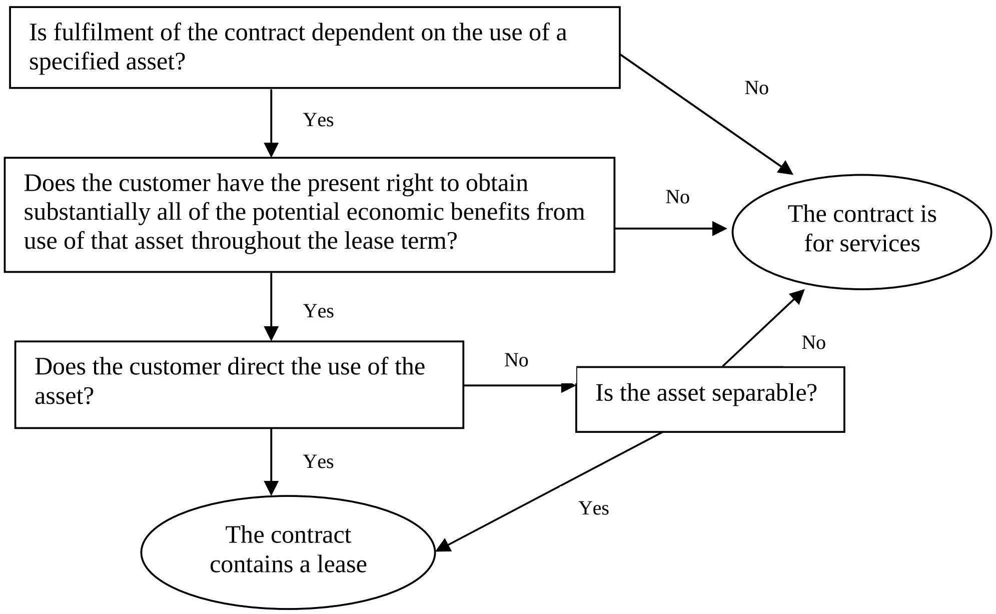
(a) The customer can use the asset on its own or together with other resources that are readily available to the customer.

(b) The asset is sold or leased separately by the supplier.

(c) The right to use the asset and the services were negotiated separately between the supplier and customer.

A contract for a bundle of assets and services that are highly interrelated such that the supplier provides a significant service of integrating those assets and services into the item for which the customer has contracted indicates that the asset is not separable.

Approach A—decision flowchart



Appendix B: preliminary draft guidance relating to the definition of a lease (Approach B in this paper)

The preliminary draft guidance included in this appendix has been prepared by the staff to help the boards reach decisions regarding the definition of a lease. The boards have not yet made decisions about the views reflected in this appendix, and, therefore, the guidance is subject to change. This appendix shows marked changes from what was originally proposed in paragraphs B1-B4 of the leases ED to:

- *define a specified asset as an identifiable asset—paragraphs B2-B4 below,*
- *clarifies that physically distinct portions of a larger asset can be specified assets, and that non-physically portions are not specified assets—paragraph B5 below, and*
- *retains the control concept in the ED with some clarifications—paragraphs B6 and B7 below.*

[Note: the guidance proposed in paragraphs B1-B5 is exactly the same as is proposed in paragraphs A1-A5 of Appendix A.]

Definition of a lease

B1. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:

(a) the fulfilment of the contract depends on ~~providing~~ the use of a specified asset or assets (the 'underlying asset') (paragraphs B2 to B5); and

(b) the contract conveys the right to control the use of a specified asset or assets for a ~~an agreed~~ period of time (paragraph B6 and B7).

Fulfilment of the contract depends on ~~providing~~ the use of a specified asset

B2. In assessing whether fulfilment of the contract depends on ~~providing~~ the use of a specified asset, ~~or assets (the 'underlying asset') to the lessee, it may be necessary to~~ a customer and supplier shall consider whether the asset or assets are implicitly or explicitly identified. An asset is implicitly ~~'specified'~~ identified if it ~~is (a) infeasible or impractical~~ would not be practically and economically feasible for ~~a lessor~~ the supplier to ~~provide~~ substitute alternative assets in place of the underlying asset during the lease term ~~or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice~~. For example, in a ~~lease of~~ contract that conveys the right to use an aircraft, it may not be practical to substitute another aircraft if ~~the lessee has made~~ extensive changes have been made to the underlying asset (the aircraft) to suit the ~~lessee's~~ customer's image, brand and requirements.

B3. ~~A contract that permits an entity to substitute a similar asset for the specified asset after the date of commencement of the lease does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset.~~ A contract is not the subject of a lease if fulfilment of the contract is not dependent on the use of the specified asset. For example, if a supplier of a specified quantity of goods or services has the right and current ability to ~~provide~~ deliver those goods or services using assets not ~~specified~~ identified in the ~~arrangement~~ contract (ie if the supplier has a substantive right to substitute the underlying asset), the underlying asset~~s are~~ is not specified and the contract does not contain a lease. A supplier's right to substitute the underlying asset is substantive if (a) it is practically and economically feasible for the supplier to substitute the asset and (b) the supplier can substitute the asset at any time without requiring the customer's consent.

B4. However, a ~~contract that permits or requires the supplier~~ supplier's right or obligation to substitute other assets only when the specified asset is not operating properly ~~may be a lease~~ does not prevent the customer from controlling the use of the asset. In addition, ~~a contractual provision (contingent or otherwise) that permits or requires a supplier~~ a supplier's right or obligation to substitute other assets for any reason on or after a specified date does not ~~preclude lease treatment~~ prevent the customer from controlling the use of the asset before the date of substitution.

B5. The underlying asset can be a physically distinct portion of a larger asset (eg a floor of a building) if that portion is explicitly or implicitly specified. A capacity portion of a larger asset that is not physically distinct (eg 50 per cent capacity of a pipeline) is not a specified asset.

Contract conveys the right to control the use of a specified asset

B6. A contract conveys the ~~right to use an asset if it conveys to an entity the right to control the use of the underlying asset during the lease term. The~~ right to control the use of the underlying asset ~~is conveyed~~ if any one of the following conditions is met:

(a) The ~~entity~~ customer has the ability or right to operate the asset or direct others to operate the asset in a manner that it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

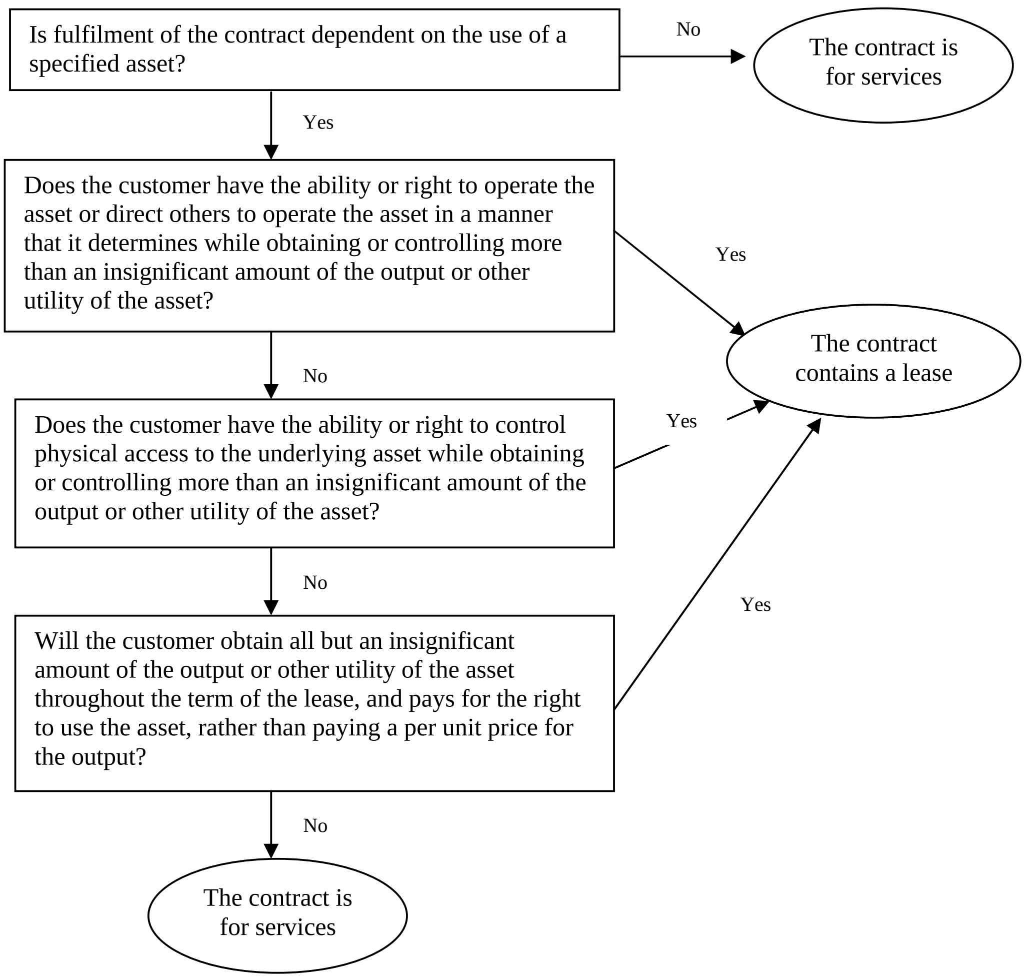
(b) The ~~entity~~ customer has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) The ~~entity~~ customer will obtain all but an insignificant amount of the output or other utility of the asset ~~during~~ throughout the term of the lease, and pays for the right to use the asset, rather than paying a per unit price for the output. ~~the price that the entity will pay for the output is neither contractually fixed per unit of ouput nor equal to the current market price per unit of output as of the time of delivery of the output. If the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of output, then the entity is~~

~~paying for a product or service rather than paying for the right to use the underlying asset~~.

B7. The output or other utility of an asset might include non-physical output such as renewable energy credits, and excludes income tax benefits (eg capital allowances).

Approach B—decision flowchart



Appendix C: Targeted outreach—boards preferred approach at February 2011 joint meeting

The preliminary draft guidance in this appendix:

- *defines a specified asset as an asset of a particular specification,*
- *clarifies that both physically distinct and non-physically distinct portions of a larger asset can be specified assets*
- *adds guidance to address assets that are incidental to the delivery of services, and*
- *revises the description of control to be consistent with the revenue recognition project.*

Definition of a Lease

C1. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:

(a) the fulfilment of the contract depends on providing a specified asset or assets (paragraphs C2-C7); and

(b) the contract conveys the right to control the use of a specified asset for a period of time (paragraphs C8-C11).

Fulfilment of the contract depends on providing a specified asset

C2. In assessing whether fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') to the customer, a customer and supplier shall consider whether the underlying asset is explicitly or implicitly identified. An asset is implicitly specified if it is not practical or economically feasible for the supplier to provide alternative assets in place of the underlying asset during the lease term. For example, in a contract that conveys the right to use an aircraft, it may not be practical to substitute another aircraft if the contract requires extensive changes to the underlying asset (the aircraft) to suit the customer's image, brand and requirements.

C3. The specificity of the underlying asset in the contract shall be both quantitative (eg size, capacity) and qualitative (eg design, functionality, location) for a specified asset or assets to exist. The specificity of an underlying asset shall be such that the benefits received by the customer would vary or be disrupted if an asset or assets of a different specification were provided by the supplier.

C4. A contract is not the subject of a lease if fulfilment of the contract is not dependent on the use of the specified asset or an asset with the same specification. For example, if a supplier of a specified quantity of goods or services has the right and current ability to provide those goods or services using assets not identified in the contract, the underlying assets are not specified and the contract does not contain a lease. However, a supplier's right to substitute a specified asset does not necessarily prevent a customer from controlling the use of the specified asset. For example, if a supplier has a right to substitute a specified asset for an asset of the same specification, the contract would still contain a lease if the customer retains the right to control the use of the specified asset or an alternative asset of the same specification.

C5. The underlying asset can be a portion of a larger asset (eg strands within, or capacity of, a fibre-optic data cable) if that portion is explicitly or implicitly specified. A portion of a larger asset is not a specified asset if the benefit received by a customer from use of the portion can vary or be disrupted because of the supplier's or other parties' use of the larger asset.

Assets that are incidental to the delivery of a service

C6. A contract may explicitly or implicitly identify an asset, but does not contain a lease if the asset is incidental to the provision of a service. The asset is likely to be incidental to the provision of a service when:

(a) specification of the asset is determined by the supplier as a mechanism to facilitate providing the service requested by the customer in the contract, such that the use of the asset is an inseparable part of that service; or

(b) the asset component of the contract is insignificant in terms of its benefit to the customer when compared to the service components of the contract.

C7. For example, a customer may contract with a supplier of digital television satellite services to view particular television channels. In the contract, the customer specifies the television channels that it would like to view, but the supplier determines and specifies the type of digital cable box to be provided to allow the customer to view the television channels.

Contract conveys the right to control the use of a specified asset

C8. A contract conveys the right to use a specified asset if it conveys to a customer the right to control the use of the underlying asset throughout the lease term. The right to control the use of the underlying asset is conveyed if the customer has the ability to direct the use of, and receive the benefit from use of, a specified asset throughout the lease term.

C9. When assessing whether a customer has the ability to direct the use of a specified asset, a customer and supplier shall consider all available evidence. The ability to direct the use of a specified asset can be evidenced as follows:

(a) By having the ability to make decisions about using the specified asset that significantly affect the benefit received by the customer from that use throughout the lease term. Examples of decisions that, depending on the circumstances, might significantly affect the benefit received by the customer include, but are not limited to:

(i) determining how, when, and in what manner the specified asset is operated;

(ii) determining whether and for what purpose the specified asset is used;

(iii) determining when and in what quantities benefits flow from the specified asset; or

(iv) determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer.

(b) A specified asset may deliver the benefit from its use to the customer without any substantive decision-making or other direction of assets or resources being required about its use after commencement of the lease. In this case, the customer has obtained the ability to direct the use of the specified asset at the inception of the contract.

C10. A customer's ability to receive the benefit from use of a specified asset refers to its present rights to obtain substantially all of the potential cash flows from use of that specified asset throughout the lease term. The customer can obtain cash flows from use of a specified asset directly or indirectly in many ways such as by using, consuming or holding the specified asset, or sub-leasing the right to use the specified asset.

Indicators of the right to control the use of a specified asset

C11. For some contracts, although the customer has the ability to receive the benefit from use of a specified asset, it may not be clear whether that customer has the right to control the use of that asset. If, having considered the factors in paragraphs A7 and A7, it is still unclear whether a contract contains a lease, additional facts and circumstances that indicate that the customer has, or does not have, the right to control the use may help with that determination. For example, the following may indicate that the customer has obtained the right to control the use of a specified asset:

(d) The customer controls physical access to the specified asset.

(e) The design or function of the asset is customer-specific and the customer has been involved in designing the specified asset.

(f) The customer has rights to obtain substantially all of the potential cash flows from use of the specified asset throughout the lease term and pays for the right to use the asset, rather than making payments that depend on amount of benefit that flows to the customer from use of the asset.

Appendix D: Targeted outreach—alternative approach discussed at February 2011 joint meeting

The preliminary draft guidance in this appendix starts with the guidance included in paragraphs B1-B4 of the leases ED, and 'marks-up' changes to that guidance, which:

- *defines a specified asset as a uniquely identifiable asset,*
- *clarifies that physically distinct portions of a larger asset can be specified assets,*
- *adds guidance to address assets that are incidental to the delivery of services, and*
- *retains the control concept in the ED with some clarifications.*

Definition of a lease

D1. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:

(a) the fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') (paragraphs D2 to D6); and

(b) the contract conveys the right to control the use of a specified asset for a ~~an agreed~~ period of time (paragraph D7).

Fulfilment of the contract depends on providing a specified asset

D2. In assessing whether fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset') to the lessee, it may be necessary to consider whether the asset or assets are implicitly or explicitly identified. An asset is implicitly 'specified' if it ~~is (a) infeasible or impractical~~ would not be practical or economically feasible for a lessor to provide alternative assets in place of the underlying asset during the lease term ~~or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice~~. For example, in a lease of an aircraft, it may not be practical to substitute another aircraft if the lessee has made extensive changes to the underlying asset (the aircraft) to suit the lessee's image, brand and requirements.

D3. ~~A contract that permits an entity to substitute a similar asset for the specified asset after the date of commencement of the lease does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset.~~ Although an asset may be explicitly identified in a contract, it is not a specified asset if fulfilment of the contract is not dependent on the use of that asset. For example, if a supplier of a specified quantity of goods or services has the right and current ability to provide those goods or services using assets not ~~specified~~ identified in the ~~arrangement~~ contract, the underlying assets are not specified assets and the contract does not contain a lease. However, a contract that permits or requires the supplier to substitute other assets only when the specified asset is not operating properly may be a lease. In addition, a contractual provision (contingent or otherwise) that permits or requires a supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

D4. In some contracts, the asset identified in the contract is a portion of a larger asset. A physically distinct portion of a larger asset (eg a floor of a building) can be a specified asset.

Assets that are incidental to the delivery of a service

D5. A contract may explicitly or implicitly identify an asset, but does not contain a lease if the asset is incidental to the provision of a service. The asset is likely to be incidental to the provision of a service when:

(a) specification of the asset is determined by the supplier as a mechanism to facilitate providing the service requested by the customer in the contract, such that the use of the asset is an inseparable part of that service; or

(b) the asset component of the contract is insignificant in terms of its benefit to the customer when compared to the service components of the contract.

D6 For example, a customer may contract with a supplier of digital television satellite services to view particular television channels. In the contract, the customer specifies the television channels that it would like to view, but the supplier determines and specifies the type of digital cable box to be provided to allow the customer to view the television channels.

Contract conveys the right to control the use of a specified asset

D7. A contract conveys the right to use an asset if it conveys to an entity the right to control the use of the underlying asset during the lease term. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

(a) The entity has the ability or right to operate the asset or direct others to operate the asset in a manner that it determines while obtaining or controlling more than an insignificant amount of the ~~output or other utility~~ economic benefits from use of the asset.

(b) The entity has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of ~~the output or other utility~~ economic benefits from use of the asset.

(c) The entity ~~will~~ has rights to obtain ~~all but an insignificant amount of the output or other utility~~ substantially all the economic benefits from use of the asset ~~during~~

throughout the term of the lease, and pays for the right to use the asset, rather than making payments that depend on the amount of economic benefits that flow to the entity from use of the asset ~~the price that the entity will pay for the output is neither contractually fixed per unit of ouput nor equal to the current market price per unit of output as of the time of delivery of the output. If the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of output, then the entity is paying for a product or service rather than paying for the right to use the underlying asset~~.