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Project	<b>Leases</b>
Topic	<b>Definition of a lease and two types of leases</b>

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## The definition of a lease

1. The leases exposure draft (ED) defined a lease as 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. Paragraphs B1-B4 of the ED provided additional application guidance for the definition of a lease by using the following two principles, which are similar to those included in IFRIC 4 *Determining whether an Arrangement contains a Lease* and Topic 840 *Leases* in the *FASB Accounting Standards Codification*<sup>®</sup>:
  - (a) the fulfilment of the contract depends on providing a specified asset or assets (the ‘underlying asset’); and
  - (b) the contract conveys the right to control the use of a specified asset for an agreed period of time.
3. Respondents to the ED and others with whom we engaged through outreach activities generally agreed with the definition of a lease and the principles relating to that definition. However, many requested additional clarity about how those principles should be applied. They noted that the consequence of determining that a contract contains a lease would be the recognition of an asset and a liability by the lessee, whereas this would not be the case today if the lease is an operating lease.
4. On the basis of comments received, we identified four topics that the boards discussed on 17 February 2011:
  - (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

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This paper has been prepared for discussion at a public meeting of the Global Preparers Forum of the IASB.

The views expressed in this paper are those of the authors.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

## GPF Meeting Paper

asset of a particular specification? As a consequence, how do rights to substitute an asset affect whether than asset is a specified asset?

- (b) Can a portion of a larger asset be the subject of a lease?
  - (c) Should the final standard address assets that are incidental to the delivery of specified services?
  - (d) When does a customer have the right to control the use of a specified asset?
5. The boards decided that it would conduct targeted outreach to obtain further input about possible changes to the requirements relating to the definition of a lease. This paper forms part of that outreach. Input that we receive from the GPF at this meeting will help the boards make final decisions about the definition of a lease at future board meetings.
6. Appendices A and B to this paper sets out preliminary draft wording proposing changes to the wording of the ED regarding the definition of a lease to respond to concerns raised by respondents to the ED.
7. Appendix A proposes to clarify some aspects of the two principles relating to the definition of a lease. Appendix B sets out more extensive changes to the meaning of both 'specified asset' and 'control the use of an asset'. Agenda papers 5D and 5E discussed at the 17 February 2011 board meeting provide more detailed information and analysis of each of the four topics mentioned in paragraph 4 above. Those papers are available on <http://www.ifrs.org/Meetings/IASB+meeting+February+2011.htm>

**Questions –Definition of a lease**

1. With respect to each of the appendices to this paper, do you think that the preliminary draft wording:
  - (a) provides a better basis on which to determine whether a contract contains a lease compared with the wording included in paragraphs B1-B4 of the ED?
  - (b) can be consistently applied?
  - (c) would create any new issues or unintended consequences?
2. Do you have any suggestions as to how to improve the wording?

In responding to those questions, it would be useful to illustrate your response by referring to typical contracts that may contain a lease.

## Two types of leases

8. The leases ED proposed a single lessee accounting approach. This approach requires that for *all* leases a lessee:
  - (a) recognise a right-of-use asset and a liability to make lease payments;
  - (b) amortises the right-of-use asset over the lease term or useful life of the underlying asset if shorter (typically on a straight-line basis); and
  - (c) incurs interest expense on the liability to make lease payments, using the effective interest method.
9. As a consequence of the combination of straight-line amortisation of the right-of-use asset and use of the effective interest method to recognise interest expense, a lessee would typically recognise higher expenses in the earlier years of a lease than in the later years.
10. Respondents to the ED had mixed views on the approach proposed in the ED, with some suggesting that there should be two types of leases for lessees as well as for lessors. [Refer to paragraphs 15-24 of paper 7A attached.] Specifically, some respondents were concerned with the expectation that, when applying the proposals in the ED, lessees would typically recognise higher expenses in the earlier years of a lease than in the later years. These respondents supported a straight-line profit or loss recognition pattern for some, or all leases, with some thinking this recognition pattern would be closer to the pattern of cash payments made by the lessee.
11. The boards discussed the attached paper (paper 7A) regarding two types of leases on 17 February 2011. The board decided to conduct targeted outreach to obtain further input regarding an accounting approach that identifies two types of leases for both lessees and lessors. This paper forms part of that outreach. Input that we receive from the GPF at this meeting will help the boards make final decisions about the lessee accounting model, and possibly the lessor accounting model, at future board meetings.

**Questions –Lessee accounting model**

1. Do you prefer that:

- i) all lessees recognise profit or loss on a consistent basis for **all** leases and that this basis should create a higher lease expense in the early years of a lease (refer to paragraphs 26-30 and 40-44 of paper 7A for arguments in favour of the approach in the ED); or that
- ii) lessees recognise higher lease expense in the early years of some lease arrangements (eg those with a significant financing element) and a straight-line pattern of lease expense recognition for other lease arrangements (eg those with an insignificant financing element) (refer to paragraphs 31-37 of paper 7A)?

2. If you prefer approach ii) above, what indicators would help distinguish between those leases recognising a straight-line pattern of lease expense and those leases recognising higher lease expense in the early years? (refer to paragraphs 57-68 for a discussion of distinguishing features)?

## **Appendix A: preliminary draft wording relating to the definition of a lease**

*The preliminary draft wording included in this appendix has been prepared by the staff to illustrate possible changes that could be made to the requirements relating to the definition of a lease. The preliminary draft wording starts with the wording included in paragraphs B1-B4 of the leases ED, and ‘marks-up’ changes to that wording to reflect the following:*

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

*The boards have not yet made decisions about the views reflected in this appendix and, therefore, the wording is subject to change. The changes reflected in this appendix are not necessarily interlinked, ie the boards could decide to make some but not all of the changes proposed in this appendix.*

### **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 providing a specified asset or assets (the ‘underlying asset’) (paragraphs ~~B~~A2 to ~~B~~A6); and
  - (b) the contract conveys the right to control the use of a specified asset for ~~a an~~ an agreed period of time (paragraph ~~B4~~A7).

### ***Fulfilment of the contract depends on providing a specified asset***

- A2. 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~~ not 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

## GPF Meeting Paper

lessee has made extensive changes to the underlying asset (the aircraft) to suit the lessee's image, brand and requirements.

A3. ~~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 a specified asset may be explicitly identified in a contract, it 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 those goods or services using assets not specified in the arrangement, the underlying assets are not specified 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.

A4. For some contracts, the underlying asset 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

A5. A contract may explicitly or implicitly identify an underlying 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 for providing a specified service requested by the customer in the contract; 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.

A6. For example, a customer may contract with a supplier of digital television satellite services to view specified television channels. In the contract, the customer specifies the television channels that it would like to view, but the

## GPF Meeting Paper

supplier determines and specifies the type of digital cable box to be provided to allow the customer to view the specified channels.

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

A7. 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~~ potential cash flows 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~~ potential cash flows 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 potential cash flows 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 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 output 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.~~



## **Appendix B: preliminary draft wording relating to the definition of a lease**

*The preliminary draft wording included in this appendix has been prepared by the staff to illustrate possible changes that could be made to the requirements relating to the definition of a lease. The preliminary draft wording reflects the following:*

- *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 wording to address assets that are incidental to the delivery of services, and*
- *revises the description of ‘control the use of an asset’ to be consistent with the control concept in the revenue recognition project.*

*The boards have not yet made decisions about the views reflected in this appendix and, therefore, the wording is subject to change. The changes reflected in this appendix are not necessarily interlinked, ie the boards could decide to make some but not all of the changes proposed in this appendix.*

### **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 a specified asset or assets; and
- (b) the contract conveys the right to control the use of a specified asset for a period of time.

### ***Fulfilment of the contract depends on providing a specified asset***

B2 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

## GPF Meeting Paper

requires extensive changes to the underlying asset (the aircraft) to suit the customer's image, brand and requirements.

- B3 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 not vary if an asset or assets of a different specification is used.
- B4 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 specified in the arrangement, 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.
- B5 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 because of the supplier's or other parties' use of the larger asset.

*Assets that are incidental to the delivery of a service*

- B6 A contract may explicitly or implicitly identify an underlying 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 for providing a specified service requested by the customer in the contract; or

## GPF Meeting Paper

(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.

B7 For example, a customer may contract with a supplier of digital television satellite services to view specified 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 specified channels.

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

B8 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.

B9 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

## GPF Meeting Paper

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.

- B10 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*

- B11 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 B9 and B10, 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:
- (a) The customer controls physical access to the specified asset.
  - (b) The design or function 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 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.