IASB/FASB Meeting
Week beginning 14February 2011

IASB Agenda reference	5C
FASB Agenda reference	131

Staff Paper

Project	**Leases**
Topic	**Principles relating to the definition of a lease**

Purpose

1. This paper, together with agenda papers 5D and 5E, discusses the principles in the *Leases* exposure draft (ED) relating to the definition of a lease. 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. Paragraphs B1-B4 of the ED provide additional application guidance for the definition of a lease by using the following two principles:

   (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. The objective of these papers is to identify how those principles in the ED regarding the definition of a lease could be clarified to address comments received from respondents to the ED, working group members, participants at the leases round table meetings and workshops and other interested parties through other outreach activities.

4. These papers will focus on the two principles underlying the definition of a lease:

   (a) That a lease involves a *specified asset* [agenda paper 5D], and

   (b) That a lease involves the right to *control* the use of that specified asset [agenda paper 5E].

Structure of the papers

5. This paper provides general background to the issue together with a summary of comments received from respondents on the definition of a lease and the staff recommendations discussed in agenda papers 5D and 5E. Agenda paper 5D discusses issues relating to the meaning of 'specified asset', and agenda paper 5E discusses 'the right to control the use of a specified asset'.

6. We have included in Appendices A and B to this paper some preliminary draft wording reflecting the views set out in agenda papers 5D and 5E. We plan to seek input through targeted outreach on that preliminary draft wording relating to the definition of a lease. We will ask those with whom we engage to apply the words to transactions so that we have a better understanding of the implications of the proposed changes, and to test whether the language would provide a better basis on which to determine whether a contract contains a lease. The feedback received will provide the boards with input to help make final decisions about the principles relating to the definition of a lease.

7. Our intent is that the appendices, once integrated and updated for discussions in this meeting, form the basis for our targeted outreach.

8. This paper contains:

   (a) Background (paragraphs 9-12)

   (b) Comment letters and other feedback (paragraphs 13-18)

   (c) Staff analysis (paragraphs 19-21)

   (d) Staff recommendations (paragraphs 22-24)

(e) Appendices A and B—preliminary draft wording of proposed changes to the principles relating to the definition of a lease.

Background

9. On 19 January 2011 and 1 February 2011, the boards discussed in joint non-decision making meetings the definition of a lease and how to distinguish between a lease and a service. This issue was one of the main concerns identified by respondents to the ED.

10. In particular, at the 1 February 2011 meeting, the boards discussed two examples, one involving rail cars, the other involving a fibre-optic cable, to identify which factors help determine how the principles underlying a 'specified asset' and the 'right to control the use of a specified asset' should be applied in determining whether an arrangement contains a lease.

11. As noted in the meetings, the ED introduces additional stress on the application of these principles compared with current practice because, when the definition of a lease is met, a lessee is required to recognise a right-of-use asset and a liability to make lease payments. However, the staff note that some of this additional stress may be reduced by tentative decisions made by the boards to simplify other aspects of the ED (eg the definition of a lease term (agenda paper 5B) and accounting for variable lease payments (agenda paper 5A)).

12. Neither this paper, nor agenda papers 5D or 5E, discuss how a contract that includes both the right to use an asset and other services should be accounted for. This will be addressed in a future paper.

Comment letters and other feedback received

13. The majority of respondents supported maintaining the definition of a lease proposed in the ED, which is similar to definitions in existing US GAAP and IFRS requirements.

14. They also agreed that the principles underlying this definition, largely carried forward from existing requirements, should be maintained.

15. However, respondents did have general concerns about the definition of a lease and the application of its underlying principles. These concerns included:

    (a) The proposed definition of a lease will be subject to additional stress and structuring focus compared with current practice because of the significant difference in accounting for a contract that is a service compared to a contract that contains a lease as proposed in the ED. Consequently, the proposed definition of a lease could create a new 'bright line'.

    (b) The proposed definition of a lease is too broad and would scope in contracts that are perceived to be service contracts. The boards should consider enhancing the disclosure requirements relating to service contract commitments, either as part of this project or another project.

    (c) The proposed principles underlying the definition of a lease are based on existing interpretations in IFRSs and US GAAP that were designed to address a narrow set of circumstances. They should therefore be further analysed by the boards because of the broad range of contracts that may be affected by the ED.

16. Respondents also identified a number of practice issues relating to the application of the principles in the ED for determining whether a lease exists. The following tables discuss these issues and, where applicable, suggestions from respondents on how to address the issues:

(a) For the 'specified asset' criterion:

Respondents' Concerns	Respondents' Suggestions	Staff analysis
(i) some standard-setters or accounting professional organisations noted that this criterion unnecessarily focused on the asset (eg registration number) being explicitly identified in the contract, leading to structuring opportunities, rather than focussing on the control of the asset (ii) some respondents requested additional guidance on applying the substitutability criteria, including application of the term 'rarely does so in practice' (iii) some respondents requested guidance on the unit of account (eg whether a specified asset can be a component of an underlying physical asset such as a space/capacity on a telecommunications cable, a pool of assets such as a group of rail cars or whether it should be aligned with other accounting guidance (eg on property, plant and equipment)).	Focus on the principles of what constitutes the underlying asset in the lease contract and consequently the relative significance of whether the underlying physical asset is: (i) available to be separately purchased (eg some asset components or portions of land may not be available for separate purchase by the lessee). (ii) fungible and interchangeable and whether the lessor has the ability to replace the asset and continue to perform under the contract, regardless of whether substitution 'rarely occurs in practice' (eg outsourcing contracts). (iii) exclusively available for use by the lessee during the lease term. (iv) conveying any economic benefit to the lessee without the provision of services that are included in the contract or considered a delivery mechanism for a service (eg digital television set-up boxes and modems/routers for providing internet service). (v) leased for a period that is significant in the context of its useful life (eg two-year lease of a new aircraft). (vi) consumed by the lessee during the lease term (eg investment property which may not depreciate in value over the lease term).	Refer to agenda paper 5D

(b) For the 'right to control the use of a specified asset' criterion:

Respondents' Concerns	Respondents' Suggestions	Staff analysis
Respondents requested additional guidance on the following: (i) how to apply the 'ability or right to operate' in situations when the lessee is directing, but relying on individuals from the lessor or a third party to operate, the right-of-use asset ii) 'output' and whether it should be based on physical or economic outputs iii) 'contractually fixed per unit of output' iv) 'current market price'	Clarification would be particularly useful for situations such as: (i) time-charters in the shipping industry or wet leases in the aircraft industry where performance is dependent on crew provided by the lessor. (ii) when, in addition to electricity, renewable energy credits (RECs) are an output from a wind farm and have significant economic value. (iii) when pricing is stated in the contract but subject to an inflation factor or a fixed escalation clause, is different in different periods (eg because of seasonality, on/off-peak pricing or different amounts in different years of the contract), is a stated amount that varies with the volume of output or is determined based upon an index (eg a commodity price index). (iv) whether current market price requires a liquid spot market to exist.	Refer to agenda paper 5E

17. Some respondents also questioned why the control criteria in the leases ED were different from the control criteria in the *Revenue from Contracts with Customers* exposure draft (the 'revenue recognition ED').

18. Comment letter respondents and participants in the workshops identified a number of examples where the assessment of whether a contract should be accounted for as a lease or a service is challenging and where the conclusions under the proposals may not be intuitive. These include:

(a) time-charter arrangements in the shipping industry;

(b) multiple elements of outsourcing contracts;

(c) 'non-core' assets (eg photocopiers and computers), although the majority acknowledged the difficulties identified by the boards in seeking to define non-core;

(d) season tickets for sporting events;

(e) cable boxes leased to receive television or satellite services;

(f) wet leases in the aircraft industry;

(g) oil rigs in the energy industry; and

(h) power purchase agreements (eg when renewable energy credits are involved or pricing is stated in the contract but varies over time).

Staff Analysis

19. The staff agree with many of the respondents to the ED that the principles included in the ED are an appropriate starting point for defining a lease as a contract that coveys the right to use an asset for a period of time in exchange for consideration. Those principles are set out in paragraph 2 of this paper.

20. According to the proposals in the ED, the accounting consequence of determining that a contract is, or contains, a lease is that the customer and supplier each recognise a lease asset and liability on its statement of financial position. Consistent with the definition of an asset in the boards' respective frameworks, an asset is a resource *controlled* by an entity[1]. Therefore, we think it is appropriate that the principles for assessing whether a contract is, or contains, a lease refer to the customer's right to *control* the use of a specified asset.

21. Nonetheless, comments received from respondents suggest that some clarity may be required regarding those principles. Agenda papers 5D and 5E discuss how those principles might be clarified.

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[1] The IASB's full definition of an asset is: An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [paragraph 4.4 in the *Conceptual Framework*]
The FASB's full definition of an asset is: Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. One of the essential characteristics of an asset in Con 6 is that a particular entity can obtain the benefit and control others' access to it. [paragraphs 25-27 in Concept Statement No. 6 *Elements of Financial Statements*]

Staff Recommendations

22. The staff recommend that the proposed wording for the *definition* of a lease (set out in paragraph 1 of this paper) be retained. Respondents agreed with the proposed definition of a lease, and the staff believe that many of the general concerns raised regarding that definition could be addressed through the proposed clarifications to the principles relating to the definition, discussed in paragraph 23.

23. The staff also recommend that we seek input on the preliminary draft wording (set out in Appendices A and B to this paper) relating to the following potential clarifications to the principles relating to the definition of a lease in the ED:

    (a) Whether the definition of specified asset should be clarified:

      (i) to focus on the quantitative and qualitative attributes of an underlying asset, rather than whether the underlying asset is uniquely identifiable; and

      (ii) how this clarification affects the guidance on substitution rights.

    (b) Whether a physical or non-physical portion of an underlying asset can be a specified asset.

    (c) Whether a contract that requires the use of an asset that is incidental to the performance of a service should be accounted for as a lease.

    (d) Whether the principle addressing 'the right to control the use of a specified asset' should be clarified to:

      (i) address specific concerns constituents have with determining what is meant by 'output' and the pricing conditions included in paragraph B4(c) of the ED ; or

      (ii) align with the control principles included within the revenue recognition ED.

24. The specific staff recommendations relating to each of these issues are included in Agenda papers 5D and 5E.

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 help the boards in reaching decisions regarding 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:

- *view A referred to in paragraph 10-18 of Agenda paper 5D [define a specified asset as a uniquely identifiable asset],*
- *view B referred to in paragraph 36-40 of Agenda paper 5D [clarify that physically distinct portions of a larger asset can be specified assets],*
- *the staff recommendation referred to in paragraph 63-66 of Agenda paper 5D [add wording to address assets that are incidental to the delivery of services], and*
- *view A referred to in paragraphs 8-10 of Agenda paper 5E [retain 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.

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 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 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 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 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~~.

Appendix B: preliminary draft wording for the definition of a lease section of the leases standard.

The preliminary draft wording included in this appendix has been prepared by the staff to help the boards in reaching decisions regarding the definition of a lease. The preliminary draft wording reflects:

- *view B referred to in paragraph 19-25 of Agenda paper 5D [define a specified asset as an asset of a particular specification],*
- *view C referred to in paragraph 41-55 of Agenda paper 5D [clarify that both physically distinct and non-physically distinct portions of a larger asset can be specified assets],*
- *the staff recommendation referred to in paragraph 63-66 of Agenda paper 5D [add wording to address assets that are incidental to the delivery of services], and*
- *view C referred to in paragraphs 12-28 of Agenda paper 5E [revise the description of control to be consistent with 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.

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 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

(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 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.