

Project

**Leases**

**Principles relating to the definition of a lease:**

Topic

**Specified asset**

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## Introduction

1. This paper discusses ‘specified asset’ as it is used in the definition of a lease. A summary of comments received from respondents regarding this principle is included in agenda paper 5C.
2. We have included in Appendices A and B to this paper some preliminary draft wording reflecting the views set out in the paper:
  - (a) Appendix A reflects **view A** discussed in paragraphs 10-18 of the paper, **view B** discussed in paragraphs 36-40 of the paper and the staff recommendation in paragraph 56 of the paper.
  - (b) Appendix B reflects **view B** discussed in paragraphs 19-25 of the paper, **view C** discussed in paragraphs 41-54 of the paper and the staff recommendation in paragraph 56 of the paper.
3. The purpose of this paper is to obtain the boards’ views on the meaning of ‘specified asset’ to enable us to seek input through targeted outreach on the preliminary draft wording included in the appendices.

## The proposals in the ED

4. The ED proposed the following guidance in assessing whether fulfilment of the contract depends on providing a specified asset or assets (the ‘underlying asset’). The wording in the ED is very similar to the words included in IFRIC
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The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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4 *Determining whether an Arrangement contains a Lease* and Topic 840

*Leases in the FASB Accounting Standards Codification®:*

- B2 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 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.
- 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. 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.

**Comments from respondents and approaches to address those comments**

5. Having considered comments from respondents to the ED and received through other outreach activities (a summary of which is included in agenda paper 5C), there are three main questions to address regarding ‘specified asset’:
- (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

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to substitute an asset affect whether than asset is a specified asset?

[paragraphs 9-29 of this paper]

- (b) Should the final standard clarify whether a specified asset can be a portion of a larger asset? [paragraphs 30-59 of this paper]
  - (c) Should the final standard address assets that are incidental to the delivery of specified services? [paragraphs 60-66 of this paper]
6. Some respondents to the ED suggested that the definition of a lease should be developed on the basis of either:
- (a) the right to use an asset that is essential to the operations of the customer (a ‘core’ asset)—this approach proposes that the costs of accounting for ‘non-core’ assets as leases exceeds the benefit of providing this information to users and therefore should not be recognised; or
  - (b) the business intent of the customer—if the customer’s intent in entering into the contract is to obtain services rather than the right to use an asset, the contract would not contain a lease.
7. When developing the ED, the boards considered whether to define a lease by referring to core assets but rejected that approach because they could not justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset, although some respondents proposed that the definition could be linked to the definition of cash-generating units.
8. We have not developed wording that might apply to a ‘core/non-core’ or ‘business intent’ model because we think that neither of these approaches would provide a basis for the recognition of a right-of-use asset that is better and more robust than existing IFRS and US GAAP requirements. We also note that neither IFRSs nor US GAAP distinguish core and non-core purchased assets, nor use ‘business intent’, for the purposes of recognition. Therefore we believe it would be inappropriate to introduce this distinction to apply only in the context of a lease.

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**Uniquely identifiable asset or an asset of a particular specification**

9. Regarding the definition of a ‘specified’ asset, the staff think that the boards have two options in this respect:
- (a) **View A:** Define a ‘specified asset’ as one that is uniquely identified or identifiable.
  - (b) **View B:** Define a ‘specified asset’ more broadly as an asset of a particular specification.

***View A: Define a ‘specified asset’ as one that is uniquely identified or identifiable***

10. Some respondents and interested parties support defining a ‘specified asset’ as an asset that is uniquely identified or identifiable. They think that this approach is generally consistent with the application of the definition of a lease in current US GAAP and IFRSs.
11. They believe that a lease should be applied at an individual asset level rather than at an ‘aggregated asset’ or portfolio level. This is because, in their view, a lease conveys the right to use a specific asset; it does not convey the right to use an asset of a particular specification.
12. They argue that if a customer recognises a right to use an asset, then the asset that the right relates to should be a uniquely identifiable asset, and not just any one of a number of assets of the same specification. More importantly, those supporting this view would argue that if the boards intend the definition of a lease to be applied by both lessees (customers) and lessors (suppliers), then the requirement that the asset is uniquely identified or identifiable is needed to enable a lessor to practically apply the derecognition approach set out in the ED. This is because it is clear which asset the lessor should derecognise. Those supporting this view question how a lessor should apply a derecognition approach to a lease if the asset that is leased is not uniquely identifiable. If the boards were to change the approach, additional guidance may be required to assist lessors applying the derecognition approach to contracts that contain a lease.

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13. According to **view A**, a supplier's right to substitute the underlying asset would result in the contract being considered a service, assuming that the rights to substitution are substantive and are not exercisable only when the specified asset is not operating properly. The supplier's right to substitute would be substantive when:
  - (a) it is practical or 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.
14. A supplier's rights to substitute an asset affects whether a contract contains a lease because the customer would no longer have the right to control the use of a uniquely identified asset if that asset could be taken and used for another purpose determined by the supplier. Proponents of this approach think that contracts involving fungible and easily replaceable assets should not be accounted for as leases because of the ease with which the supplier can interchange the assets used to fulfil the contract.
15. Recent outreach activities suggest that many constituents (including the leasing industry, preparers and some standard setters) support this approach. The advantages of this approach are that it seems to be more consistent with how practice has generally applied the 'specified asset' criterion, is relatively straight-forward to apply, and, as noted above, many think that only uniquely identifiable assets can be the subject of a lease.
16. The main disadvantage is that there are concerns that it might be relatively easy to structure a contract so that the customer always has the right to use an asset but the asset is not uniquely specified. The ED attempted to deal with this issue by stating that an asset is implicitly specified 'if the lessor can substitute another asset for the underlying asset but rarely does so in practice'. However many respondents to the ED and participants at round table meetings indicated that assessing whether a supplier rarely or more frequently substitutes an asset would be difficult to operationalise (for example, when a supplier does not have a past practice of providing similar assets for the use of

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customers). This would be particularly challenging for customers who may have no means of assessing how frequently a supplier substitutes an asset.

17. If the boards support **view A**, we recommend reverting to the wording defining a ‘specified asset’ that is similar to that included in IFRIC 4 and Topic 840 on when substitution rights are substantive. This is because respondents generally found the wording changes to the existing requirements proposed in the ED confusing. We also believe that the language in IFRIC 4 and Topic 840 in this respect more clearly articulates the principle—that a contract does not contain a lease if fulfilment of the contract is not dependent on the specified asset. Our view is that the amended wording reflecting this principle may remove some of the structuring concerns.
18. Paragraphs A2 and A3 of Appendix A to this paper set out preliminary draft wording in this respect.

***View B: A specified asset is an asset of a particular specification***

19. An alternative approach for the boards would be to define a ‘specified asset’ more broadly as an asset of a particular specification.
20. This is the direction that board members generally supported at recent board meetings and is considered by the staff to be a broader interpretation of ‘specified asset’ than is currently applied in practice.
21. This approach would say that if fulfilment of a contract depends on providing an asset of a particular specification, then that contract would be a lease if the contract also conveys the right to control the use of an asset of that particular specification. So, for example, in the rail car example discussed at the 1 February 2011 joint meeting, the rail cars would be specified assets even if the supplier has a substantive right to substitute any of the rail cars for a rail car of the same specification at any time during the lease term.
22. The principle behind this approach is that the customer receives (and would continue to receive) the same benefits from the use of other similar or equivalent assets because it has the right to use a specified asset, or an asset of the same functionality, throughout the lease term.

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23. If the customer's right to use an asset of the same functionality throughout the lease term is not interrupted 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. In this case, the customer would still have the right to use an asset of a particular specification and should include this right on its statement of financial position. When applying this approach to the rail car example, the customer may receive the same benefit from use of a rail car with a different registration number to that specified in the contract as long as the rail car provides the same functionality. However, the customer may not receive the same benefits if the supplier provides a different type of rail car, with different functionality.
24. If the boards support this approach, we think that the standard should require the contract to specify the asset both from a quantitative perspective (eg size, capacity) and a qualitative perspective (eg design, functionality, location). Preliminary draft wording with respect to this approach is set out in paragraphs B2-B4 of Appendix B to this paper.
25. According to this approach, a supplier's right to substitute an asset does not directly affect whether a specified asset exists if the supplier must substitute the asset for an alternative asset of the same specification. Paragraph B4 of Appendix B to this paper sets out preliminary wording regarding the effect of rights of substitution if the boards define a 'specified asset' as an asset of a particular specification.

**Staff recommendation**

26. Some staff are attracted to **view A**—to define 'specified asset' as a uniquely identified or identifiable asset, consistent with IFRIC 4 and Topic 840—for the reasons set out in paragraphs 10-15 of this paper. We understand that constituents are generally supportive of this approach and believe that its application is such that contracts are treated as leases when it is appropriate to do so, despite the concerns about possible structuring.

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27. Other staff are attracted to **view B**—to define ‘specified asset’ as an asset of a particular specification—for the reasons set out in paragraphs 19-23 of this paper. This approach would address the possible structuring opportunities that might otherwise exist.
28. For these reasons, we recommend seeking input through targeted outreach on the preliminary draft wording for both **View A** and **View B** regarding the definition of ‘specified asset’, asking:
  - (a) for **view A**, whether the existing requirements provide opportunities to structure contracts to avoid lease accounting when the contract, in all other respects, would be a lease.
  - (b) For **view B**, whether the proposed change to the definition of a specified asset would be easier to apply and would provide a better basis on which to determine whether a contract contains a lease (asking those with whom we engage to apply the draft wording to contracts).
29. The feedback received will provide the boards with input to help make final decisions about the definition of ‘specified assets’.

Question—specified asset
<p>Which view do the boards prefer? [If the board members have a clear preference for one of the two views, the targeted outreach could be limited to that preferred view.]</p> <p>Do the boards agree that we seek input on the draft wording through targeted outreach?</p>

**A portion of a larger asset**

30. The ED is silent regarding whether a right-of-use asset can relate to a portion of a larger asset.
31. IFRIC 4 acknowledges that it ‘does not address how to determine when a portion of a larger asset is itself the underlying asset for the purpose of applying IAS 17. Nevertheless, arrangements in which the underlying asset



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would represent a unit of account in either IAS 16 or IAS 38 are within the scope of this Interpretation.’

32. Topic 840 notes that the guidance ‘does not address whether an undivided interest or a pro rata portion of property, plant, or equipment could be the subject of a lease. The issue of how to determine if a component part of property, plant or equipment is itself property, plant, or equipment is not subject of this Topic. Nevertheless, arrangements that identify a physically distinguishable portion of property, plant, or equipment are within the scope of this Topic.’ [paragraph 840-10-15-4]
33. Given that it is common practice in particular industry sectors to enter into arrangements for the right to use a portion of a larger asset (eg a stated capacity of, or a specified strand within, a fibre-optic data cable), respondents have asked for clarity in this area.
34. Again, the staff think that the boards have a number of options:
  - (a) **View A:** Continue to be silent on portions of a larger asset, following the approach in the ED. [paragraph 35 of this paper]
  - (b) **View B:** Carry forward the guidance within IFRIC 4 and Topic 840 (set out above in paragraphs 31 and 32) without adding any further guidance—preliminary draft wording is included in paragraph A4 of Appendix A to this paper. This would clarify that a physically distinct portion of a larger asset can be a specified asset. [paragraphs 36-40 of this paper]
  - (c) **View C:** Clarify whether a physical or non-physical (eg capacity) portion of a larger asset can be a specified asset. [paragraphs 41-55 of this paper]

***View A: continue to be silent on portions of a larger asset***

35. The staff acknowledge concerns raised by constituents relating to the lack of clarity provided in the ED on whether a right of use asset can relate to a portion of a larger asset. Consequently the staff do not think that the final

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standard should remain silent on this matter. We do not recommend that the boards proceed with **view A**.

***View B: provide clarity about physically distinct portions of a larger asset***

36. Proponents of **view B** see no reason why the guidance clarifying that a physically distinct portion of a larger asset (eg a floor in a building) can be the subject of a lease is not carried forward into the final leases standard.
37. However, they would not support providing additional guidance on whether a non-physically distinct portion of a larger asset (eg 50 per cent of the capacity of a fibre-optic cable) can be a specified asset.
38. Some proponents of **view B** think that the boards' respective frameworks are not clear on whether a right to use a non-physical portion of a larger asset would meet the definition of an asset. They hold the view that the leases project is not the place to address the issue but rather this should be addressed within the conceptual frameworks project.
39. Other proponents of **view B** acknowledge that although further guidance would be useful, practice has evolved to account for contracts that convey the right to use a non-physical portion of a larger asset on a relatively consistent basis (ie capacity portions of a larger asset are generally not considered to be specified assets). Therefore, they would not recommend providing any additional guidance until the elements phase of the conceptual frameworks project is complete.
40. Paragraph A4 of Appendix A to this paper sets out preliminary draft wording reflecting **view B**.

***View C: Clarify whether a physical or non-physical (eg capacity) portion of a larger asset can be a specified asset***

41. Proponents of **view C** think that the final lease standard should provide clarity on whether **both** physical **and** non-physical portions of a larger asset can be specified assets.

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42. The second example discussed by the boards at the 1 February 2011 board meeting relating to the fibre-optic data cable addressed this issue of non-physical portions of a larger asset. Could a contract to provide 50 per cent of the data capability of one fibre-optic data cable for a period of time contain a lease?
43. Feedback received from 1 February 2011 board meeting indicated that at least some board members think that a non-physical portion of a larger asset could be a specified asset. Some commented that this approach was conceptually consistent with the right-of-use model proposed in the ED and an approach of viewing an underlying asset as a bundle of rights.
44. Nonetheless, some board members felt uncomfortable about the implications of saying that a non-physical portion of a larger asset could be a specified asset. Would this result in almost every service contract containing a lease because every customer obtaining a service indirectly obtains the output from a capacity piece of an asset used by the supplier to deliver the service?
45. Comments received from board members, respondents to the ED and other interested parties support the view that a physical portion of a larger asset (eg a floor of a building) can be a specified asset.
46. However, if we all agree that a floor in a building can be a specified asset, why would the boards stop there? Proponents of **view C** would argue that the principle underlying a floor of a building being a specified asset would lead to concluding that, for example, one strand of a 3-strand fibre-optic cable could be a specified asset, which would lead to questioning why the right to use one third of one fibre-optic cable would not also be a specified asset?
47. It is difficult to find any conceptual grounds on which to conclude that physical portions of a larger asset could be specified assets, but non-physical portions of a larger asset would not. Past transactions indicate that capacity portions of a larger asset have been sub-leased to other parties (eg capacity of a pipeline, a data cable or a satellite dish) and may provide a benefit to a customer that is economically similar to the provision of a physical component of a physical asset.

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48. For example, two customers that each has a contract for the right to use 100 per cent of the capacity of a pipeline may account for those contracts as leases. In contrast, two customers that each has a contract for the right to use 50 per cent of the capacity of a pipeline that is twice the size may not account for those contracts as leases.
49. If the boards were to apply **view C**, they could clarify that:
- (a) both physical and non-physical portions of a larger asset can be specified assets (paragraphs 50-54 of this paper); or
  - (b) physical, but not non-physical, portions of a larger physical asset can be specified assets (paragraph 55 of this paper).
50. If the boards were to decide to clarify that both physical and non-physical portions of a larger asset can be a specified asset, we recommend that this should *not* be done in isolation. Rather, this change should only be done if the boards also change the requirements relating to the right to *control* the use of a specified asset (see Agenda paper 5E).
51. This is because the combination of widening the meaning of a specified asset in this way, together with a definition of control that can be met by receiving output or benefits alone (criterion (c) of paragraph B4 of the ED) could lead to some service contracts inappropriately being considered to be leases.
52. If the right to control the use of an asset is redefined to require both ‘power’ and ‘benefit’ elements (as suggested in paragraphs 13-29 of Agenda paper 5E), we think that a customer would be less likely to be able to control the use of a non-physical portion of some larger physical assets. Consequently, not every contract that explicitly or implicitly provides a customer with a capacity piece of a larger physical asset would necessarily be a lease.
53. In addition, if the boards were to support this approach, we recommend clarifying that a portion of a larger asset is not a specified asset if the benefit received by a customer from use of the portion can be reduced by the supplier’s or other parties’ use of the larger asset. A customer would be required to have exclusive use of the portion of an asset for it to be a specified asset. This clarification would address, for example, a contract that delivers

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internet access to numerous customers whereby each customer's connection speed can be reduced if a large number of other customers are using the service.

54. Paragraph B5 of Appendix B to this paper provides a preliminary draft of this wording.
55. If the boards were to clarify that physical, but not non-physical, portions of a larger physical asset can be specified assets, we think that the rationale would be based upon a cost-benefit approach (including concerns about unintended consequences), rather than on a conceptual basis. We think that if the boards supported this approach that the criteria for determining whether a specified asset is implicitly identified could be expanded to address situations in which a contract is structured to identify a non-physical component, rather than physical component of an asset.

**Staff recommendation**

56. The staff do not recommend **view A**, remaining silent on portions of a larger asset. As a minimum, the staff recommend **view B**, to carry forward the guidance in IFRIC 4 and Topic 840 that clarifies that physically distinct portions of a larger asset can be a specified asset for the reasons set out in paragraphs 36- 39 of this paper.
57. Some staff are attracted to **view C**—to clarify whether non-physical portions, as well as physical portions of a larger asset can be a specified asset, for the reasons set out in paragraphs 41-48 of this paper. Those staff think that non-physical portions could be a specified asset, but *only* if the boards also decide to revise the description of control (**view C** discussed in paragraphs 13-29 of agenda paper 5E). Nonetheless, all staff have concerns about the implications and possible unknown consequences of expanding the application of the definition of a lease to non-physical portions of a larger asset and acknowledge that, for cost/benefits reasons, it may be appropriate to clarify that non-physical portions of a larger asset would usually not meet the definition of a specified asset.

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58. Therefore, the staff recommend that the boards seek input through targeted outreach on the preliminary draft wording set out in paragraph B5 of Appendix B of this paper, asking participants about the possible consequences of expanding the definition of a specified asset to include both physical and non-physical portions of a larger asset.
59. The feedback received will provide the boards with input to help make final decisions about the definition of ‘specified assets’.

**Question—portions of a larger asset**

Which view do the boards prefer? [In responding to this question, the Board members should assess the views from both a conceptual and operational perspective. If Board members think that **view C** is neither a better approach nor a viable approach, the staff would not conduct additional outreach on this topic. In that case, the boards could tentatively decide to carry forward the guidance in IFRIC 4 and Topic 840 that clarifies that physically distinct portions of a larger asset can be a specified asset (**view B**).]

**Assets that are incidental to the delivery of specified services**

60. The ED did not discuss assets that might be incidental to the delivery of specified services. Respondents to the ED, participants at round table meetings and representative from the working group raised a number of examples of contracts that could be considered a lease according to the definition in the ED whereas the contracts appeared to be for services. Examples raised include season tickets at sporting venues or a cable box provided when a customer contracts to have viewing rights to particular television channels.
61. We agree with those respondents who suggested that there may be some situations when an asset is either explicitly or implicitly identified but either the contract does not necessarily contain a lease or the benefits would not exceed the costs of applying lease accounting. A service contract might be such that the customer cannot obtain the services without having use of an identified asset; if the customer agrees to obtain the services from the supplier, it may not be possible to obtain the right to use an asset needed to receive the benefits from the service from another supplier. In addition, in most service

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contracts, the service provider would generally control any specified asset and the customer may be indifferent as to what asset is used as long as it is provided with the required and acceptable service.

62. For example, in a digital television satellite service contract, the customer specifies in the contract the television channels that it would like to view, but the supplier determines and may specify in the contract the type of digital cable set-up box to be provided to allow the customer to view the specified channels. The customer is not likely to care which cable box is provided, or whether a cable box is provided at all, as long as it has viewing rights to the specified television channels.

**Staff recommendation**

63. In response to comments received from respondents to the ED, we recommend adding some wording regarding assets that are incidental to the delivery of specified services—preliminary draft wording is set out in paragraph A5 and A6 of Appendix A, and B6 and B7 of Appendix B, to this paper (the wording is the same in each appendix). We think the language used is consistent with the overriding principle in paragraph B1 of the ED that states that ‘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...’.
64. The proposed wording also explicitly refers to situations in which 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. Those words have been included to address, for example, a season ticket for a sporting venue. In the season ticket contract, the seat number is likely to be specified. However the right to use that specific seat is likely to be an insignificant component of the overall service that the customer is buying—the customer would not obtain such a right to use the seat without all of the services that come with the use of the seat.
65. If the boards agree with the staff recommendation in paragraph 63 and with the preliminary draft wording set out in paragraph A5 and A6 of Appendix A to

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this paper, this may lead to questions about how to apply those words, such as questions about the meaning of ‘incidental’ or ‘insignificant’.

66. To address this issue, we propose seeking input through targeted outreach about the implications of the proposed change and whether the wording proposed in this respect could be applied without additional guidance. If additional guidance is required, it may be possible to expand the guidance relating to the right to control the use of an asset because, in a contract for services, the supplier generally controls the use of the assets used to provide the services.

**Question– assets that are incidental to the delivery of specified services**

The staff recommend adding some wording regarding assets that are incidental to the delivery of services (see paragraphs A5 and A6 of Appendix A).

Do the boards agree? If so, do the boards agree that we seek input on the draft wording through targeted outreach?



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

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*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 B2 and B3 of the leases ED, and ‘marks-up’ changes to that wording to reflect:*

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

*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**

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[Paragraph A1 sets out the principles and paragraph A7 relates to control—these paragraphs are included in Appendix A to agenda paper 5C]

***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

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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.

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

*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**

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[Paragraph B1 sets out the principles and paragraphs B8-B11 relate to control—these paragraphs are included in Appendix B to agenda paper 5C]

***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 benefit received by the customer would not vary if an asset or assets of a different specification is used.

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- 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 benefits 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.