Staff Paper

Project	**Leases**
Topic	**Principles relating to the definition of a lease: Right to Control the Use of an Asset**

Introduction

1. This paper discusses 'the right to *control* the use of a specified asset' as it is used in the context of 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 8-10 of the paper.

    (b) Appendix B reflects **view C** discussed in paragraphs 13-29 of the paper.

3. The purpose of this paper is to obtain the boards' views on the control principle relating to the definition of a lease 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 proposes the following guidance in assessing whether a contract conveys the right to control the use of a specified asset. The wording in the ED is very similar to the words included in IFRIC 4 *Determining whether an Arrangement contains a Lease* and Topic 840 *Leases* in the *FASB Accounting Standards Codification®*:

B4 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 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 of the asset.

(c) The entity will obtain all but an insignificant amount of the output or other utility of the asset during the term of the lease, and 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 the output, then the entity is paying for a product or service rather than paying for the right to use the underlying asset.

5. Consequently, the ED defines *control* in the context of a lease as either:

(a) having the active ability to operate or control physical access to an asset (a 'power' element) as well as the right to obtain some output or other utility of the asset (a 'benefit' element)—paragraph B4(a) and (b) of the ED set out above in paragraph 3 of this paper; or

(b) having the right to obtain all but an insignificant amount of the output or other utility of the asset (a 'benefit' element only) as long as the pricing is such that the customer is paying for the right to use the asset, rather than for actual use or output—paragraph B4(c) of the ED, set out above in paragraph 3 of this paper. This criterion implies that control can be passive in nature, resulting not only from directing the use of an asset actively. Rather, a customer can control the use of an asset indirectly by effectively preventing others from obtaining any output or other utility from the asset.

Comments from respondents and approaches to address those comments

6. The main comments received from respondents regarding the right to control the use of a specified asset (summarised in agenda paper 5C) relate to the following elements of the proposals:

(a) How should the 'ability or right to operate' concept be applied when a customer relies on personnel employed by the supplier to receive benefits from use of the specified asset (paragraph B4(a) of the ED)?

(b) What does 'output', 'insignificant', 'contractually fixed per unit' and 'current market price' mean within paragraph B4(c) of the ED?

(c) Why would the concept of control applied when a customer obtains the right to control the use of an asset be different from the concept of control applied when a customer obtains control of a good (addressed within the proposals in the *Revenue from Contracts with Customers* exposure draft (the 'revenue recognition ED'))?

7. We think that there are a number of ways that the boards could address the main comments raised:

   (a) **View A:** retain the concept of control already in IFRIC 4 and Topic 840 (and proposed in the ED) regarding the right to control the use of a specified asset, but change the wording of paragraph B4(c) to clarify the principle underlying those words, [see paragraphs 8-10 of this paper]

   (b) **View B:** Change the wording of paragraph B4(c) of the ED as proposed by **view A** and, in addition, add requirements to clarify how to apply the 'ability or right to operate' concept. [see paragraph 11 of this paper]

   (c) **View C:** revise the description of control in the lease standard to be consistent with the concept of control included in the revenue recognition ED. [see paragraphs 12-28 of this paper]

View A—retain the concept of control in the ED with some wording clarifications

8. As noted in paragraph 0 above, comments received on the ED indicated that paragraph B4(c) of the ED creates the most significant difficulty in applying the control criteria in current practice.

9. As noted above in paragraph 5(b), we think that the principle behind paragraph B4(c) of the ED is that a customer controls the use of an asset if it obtains all or almost all of the benefits from use of that asset and pays for the right to use the asset, rather than the actual use of, or output from, the asset (eg in take-or-pay contracts). In that case, the customer is considered to be taking on asset risk, rather than just receiving a service from use of the asset. **View A** proposes that the boards change the wording of paragraph B4(c) of the ED to clarify this principle by amending the words that have caused confusion in practice.

10. There are two ways that this could be done:

    (a) Change the wording of paragraph B4(c) of the ED somewhat along the lines of the following (included as paragraph A2(c) of Appendix A to this paper):

    > The entity has rights to obtain substantially all of the potential cash flows from use of the asset throughout the lease term 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.

    We think the wording proposed is an improvement on the wording of paragraph B4(c) of the ED because:

    (i) 'substantially all of the potential cash flows' articulates the principle better than 'output'. 'Output' has been difficult to apply when multiple parties receive output of an asset and when the asset creates benefits that are not physical in nature (eg renewable energy credits from power plants). 'Substantially all of the potential cash flows' is also not a new concept—those words are used in the revenue recognition ED to explain the 'benefit from use' received by a customer when it obtains control of a good or service.

    (ii) the wording more clearly articulates the principle underlying this criterion that a customer controls the use of an asset if it is paying for the right to use, and not just for the benefits from use, of the asset (the staff note that this could be supplemented with an example of how the pricing element of the principle could be applied).

(b) Retain the structure of the wording of paragraph B4(c) of the ED but add some clarity about what 'fixed price per unit' and 'current market price' are intended to mean. Requirements or guidance within other standards may be helpful in this respect. For example, requirements or guidance within IAS 32 *Financial Instruments: Presentation* may be helpful in explaining 'fixed price' and the financial instruments or fair value measurement standards may be helpful in explaining 'current market price'. [We have not developed preliminary draft wording in this respect because we prefer the approach to **view A** set out above in paragraph 10(a).]

View B—amend the wording of paragraph B4(c) of the ED and add guidance on the application of 'the ability or right to operate'

11. To address the questions raised about the application of 'the ability or right to operate' an asset, the boards could further explain how a customer might have that ability to operate an asset, along the lines of paragraph B9(a) of Appendix B to this paper. **View B** proposes that the boards would make this change as well as the changes proposed by **view A**.

View C—revise the description of control to be consistent with the revenue recognition standard

12. The proposals regarding the right to control the use of an asset in the leases ED were carried forward from IFRIC 4 and Topic 840 largely unchanged. That description of control is not consistent with the proposals in the revenue ED or within other standards, eg consolidation standards. This is because paragraph B4(c) of the ED defines control based on a 'benefit' element only, whereas the revenue recognition ED and consolidation standards define control requiring both 'power' and benefit' elements.

13. **View C** proposes that this description of control is updated in the final Leases standard to be consistent with the proposals in the revenue recognition ED.

Preliminary draft wording in this respect is set out in paragraphs B8-B11 of Appendix B to this paper.

The revenue recognition ED

14. The revenue recognition ED states that:

> a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service.…The customer's ability to receive the benefits from an asset refers to its present right to obtain substantially all of the potential cash flows from that asset (either an increase in cash inflows or a decrease in cash outflows). The customer can obtain cash flows from an asset directly or indirectly in many ways such as by using, consuming, selling, exchanging, pledging or holding the asset.

15. Although some respondents to the revenue recognition ED had questions about the application of the control concept to services, feedback received from those respondents has been positive in terms of the application of the control concept to goods (or assets).

The approach

16. Accordingly, determining whether a customer obtains the right to control the use of an asset in a lease contract would not be assessed differently from determining whether a customer obtains control of a good (or asset) in a sales contract. In effect, this would change the definition of control in the leases standard so that control is no longer defined solely on the basis of an 'output' or 'benefit' element. Rather, control would be defined to include a 'power' element (the ability to direct the use of an asset) and a 'benefit' element (the ability to receive the benefits from use of an asset).

17. Consistency with the control concept in the revenue recognition standard would, in effect, mean defining a lease as a contract that conveys control of a specified asset for the length of the lease term, or in other words, a contract whereby a customer has 'purchased' a specified asset but perhaps only for a piece of its economic life. This approach would be consistent with a model that regards a lease as a transfer of some of the rights to use a specified asset. The principle

behind the approach is that a customer that has a right to use a specified asset for an agreed period of time is in a similar position in terms of its use of the asset as if it had purchased the asset. The accounting for a lease supports this view—if a customer has the right to use an asset, and receive benefits from that use, then it follows that the customer should include the asset on its statement of financial position.

18. Another way to look at a lease is as contract that permits the customer (the lessee) to use a specified asset continuously throughout the lease term. The supplier (the lessor) is delivering that exclusive access to the specified asset throughout the lease term. The way to assess whether the customer has that exclusive access to (or right to use) a specified asset is to identify whether the customer has the right to control the use of the specified asset for the period of the contract. Although **view C** proposes revising the description of control to require both a 'power' and 'benefit' element, we do not think that this change would be contrary to a model that views a lease as a contract that permits access to a specified asset continuously throughout the lease term.

Consequences

19. Some of the consequences of **view C** that we have identified are as follows:

    (a) Fewer contracts would convey the right to control the use of an asset (ie the definition of control would have narrower application) compared with the proposals in the ED for two reasons:

        (i) A customer would not control the use of an asset solely on the basis that it has exclusive use (ie rights to obtain substantially all of the potential cash flows from use) of the asset. Accordingly, some take-or-pay contracts may not contain a lease if the customer does not have the ability to direct the use of the specified asset or assets.

        (ii) A customer would be required to have the ability to receive substantially all of the potential cash flows from use of an asset as well as the ability to direct the use of that asset in order to control the use of an asset. The ED proposed that a customer could control the use of an asset if it obtains more than an insignificant amount of the output or other utility of an asset when the customer also has the ability to direct the use of the asset. Accordingly, a contract for the right to use an asset for a portion of time (eg 5 hours in every day) may not contain a lease, unless the customer has the right to control the use of the asset together with others who also receive benefits from use of the asset.

(b) If the boards were to widen the meaning of 'specified' (discussed in paragraphs 19-25 of Agenda paper 5D) or clarify that a portion of a larger physical asset could be a specified asset (discussed in paragraphs 36-55 of Agenda paper 5D), we think that **view C** would help to address concerns that these changes increase the scope of the leases standard. Generally, when a contract is for services, the customer would not have the ability to direct the use of a specified asset, even if the customer receives all of the benefits from use of a portion of a larger physical asset or assets. Consequently, to address the concerns of some board members and constituents, we think that changes to the control concept should be made to reduce the scope of contracts that are to be accounted for as leases if the boards decide to broaden the definition of specified asset.

20. **View C** would address the main concerns raised by respondents to the ED as set out in paragraph 0 of this paper. Respondents to the ED and round table participants generally thought that the definition of a lease captured too many contracts**—view C** would be a way of addressing this concern.

21. **View C** also applies a concept of control that is not only consistent with revenue but also with other standards that refer to control, eg the consolidation standards. Within consolidation, the boards have recently moved away from defining control solely or predominantly on the basis of 'benefits' to a control model that requires both 'power' and 'benefit' elements.

22. In addition, **view C** would provide a better means of dealing with service contracts that could be considered to be a lease according to the current requirements in IFRIC 4 and Topic 840. We understand that practice has developed such that some contracts are structured to ensure that they do not

meet the current control requirements when entities to a contract think that the contract is for services (for example, by ensuring that a customer obtains a large proportion of the output of an asset but just below what might be considered to be ‘all but an insignificant amount’).

The preliminary draft of the wording

23. If the boards support **view C**, then we think that it is necessary to explain in more detail how to apply ‘the ability to direct the use of asset’ because a customer would be required to have that ability for a contract to be a lease. Paragraph B9 of Appendix B to this paper sets out a preliminary draft of this wording.

24. Paragraph B9(a) of Appendix B to this paper describes ‘the ability to direct the use of an asset’ in terms of being able to make decisions about that use that affect the benefits received by the customer. The principle behind those words is that having the ability to direct relates to being able to be involved in controlling *how* the asset is used to deliver benefits to the customer rather than being concerned only with the benefits received. The wording of paragraph B9(a) of Appendix B to this paper is similar to the requirements in the consolidation standards that describe power in the context of controlling an entity as the power or ability to direct the activities that significant affect the entity’s economic performance.

25. Paragraph B9(b) addresses assets that can be used by the customer without any substantive decision-making or other direction being required after commencement of the lease. When a customer has the right to use such an asset, we think that the customer has obtained the right to control the use of the asset at inception of the contract. This is because the asset has been designed or ‘preprogrammed’ to deliver the benefits from use to the customer without significant intervention by either the customer or supplier. In this case, the contract conveys the right to use an asset (without any ongoing direction) if the asset is specified and the customer receives the benefit from use of the asset. For example, this might be case for a data cable that, after it is installed and

made operational, requires very little ongoing maintenance or intervention by either the supplier or its customers who use the cable.

Unintended consequences

26. However, it is important to note that we do not know whether redefining control in this way might raise new issues or unintended consequences. The proposals in the revenue recognition ED regarding control have been well received in the context of determining whether a customer obtains control of an asset in a sales contract. Those proposals have not yet been tested when applied to a contract that conveys the right to use an asset.

27. In addition, we think that one of the objectives of the present definition of a lease in US GAAP and IFRSs was to require some take-or-pay contracts to be accounted for as a lease. Redefining control in this way may scope out some take-or-pay contracts from the definition of a lease.

28. It is also worth noting that the potential changes that the boards might make to other aspects of the lease proposals might take some stress off the definition of a lease. For example, if the boards decide to require straight-line profit or loss recognition for some leases, or change the proposals regarding lease term (agenda paper 5B) and variable lease payments (agenda paper 5A), it may not be necessary to substantively change the definition of a lease from the proposals in the ED.

Staff recommendation

29. The staff do not recommend **view B**, adding guidance on the application of ‘the ability or right to operate’. This is because the questions raised in this respect related to a narrow population of contracts and we do not think that additional guidance is required if the current concept of control is retained.

30. Some staff are attracted to **view C** for the reasons set out in paragraphs 12-22. They believe that such an approach would provide a more consistent basis for determining whether a contract contains a lease and, consequently, whether a customer should recognise an asset. Nonetheless, all staff have concerns about

whether such a change to the definition of a lease would raise new issues not yet identified.

31. For these reasons, the staff recommend that the boards seek input through targeted outreach on the preliminary draft wording for both **view A** and **view C** regarding control set out in this paper, asking:

    (a) for **view A**, whether the proposed amendments to the wording of paragraph B4(c) would address many of the concerns raised by respondents when considered together with potential changes to other aspects of the leases standard.

    (b) for **view C**, whether the proposed revision to the description of control would be easier to apply and 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).

32. The feedback received will provide the boards with input to help make final decisions about the principles relating to the definition of a lease.

Question – right to control the use of a specified asset
Which of the views do board members 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 limit the targeted outreach to the preliminary draft wording for **view A**.] Do the boards agree that we seek input on the draft wording through targeted outreach?

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 paragraph B4 of the leases ED, and 'marks-up' changes to that wording to reflect ***view A*** *referred to in paragraphs 8-10 of this paper [retain the control concept in the ED with some clarifications]. The boards have not yet made decisions about the view reflected in this appendix and, therefore, the wording is subject to change.*

Definition of a lease

[Paragraph A1 sets out the principles and paragraphs A2-A6 relate to specified assets—these paragraphs are included in Appendix A to agenda paper 5C]

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 C*** *referred to in paragraphs 12-28 of this paper [revise the description of control to be consistent with the revenue recognition project]. The boards have not yet made decisions about the view reflected in this appendix and, therefore, the wording is subject to change.*

Definition of a Lease

[Paragraph B1 sets out the principles and paragraphs B2-B7 relate to specified assets—these paragraphs are included in Appendix B to agenda paper 5C]

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 the amount of benefit that flows to the customer from use of the asset.