Project: **Leases**

Topic: **Examples to distinguish a service from a lease: Education session**

Purpose

1. On 19 January 2011, the boards discussed in an education session some of the concerns identified by respondents to the Leases exposure draft (ED) relating to the proposals for defining a lease and differentiating between a lease and a service.

2. The majority of respondents supported maintaining a definition of a lease that is based on the underlying principles included in the ED, which were carried forward from current IFRSs and US GAAP.

3. However, respondents requested further clarification of how the principles in the ED should be applied in determining whether an arrangement should be accounted for as a lease or as a service. They identified that the ED introduces additional stress on the application of these principles 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.

4. **The purpose of this paper is to identify how the principles in the ED regarding the definition of a lease (ie differentiating between a lease and a service) could be clarified to address the concerns raised by respondents.**

5. Consistent with the proposals in the ED, we assume that a lessee:

   (a) recognises a right-of-use asset and a liability to make lease payments when an arrangement meets the definition of a lease.

   (b) does not recognise a right-of-use asset or a liability to make lease payments when an arrangement is determined to be a service.

6. This paper does not discuss how an arrangement that includes elements of both a lease and a service should be accounted for. This will be addressed in a future analysis that will consider whether, for instance, the accounting should follow the predominant factors in the arrangement (ie is it a lease with ancillary services or a service that includes ancillary assets) or whether it would be more appropriate to bifurcate the service and lease components.

7. In addition, this paper does not discuss the adequacy of disclosures relating to any arrangements that the boards determine do not meet the definition of a lease. This will be addressed in a future analysis that will consider whether those disclosures should be considered as part of the leases project or as part of another project.

8. This paper focuses on two examples. They are modified versions of the examples included in IASB agenda paper 4/FASB Memo 125 discussed at the 19 January 2011 education session.

Questions to the boards
To achieve the purpose of this paper, board members are asked: 1) Which factors discussed in the examples help determine how the principles of specified asset and the right to control the use of a specified asset should be applied in determining whether an arrangement contains a lease? 2) Are there other factors that are not included in this paper that could help make that determination?

9. Appendix A contains a matrix of the possible factors discussed in this paper that may help determine whether an arrangement is a lease. This is provided to assist board members with their analysis of the examples presented.

10. Further, the paper includes another five examples in Appendix B. Four of them were included in the 19 January 2011 board paper. We can discuss these if we have time, or if board members think that some of the factors included or the thought process in those examples would be helpful in the discussions at this meeting.

Staff Analysis

11. We 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. We think those principles are broadly correct and consistent with the proposed right-of-use model. These principles are that:

    A contract is, or contains a lease, if:

    (a) fulfilment of the contract depends upon the supplier (lessor) providing a *specified asset* or assets; and

    (b) the contract conveys the right to use the underlying asset if the arrangement conveys to the purchaser (lessee) *the right to control the use of a specified asset*. (emphasis added)

12. In applying the **<u>specified asset</u>** principle we think that a specified asset must be substantive and identified, either explicitly or implicitly, in the contract.

13. For the specified asset to be substantive, we think that the purchaser (lessee) depends on the specified asset to fulfil the contract. For the purchaser (lessee) to depend on the specified asset, the purchaser (lessee) should not be indifferent to the type of asset identified in the arrangement.

14. We think that the more customised or unique the asset included in the arrangement:
    (a) the more likely the arrangement contains a lease;
    (b) the more likely the customer has control over the right to use the asset; and
    (c) the less likely the asset is fungible asset and just a means of providing a service.

15. Respondents indicate that when applying the specified asset principle, further clarity is needed when:
    (a) the supplier can substitute the assets used to fulfil a contract; and

(b) the specified asset is a component or portion of a larger asset, contrasting application of the principle to a floor in a building with application of the principle to the capacity of a pipeline.

16. In applying the **right to control the use of a specified asset** principle, the supplier (lessor) is expected to retain legal title of the specified asset throughout the contract term. Therefore, we think that control should focus on the right to direct the operation of the specified asset, including consideration of the right to control physical access of the asset during the contract term.

17. However, respondents indicated that when applying the right to control the use of a specified asset principle, further clarity is needed when:

(a) the supplier provides additional services relating to the specified asset; and

(b) the purchaser obtains all but an insignificant amount of the output or other utility of a specified asset.

18. In the examples below, we analyse and discuss the tension points in determining when a contract should be accounted for as a lease.

Examples

Example 1: Arrangement for pooled rail cars

Initial fact pattern:

An arrangement between Customer and Freight Supplier allows Customer to use 10 rail cars (wagons) owned by Freight Supplier for five years. The freight that Customers intends to transport requires rail cars of a type that is specified by Customer in the arrangement.

Each rail car has a unique identification number that is stated in the arrangement.

Customer determines how the rail cars should be used throughout the five year term (eg when and where freight is to be transported) and uses a party other than Freight Supplier to operate the rail cars.

When the rail cars are not in use they are kept in Customer's depot.

Customer pays a flat fee of CU[1]50,000 per car annually.

19. In applying the principles identified by the staff in paragraphs 11 – 18 above, the following indicators could lead to a conclusion that there is a specified asset and a right to control the use of a specified asset:

    (a) ***Specified asset*** –

    (i) ***Identification*** – There are assets identified in the arrangement (10 rail cars, identified by a unique identification number).

    (ii) ***Substantive*** – The specification is substantive. Customer depends upon rail cars of a specified type to transport the freight. Rail cars of a different type could not be used to transport the freight.

    (iii) ***Asset components substantively identified*** – The assets substantively identified are 10 individual rail cars or could be considered a pool of 10 cars. These rail cars are separate physical assets.

[1] CU = currency unit

(b) ***Control*** –

(i) ***Right to direct the operation*** – Customer has the right to operate 10 rail cars for the five-year term of the arrangement and obtain the benefits of the use of the rail cars during this period.

(ii) ***Right to control physical access*** – When the Customer is not using the rail cars, they are kept in the Customer's depot and are not available for use by other parties. The Customer controls the physical access to the rail cars.

> **What if:**
>
> A) Starting with the initial fact pattern, but the arrangement requires Freight Supplier to substitute a specific rail car with an equivalent rail car of the same type from a pool of rail cars when a specific car needs servicing or repair.

20. We do not think that this substitution, which is similar to a warranty obligation, significantly changes the analysis of the initial fact pattern in paragraph 19 and whether there is a specified asset.

21. The existence of this substitution requirement does not substantively affect the dependency that Customer has upon the 10 rail cars to fulfil the arrangement or the ability of Customer to direct the use of the cars.

> **What if:**
>
> B) Stating with the initial fact pattern, but when the rail cars are not being used by Customer, they are stored in a central depot. The central depot includes equivalent rail cars of the same type that are owned by Freight Supplier but available for use by other customers of Freight Supplier. Others are not allowed to use the specific rail cars dedicated for Customer.

22. We do not think that changing the physical location of where the rail cars are stored when they are not in use significantly changes the analysis of the initial fact pattern in paragraph 19.

23. Customer retains the right to direct the operation and obtain the benefits of the use of the 10 rail cars during this period.

What if:

C) Stating with the initial fact pattern, but the arrangement allows Freight Supplier to substitute a specific rail car with an equivalent rail car of the type (ie size and functionality) from the pool of rail cars stored in the central depot. Freight Supplier can substitute the rail cars at any time, and for any reason, without the prior consent of Customer. Freight Supplier has substituted the rail cars before, but this only occurs rarely.

Customer determines how the rail cars should be used throughout the five year term (eg to when freight is to be transported and between which destinations).

Specified asset

24. We continue to think that the specificity of the type of the rail cars is more substantive than the unique identification number when determining whether a specified asset exists and think that that the specified asset could be identified as a pool of 10 rail cars of a specified type rather than the right to use 10 specific rail cars.

25. However, because it is economically and contractually feasible for Freight Supplier to interchange the rail cars made available for use by Customer, there is an indication that the rail cars are interchangeable in nature.

26. This may indicate that Customer is indifferent between which of the rail cars in the depot are made available for use because they are all of the same type, and consequently perceives the rail cars to be more of a means of providing a transportation service.

Control

27. The staff do not think that Freight Supplier's right to substitute the rail cars at any time necessarily means that Customer no longer has the right to control the use of 10 rail cars. Although Customer no longer has the right to control physical access to the 10 specific rail cars (and thus, cannot control the use by others of the 10 rail cars), it might still have the right to control the use of a pool of 10 rail cars of a specified type by having the right to direct how 10 rail cars of that type are to be used during the term of the arrangement (eg by making decisions about when, where and in what manner the rail cars are used).

28. We think that the following indicators would help in determining whether the specified asset principle is achieved:

    (a) knowledge of the number of rail cars of the specified type available in the depot. Whether there are 20 or 2000 rail cars in the depot affects the extent to which the rail cars are viewed as fungible, interchangeable assets; or

    (b) if there is evidence that Freight Supplier only ever replaces the rail cars for repairs or in rare circumstances and how indifferent Customer is when Freight Supplier makes those changes.

What if:

D) Starting with the initial fact pattern, but Freight Supplier provides the drivers and engines used to move the rail cars between locations.

However, the arrangement requires Customer to direct Freight Supplier when freight is to be transported and between which destinations. Freight Supplier will provide instructions to the driver on which rail cars should be transported by the engine for any journey undertaken by the driver.

When undertaking a journey, the engine used by the driver may transport rail cars used by other parties other than the Customer.

Control

29. We think that, in applying the indicators of the principles identified by the staff in paragraphs 11 – 18 above, the following could lead to a conclusion that Customer does not have the right to control the use of a specified asset:

    (a) the use of the rail cars is dependent upon the use of another asset (the engine). The use of this engine is controlled by **Freight Supplier**, based on the instructions that Freight Supplier provides the driver.

    (b) the benefit that Customer gets from the rail cars is dependent upon the additional operational services (ie the provision of a driver and an engine to transport the rail cars) provided by **Freight Supplier**.

    (c) **Freight Supplier** has flexibility in how it directs the driver to perform and satisfy the arrangement with Customer. For example, Freight Supplier can determine whether the engine will transport other rail cars, or just the Customer's rail cars.

What if:

E) Instead of starting with the initial fact pattern, the arrangement between Customer and Freight Supplier requires Freight Supplier to transport a specific quantity of goods in accordance with a stated timetable for a period of five years.

The timetable and quantity of goods specified is equivalent to Customer having the use of 10 rail cars for five years.

Freight Supplier provides the rail cars, driver and engines as part of the arrangement. The arrangement states the nature and quantity of the goods to be transported, but does not provide any details of the rail cars to be used to transport the goods.

Transportation of the goods identified in the arrangement will require rail cars of a type similar to those identified by the Customer in the initial fact pattern. Freight Supplier could use any rail cars from a large pool of similar rail cars to transport the goods over the five year period.

Customer pays a flat fee of CU500,000 annually.

30. We think that, in applying the principles identified by the staff in paragraphs 11 – 18 above, the following indicators could lead to a conclusion that Customer does not have a specified asset and the right to control the use of a specified asset:

(a) ***Specified asset*** –

(i) ***Identification*** – There is not an explicit or implicit indication description of which individual rail cars Freight Supplier would use to transport the goods. However, there is an implicit indication of the type of the rail cars to be used because of the type of goods to be transported.

(ii) ***Substantive*** – The terms of the arrangement indicate that Customer is indifferent to which rail cars from Freight Supplier's large pool of similar cars are used to transport the goods. This could indicate that the rail cars are just a means for providing a transportation service to Customer.

(iii) ***Asset components substantively identified*** – If there is a specified asset, it relates to the right to use the equivalent of 10 rail cars of a specified type, rather than 10 specific rail cars.

(b) ***Control*** – The assessment of control would be similar to the assessment in paragraph 29 (previous example).

31. The staff think that if this fact pattern is considered an economically similar arrangement to the fact pattern identified in D) that there should be consistency in the assessment of the between the two fact patterns.

Example 2: capacity of a telecom cable

> **Starting fact pattern:**
>
> Telco installs a high speed fibre-optic data cable between two buildings – one building is occupied by Customer A and the other building is occupied by Customer B. There are no other cables connecting the two buildings.
>
> Within the cable are two separate fibres (fibre A and fibre B). Both fibres have identical functionality and are not expected to require significant operational decisions or maintenance to provide this functionality over the 25 year useful life of the cable.
>
> Customer A has an arrangement with Telco to pay a flat monthly fee of CU500 for exclusive use of fibre A for seven years.
>
> Customer B has a similar arrangement with Telco to pay a flat monthly fee of CU500 for exclusive use of fibre B for seven years.
>
> The two arrangements do not allow Telco to interchange use of fibre A and fibre B and it is not economically feasible for Telco to substitute a separate high speed fibre-optic data cable.

32. The staff think that in applying the principles identified by the staff in paragraphs 11 – 18 above, the following indicators could lead to a conclusion that Customer has a specified asset and the right to control the use of a specified asset:

Specified asset

(a) ***Identification*** – The arrangement specifically identifies fibre A.

(b) ***Substantive*** – The specification is substantive, Telco cannot substitute fibre A for another asset that will provide the same functionality to Customer A. Therefore, Customer A depends on fibre A to provide data connection between Building A and Building B.

(c) ***Asset components substantively identified*** – The asset component substantively identified is a physical asset (fibre A) which is a component of a larger tangible asset (the high speed fibre-optic data cable).

Control

(a) Customer A has exclusive use of fibre A during the seven year period and obtains all of the output and economic benefit relating to fibre A.

(b) Neither the entire fibre-optic cable, nor fibre A, requires significant operational decisions to be taken or maintenance to be carried out by a party other than Customer A during the term of the arrangement.

What if:

A) The high speed fibre-optic data cable between the two buildings is just one fibre.

Customer A has an arrangement with Telco to pay a flat monthly fee of CU500 for use of 50% of the data capability of the fibre for seven years.

Customer B has an arrangement with Telco to pay a flat monthly fee of CU500 for exclusive use of the other 50% of the data capability of the fibre for seven years.

Telco is expected to provide significant ongoing maintenance of the fibre to provide the data capability specified in the arrangement over the seven years.

33. The staff have identified the following indicators that affect application of the principles identified by the staff in paragraphs 11 – 18 above, for determining whether Customer has a specified asset and the right to control the use of a specified asset:

Specified asset

(a) ***Identification*** – The arrangement specifically identifies 50% of the data capability of a tangible fibre asset.

(b) ***Substantive*** – The specification is substantive, Telco cannot provide Customer A with the data capability from another tangible fibre asset.

(c) ***Asset components substantively identified*** – The asset component substantively identified is a capacity or space component of a tangible asset.

34. The staff think that determination of whether there is a specified asset depends upon whether a specified asset can be a component of a larger asset, even if that component cannot be physically identified.

Control

35. If 50% of the data capability of a tangible fibre asset could be considered a specified asset, the staff think that the determination of whether Customer A has **control** over the specified asset would need to consider the ongoing maintenance of the fibre provided by Telco.

36. Although Company A has exclusive use of 50% of the capacity of the fibre during the seven year period and obtains all of the output and economic benefit relating to this capacity, the staff think that, in assessing control, Company A should 'look through' to the underlying physical asset (ie the entire high speed fibre-optic data cable).

37. In looking through to the underlying physical asset, the fact that Telco is required to undertake ongoing maintenance of the fibre, and that maintenance is essential to the benefit that Company A obtains from the arrangement, indicates that Company A may not be able to control the specified asset.

38. This is because the benefit that Company A obtains from fibre A depends upon significant ongoing services provided by Telco that Company A does not control, indicating that fibre A might be ancillary to receiving the data transfer service. This assessment may depend on how significant these ongoing services are to the benefit that Company A obtains from fibre A.

39. The above analysis implies that control is more than simply having the right to prevent others from accessing the use of a specified asset by virtue of the fact that a purchaser takes all of the capacity or output from a specified asset. If the specified asset requires ongoing activities for a purchaser to benefit from that asset, then these ongoing activities should be considered in determining whether the purchaser has obtained control of the specified asset.

Appendix A: template for Board members' responses

*ULA refers to the underlying asset

Examples	**Board view**												
		Reasons											
		ULA* is identified: explicit or implicit	Substan-tive ULA: Customer cares which type of ULA	Level of services provided	Feasible to substitute ULA	Customer indiffe-rent with ULA	Customer has exclusive use of specified asset	Customer controls physical access of ULA	Customer controls operations of ULA	ULA is mechanism for services	Customer prevents others from using ULA	ULA is a physical asset, not portion of it	Others
1 Renting pooled rail cars—BASIC													
1A Renting pooled rail cars—substitution when cars are not working													
1B Renting pooled rail cars—cars stored in central depot													

Examples	**Board view**												
		Reasons											
		ULA* is identified: explicit or implicit	Substan-tive ULA: Customer cares which type of ULA	Level of services provided	Feasible to substitute ULA	Customer indiffe-rent with ULA	Customer has exclusive use of specified asset	Customer controls physical access of ULA	Customer controls operations of ULA	ULA is mechanism for services	Customer prevents others from using ULA	ULA is a physical asset, not portion of it	Others
1C Renting pooled rail cars—cars stored in central depot/ substitution without prior consent													
1D Renting pooled rail cars—Freight Supplier provides drivers and engines													
1E Freight Supplier transports goods (no freight car rental)													

Examples	**Board view**												
		Reasons											
		ULA* is identified: explicit or implicit	Substan-tive ULA: Customer cares which type of ULA	Level of services provided	Feasible to substitute ULA	Customer indiffe-rent with ULA	Customer has exclusive use of specified asset	Customer controls physical access of ULA	Customer controls operations of ULA	ULA is mechanis m for services	Customer prevents others from using ULA	ULA is a physical asset, not portion of it	Others
2 Using fibre-optic data cable—each customer has its own fibre													
2A Using fibre-optic data cable—data capability of one fibre split between customers A and B													

Appendix B: additional examples given in January Board Advisors meeting

Photocopy machine example:

Renter rents a photocopy machine for three years from Supplier and will pay CU21 for each photocopy made. The photocopy machine's registration code is included in the contract with Supplier.

Renter specifies that the photocopy machine must be able to print in colour, staple and sort papers. The contract is non-cancellable. The expected life of the machine is for 5 years. The photocopy machine is in Renter's premises.

(a) In regard to the Renter and the Supplier—should this arrangement be accounted for as a service or a lease?

(b) Would your decision change if the photocopy machine is located in Supplier's premises but the machine is only dedicated for Renter's use?

(c) Would your decision change if the contract requires that Renter must only use Supplier's services to maintain the photocopy machine but the photocopy machine is located in Renter's premises? Maintenance services occur after every 10,000 copies. The photocopy charges include maintenance services.

(d) Would your decision change if Renter is required to pay a minimum of CU500 per month and, for photocopies made after 100,000 copies, Renter pays CU1 per additional sheet. The photocopy machine is located in Renter's premises.

[2] CU = currency units

Outsourcing example:

Company C outsources its IT systems to an Outsourcing Company. Company C specifies in the contract the following:

- the service level required (eg the speed of the data transfer); and

- the location (which is outside of Company C's premises) and brand of hardware used to store the data.

The Outsourcing Company's server farm contains five servers that meet Company C's functionality requirements. This means that Outsourcing Company has capacity to serve other clients within its premises. Company C requires a dedicated server because the data kept is sensitive to Company C.

Company C pays CU500 per month based on a maximum amount of data. Even if Company C did not specify which server to meet its IT needs, Company C would normally need an entire server to meet its needs.

The Outsourcing Company is responsible for all maintenance and security of the server and facility and providing technical upgrades on the server without the explicit consent of Company C.

(a) In regards to Company C *and* the Outsourcing Company—should this arrangement be accounted for as a lease or a service?

(b) If this is a lease contract, what is the specified asset?

(c) if the server is on Company C's premises, does this change your views?

(d) if the server is not dedicated to Company C, does this change your view?

Parts supply agreement example:

Purchaser P and Supplier S enter into a parts supply agreement to make 50 railcar trains. Supplier S uses a specific tooling equipment that is specific to the needs of Purchaser P. The tooling equipment is identified in the agreement and Supplier S could not use an alternative item of tooling equipment to fulfil the contract because Supplier S only has one item of equipment that meets Purchaser P's needs.

It is determined that this contract meets the 'specified asset' criteria.

The estimated capacity of the tooling equipment is 500,000 units. Supplier S estimates that the production of the 500,000 units would consume about half of the economic benefits associated with the tooling equipment (which has a useful economic life of 10 years).

S expects that P takes all of the output produced by S using the specific tooling during the first five years. No other purchaser will take output from the tooling equipment during this five year period. Supplier S is responsible for maintaining the tooling equipment. That equipment could be used to produce items for other customers.

Purchaser P and Supplier S agree upon the following unit price reductions in the parts supply agreement:

- from 0 to 100,000 units, price per each unit CU150;
- from 100,001 to 200,000, price per each unit CU140;
- from 200,001 to 300,000, price per each unit CU135;
- from 300,001 to 400,000, price per each unit CU132;
- above 400,000 price per each unit CU130.

(a) In regard to Purchaser P *and* Supplier S—should this arrangement be accounted for as a lease or a service?

(b) Do you think this arrangement meets the intent of the fixed price per unit output criterion in the ED?

(c) Would your response change if the specific tooling equipment is located in Purchaser P's premises and Supplier S continues to maintain the tooling equipment?

(d) Would your response change if Purchaser P pays a flat rate of CU67,250,000 (500,000 units x CU134.50), regardless of the quantity produced by the tooling equipment?

(e) Would your response change if the tooling equipment's useful life is to only produce all of Purchase P's 500,000 units?

Power purchase agreements example:

> Company D is a developer and operator of a wind generation facility.
>
> Company D enters into a power purchase agreement with Large Public Utility Company whereby Company D agrees to sell 100 per cent of its electricity output to the utility company for 20 years at a price that is neither contractually fixed per unit of output nor equal to the current market price per unit of output.
>
> Renewable energy credits (RECs) are also created when the electricity is generated. These are liquid (ie transferable) certificates with significant economic value to recipients. Company D enters into an agreement to sell 100 per cent of the RECs to Small Public Utility Company for 20 years at a price that is neither contractually fixed per unit of output nor equal to the current market price per unit of output.
>
> (a) In regard to the lessee *and* the lessor—is this agreement a lease or a service?
>
> (b) If the RECs did not exist, would that change your mind on whether the arrangement contains a lease?

Time charter example:

> As is common in the shipping industry, a ‘time charterer’ enters into a contract of freightment with a shipowner for the use of a named ship to transport the charterer's cargos during a specific period of time.
>
> The charterer may be chartering the ship either to carry its own cargo or cargos owned by third parties. Under a standard time charter, the charterer pays a daily or monthly hire, based on the market rate at the date of the contract, for the use of the ship (including the captain) and also pays for the costs of all fuel consumed by the ship and all port fees. Additionally, the time charterer pays all cargo loading and unloading charges.
>
> Under the time charter, cleaning services relating to the cargo space or other relevant services, such as overseeing the loading and unloading of cargos and management of cargos at sea, are the responsibility of the shipowner in addition to maintenance and overhaul. Food and water for captain and crew are also provided by the owner.
>
> The time charter rates are based on highly volatile market prices, creating significant challenges in allocating payments between the components of the lease contract.

In regard to the lessee *and* the lessor—is this agreement a lease or a service or the arrangement contains a lease with services?