Project: **Leases**

Topic: **Differentiating between a service contract and a lease**

## Objective

1. The objective of this paper is to discuss how to differentiate between contracts that are leases and contracts that are services.

2. Under existing leasing guidance, a significant issue is distinguishing between finance leases (which are on balance sheet for lessees) and operating leases (which are off balance sheet). Because the accounting for an operating lease and a service contract is similar under current US GAAP and IFRSs, lessees may be less concerned whether an arrangement is classified as a service contract or an operating lease.

3. However, under the new lease proposals, both lessees and lessors would recognize assets and liabilities on their balance sheet for all leases, and therefore, differentiating between contracts that are leases and contracts that are services becomes more significant because of the difference in accounting for each type of contract.

4. Therefore, it is important to clearly define a lease in the proposed leases requirements.

5. In this paper, the staff have included some examples of situations that have introduced challenges in current practice with regards to applying the existing criteria in IFRSs and US GAAP (which have largely been carried forward into the *Leases* Exposure Draft) for determining whether a contract is a lease or a service. Those examples are meant to facilitate the working group discussion.

## Summary of the proposals in the *Leases* exposure draft

6. The boards propose to define a lease as follows:

   > A lease is a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration.

7. Any contract that meets this definition is a lease contract, not a service contract.

8. In the boards' view, this definition retains the principle in the definition of a lease in both IFRSs and US GAAP.

9. To help an entity determine whether a contract is a lease or a service the exposure draft *Leases* (the ED) incorporates the requirements of US Accounting Standards Codification (ASC) Section 840-10-15 (formerly EITF Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease*) and IFRIC 4 *Determining whether an Arrangement contains a Lease*.

10. In particular, the ED proposes that a contract is, or contains, a lease if:

    (a) the fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset'); and

    (b) the contract conveys the right to control the use of a specified asset for an agreed period of time (see paragraph B1 of the ED).

## Feedback received

11. Since the issuance of the leases ED, the staff have been involved in numerous outreach activities to solicit feedback on the ED. During the outreach activities, many have commented on the difficulty of distinguishing between a lease and a service contract. Constituents explained to the staff that this tension is not so critical under existing requirements because for operating leases, a lessee only

recognises rental expense over the lease term, similar to how a service contract is accounted for. However, because the ED would propose that lessees and lessors recognize assets and liabilities on their balance sheet, there will be more scrutiny in determining whether an arrangement is a service or is (or contains) a lease.

12. Other respondents also added that unless the boundary between a lease contract and a service contract is better defined, off-balance-sheet financing could remain because entities will attempt to structure contracts to convey services versus leases.

## Fulfilment of the contract depends on providing a specified asset or assets

13. 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 in applying the current guidance 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.

14. 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.

15. A contract that permits an entity to substitute a similar asset for the specified asset after the date of commencement of the contract does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset.

16. 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.

17. The following examples are included to demonstrate the difficulties in applying the guidance. During our outreach activities, constituents have specifically identified difficulties relating to whether a specified asset can be:

    (a) a component of a single IAS 16 asset, or an aggregation of a number of IAS 16 assets, rather than a just a single IAS 16 asset; or

    (b) viewed as being substitutable

## Example 1: Renting pooled freight cars

Company A has an arrangement with Company AA for the right to use freight cars. The arrangement identifies the specific freight cars that Company A has the right to use for a period of time. However, Company AA may substitute at any time the specific freight cars for other similar freight cars from a pool.

What is the specified asset? Is it:

a) the specific car (identified by a specific reporting number) in which case this car can be replaced by an identical car?

b) the pool of cars for which Company A has an arrangement to utilise a specific number of cars (but not necessarily the specific cars) for a period of time?

## Example 2: Renting a capacity of a telecom cable

Company B rents 50% of the capacity of a cable from a Telecom Company. The Telecom Company rents the other 50% of the cable capacity to another company.

Under the proposed definition of a lease, what is the specified asset?

Is it the entire cable, or a portion of the cable? Can an asset be sub-divided into components? How can one determine when a portion of a larger asset is the underlying/leased asset itself?

## Example 3: Renting cable TV

Company C rents digital entertainment programming via satellite to subscribers. During the term, the company provides equipment to subscribers for a monthly charge. The company cannot provide its service without providing its unique equipment. The company would replace the equipment during the agreement if the equipment is faulty, but rarely substitutes the equipment in practice.

Under the proposed definition of a lease, does a specified asset exist even if:

a) the equipment is merely a conduit to providing the programming the subscribers are purchasing; and

b) it would be feasible and practical for the equipment to be exchanged during the lease term?

**Question 1**

What are your views on the ’specified asset’ guidance? Does it appropriately identify underlying assets that can be the subject of leases? If not, how should it be modified?

Is the ‘specified asset’ guidance sufficient? If not, what additional guidance is needed (e.g. regarding the components of an asset)?

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

18. The ED proposes, consistent with current US GAAP and IFRS that a 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.

19. During our outreach activities, constituents indicated that most problems associated with determining whether an entity controls the right to use an underlying asset arise from interpreting the criterion in paragraph 19(c). In particular, the boards have been asked to provide more guidance on:

(a) What does ‘fixed price per unit of output’ mean?

(b) What is the output of an asset?

20. The following examples are to demonstrate the difficulties in applying the guidance regarding the paragraph 19(c).

## Example 1: Parts supply agreement

Purchaser P and Supplier S enter into a parts supply agreement for the lifetime of the finished product concerned. S uses tooling equipment that is specific to the needs of P. The tooling is identified in the agreement and S could not use an alternative asset. The estimated capacity of the tooling equipment is 500,000 units which correspond to the total production of the finished product units over its life cycle. P takes substantially all of the output produced by S using the specific tooling.

Purchaser P and supplier S agree upon the following unit price reductions in the parts supply agreement to reflect S's increasing efficiencies and economics of scale:

- from 0 to 100,000 units, price per each unit CU[1]150;
- 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.

How should the term "fixed price" be interpreted in determining whether the contract meets the definition of a lease? Does this pricing structure meet the "fixed price" criteria?

[1] CU = currency units

### Example 2: Power purchase agreements

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% 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 certificates with significant economic value to recipients. Company D enters into an agreement to sell 100% 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.

Under the proposed definition of a lease, should the RECs be considered "output" to determine whether the entity obtains or controls "more than an insignificant amount of the output or other utility of the asset" "?

21. The following example is to demonstrate the difficulties in applying the guidance regarding paragraphs 19(b) and 19(c), the ability or right to control physical access while 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.

**Example 3: Renting a photocopy machine**

Company C rents a photocopy machine for 3 years from Supplier B and will pay CU1 for each photocopy made.

If the photocopy machine is in Company C's premises, does the arrangement contain a lease?

If the machine is not in the Company C's premises, does the arrangement contain a lease? Does this answer change if the Company C pays CU1,000 per month, rather than CU1 for each photocopy made?

**Question 2**

What are your views on the 'right to control the use' guidance? Does it appropriately identify whether arrangements contain a lease? If not, how should it be modified?

Is the 'right to control the use' guidance sufficient? If not, what additional guidance is needed (e.g. determining 'output' and whether/how the 'fixed price' condition can be applied)?