Staff Paper

Project **Leases**

Topic **Definition of a lease: Some preliminary thoughts**

Objective

1. This paper discusses how to differentiate between a contract that is within the scope of the leases standard and one that is outside of the scope of the leases standard, and that is therefore accounted for as an executory contract (service).
2. The purpose of this paper is to form a basis for discussion on what underlying principles should be in the definition of a lease and to identify a possible path forward. The purpose of this paper is not to reach final conclusions. We will bring a more fully developed paper on the definition of a lease and differentiation between a lease and a service at a future meeting.
3. The issues raised in this paper were also discussed by the Leases Working Group on Friday, 7 January 2011. This paper included their feedback.
4. **The boards are asked to focus on the following questions for discussion during this meeting.**

Questions - fundamental
1. What is a lease?
(a) Do you think that all leases:
(i) are a form of financing?
(ii) are different to executory contracts?

(iii) should be uniquely accounted for?

Please explain the reason(s) for your answers.

(b) What is the asset acquired by a lessee? Is it the 'right-of-use' asset or the underlying asset (or a component of the underlying asset) that is subject to the lease?

2. Do you think that the development of the definition of a lease should reflect both lessee and lessor perspectives?

Questions - Technical

3. Are the principles in IFRIC 4/EITF 01-08 effective to distinguish between leases and services? Do you think some of parts of IFRIC 4/EITF 01-08 need to be amended?

4. With regard to clarifying some of the principles in IFRIC 4/EITF 01-08:

(a) What are your views on the guidance on specified assets? Do you think that additional guidance is needed regarding the unit of account to be applied (eg can there be leases of a portion of an asset, of a component or of a pro rata share of an asset or pools of assets)?

(b) What is your view on the right to control of the use of the asset guidance?

5. The criteria for distinguishing a lease from a service in the ED were from the existing guidance in IFRIC 4/EITF 01-08. That existing guidance poses challenges in current practice. However, the distinction has been less critical since many of the leases identified by IFRIC 4/EITF 01-08 are operating leases and the accounting for operating leases is similar to that of services.

6. However, the proposals in the ED result in significantly different accounting for a lease compared with a service. Therefore, the issues in current GAAPs have become more significant.

7. Appendix A includes some examples that highlight those challenges in current practice with regards to applying the existing guidance for determining whether a contract is a lease or a service. The staff think that the types of transactions in the examples best illustrate the difficulties in applying the proposals in the ED, and therefore **we ask the boards to limit discussion to those examples.**

8. In addition to determining whether a contract is a lease or a service, this paper discusses the guidance in the ED for contracts that contain both service and lease components.

Structure of the paper

9. To aid the boards' discussion on answering the questions above, the paper is structured as follows:

Topic	**In which section in this paper?**
(a) Summary of ED proposals and preliminary feedback received to date	Paragraphs 10-13 Appendix A contains examples that create challenges in current practice
(b) Possible approaches	Paragraphs 14-15 Appendix B
(c) Preliminary staff views on the possible approaches of the two criteria to determine whether a contract is, or contains, a lease: i) fulfilment of the contract depends on providing a specified asset or assets. ii) the contract conveys the right to control the use of a specified asset.	Paragraphs 16-22 Appendix C contains preliminary staff analysis on those criteria
(d) How to deal with contracts that contain both service and lease components, including both non-distinct service/lease elements	Appendix C

ED proposals and preliminary feedback

10. The majority of respondents have commented on the difficulties of applying the proposal for distinguishing between a lease and a service contract. Feedback includes:

Proposals	Feedback

A contract is, or contains a lease if it meets two criteria:
 	
(a) the fulfilment of the contract depends on providing a specified asset or assets (the 'underlying asset').
	• Difficult to determine or assess what is the 'specified asset'. What level should it be?
	  - pooled asset level (eg for vehicles or rail coach entities) – see Example 1
	  - component (pro rata or portion) asset level (eg for the telecommunications industry) – see Example 2
	• What is the 'specified asset' (eg for the outsourcing industry) – see Example 3
	• Would guidance about the 'substitutability' or 'exchangeability' of the underlying asset assist in determining what is the specified asset?

(b) the contract conveys the right to control the use of a specified asset for an agreed period of time. Control of the use of a specified asset is conveyed if any one of the following three conditions is met: i) 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. ii) 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. iii) 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	• What does 'fixed per unit of output' mean (eg for the supply agreement) – see Example 4 • What is 'output'? (eg for the utilities industry) – see Example 5 • What is an 'insignificant amount'? (eg If a lessee controls 100% of the output of a specified asset which is 50% of a pipeline, is that more than an insignificant amount of the asset?

Proposals	Feedback
unit of output as of the time of delivery of the output.	

11. In addition, many constituents raised concerns regarding the ability of preparers to separate a contract into its service and lease components (eg for the shipping industry – see Example 6). Those constituents commented that service and lease components of some contracts are so interlinked, and therefore lease components are not distinct and those contracts should be accounted for as services.

    (a) The staff think that we need to address two issues. Many think that the existence of a highly interrelated or interlinked service with lease suggests that the whole arrangement is a service, rather than a lease and a service.

    (b) Even if the contract contains both a lease and a service, it can be difficult to separate the two components (and to reliably measure those components).

12. Some constituents, including the Leases Working Group members, also commented that unless the boundary between a lease contract and a service contract is better defined, off-balance-sheet financing could remain because entities may attempt to structure contracts to convey services rather than rights of use.

13. In discussions with interested parties, specifically at the recent roundtables and working group meeting, it became clear that many felt that the board should begin their redeliberations on the definition of a lease by clarifying whether they view that all leases should be accounted for:

    (a) as a form of financing;

    (b) differently to executory contracts;

    (c) uniquely; and

(d) as a ‘right-of-use’ or in the context of a physical asset, or component/portion of a physical asset underlying the lease contract.

Possible approaches

14. On the basis of its preliminary assessment of the feedback received, the staff propose the following three options for addressing this issue:

    (a) Identify alternative approaches to the guidance in IFRIC 4/EITF 01-08 for differentiating between a lease and a service. The consideration could include:

        (i) This would require revisiting the fundamental principles underlying existing guidance. This process would start by considering whether a lease will always mimic a purchase and loan and identifying what is the unit of account when determining a lease; and

        (ii) Whether capitalise all cash flows committed by an entity in the contract, including those associated with executory contracts.

    (b) Carry forward the principles in IFRIC 4/EITF 01-08 (ED) but provide further guidance on critical elements and on how to apply them (eg application guidance on what the boards mean by ‘fixed price’, ‘output’ and ‘specified asset’).

    (c) Retain most of the principles in IFRIC 4/EITF 01-08 because they are not fundamentally wrong. Reconsider some of the areas where there are known practice issues to see whether those principles are correct (eg consider whether to remove the criterion regarding ‘fixed per unit of output’). This approach does not preclude providing further guidance on parts of the principles that already work.

15. Appendix B lists the advantages and disadvantages of these approaches.

Preliminary staff views

16. We think that developing the definition of a lease should reflect both lessee and lessor perspectives and that the boards should deliberate the definition for lessees and lessors at the same time.

17. We think that the boards' views on what is a lease affects how the boards will develop the accounting for leases and the lessor accounting model.

18. It could be argued that a lease is a form of financing and that the principles in developing what is a lease and lease accounting should continue to reflect that view. This view has been the premise of the leases project as the Leases DP and the ED stated that leasing is an important source of financing. Consequently, the boards proposed a right-of-use model for lessees. The accounting of the lessee's assets and liabilities reflects that premise.

19. However, some may argue that a lease transaction, as currently defined, may not just include contracts that are a form of financing and, instead, represent a pure operating rental agreement. Some of the feedback we have received suggest that there are problems when the current guidance identifies leases in services where it is the **lessor** using the underlying asset to provide goods or services to the lessee. In such cases, the lessor may retain significant risks related to the underlying asset. (That was one of the reasons the boards concluded that the derecognition lessor model could not be applied to all contracts that would be deemed to be leases under the guidance in the ED.) Consequently, execution of the contract occurs throughout the lease term. .

20. In a lease transaction, it is important to identify what **the asset** is that is acquired by a lessee. Is the right-of-use asset a portion of the underlying asset or a separate asset related to the underlying asset?

    (a) One view is that a lessee is paying for the right to use the underlying asset. Under this view, the underlying asset is a bundle of rights, any portion or all of which can be transferred to a lessee at a point in time. Therefore, the right-of-use asset is similar to a good, rather than a service provided over time. The lease contract transfers the right to use the underlying asset that was previously held by the lessor to the lessee.

(b) The other view is that the underlying asset cannot be componentised and thus a lessee acquired a separate asset, entirely new asset, which is the right-of-use asset.

21. We do not think that the principles in IFRIC 4/EITF 01-08 are fundamentally wrong. However, that guidance was created for a different reason and when there were two types of accounting for leases. The preliminary staff analysis in Appendix C summarises our reasons for this view. We think that the boards should move forward with either approach (b) or approach (c).

(a) We think that fulfilment of a contract depends on the lessor providing a specified asset or assets. Is the lessee indifferent to the asset that is being used? However, additional guidance is needed on how to apply this criterion - what is the specified asset: is it the right-of-use asset or the underlying asset?

(b) We think that the boards need to clarify the meaning of a ‘right to control the use of the underlying asset’, including what is ‘output’. In a contract for the output from an asset, a lessee controls the underlying asset when the lessor has the right (if not the practical ability) to provide the output using other assets

(c) We think that the issue relating to distinct or non-distinct lease/service components relates to the definition of a lease. That is, we think that if a lease and/or service are not distinct, we need to consider whether the whole contract is a lease or service, rather than a lease and a service.

22. We think that any major changes made by the boards on the definition of a lease may require further field testing, because the finalisation of the overall leases standard depends critically upon what falls into the scope of that standard.

Appendix A – examples

A1. This Appendix includes some examples of situations that have raised challenges in current practice and, therefore, would also raise issues in applying the proposed principles in the ED to those examples. Appendix C contains some preliminary staff analysis and possible paths forward to address these challenges.

Specified asset

A2. The first three examples demonstrate the difficulties in applying the guidance in determining what constitutes the specified asset. During our outreach activities, constituents have specifically identified difficulties relating to whether a specified asset can be:

(a) regarded as a component of a single item of property, plant and equipment, or as an aggregation of a number of items of property, plant and equipment, rather than just using the same unit of account as in the property, plant and equipment guidance in IFRS and US GAAP; or

(b) substituted for another asset. For example when the lease asset is capable of being exchanged, even though substitution rarely occurs in practice.

Example 1: renting pooled rail freight cars

> Company A has an arrangement with Company AA for the right to use rail freight cars. The arrangement identifies the specific freight cars that Company A has the right to use for a period of time. However,

Company A may at any time substitute the specific freight cars for other similar freight cars from a pool.

What is the specified asset? Is it the:

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

b) pool of cars for which Company A has an arrangement to use 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 data cable from a telecommunications company. The telecommunications 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/lease asset itself?

Example 3: outsourcing contract

Company C outsources its data warehousing to an IT Company. The outsourcing contract may specify one, or a combination of the following:

- the amount of data storage space;

- a specific server; or

- the location of the data warehousing facility.

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

Right to control the use of a specified asset

A3. Constituents have indicated that most common problems associated with 'the right to control the use of a specified asset' criterion arise from interpreting the third condition:

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..

A4. The following two examples illustrate some of the issues where more guidance has been requested:

(a) What is meant by ‘fixed price per unit’?

(b) What is meant by ‘output’?

Example 4: 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 corresponds to the total production of the finished product units over its life cycle. P takes 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:
>
> - 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’ criterion?

Example 5: 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.

[1] CU = currency units

> 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% 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'?

Is the lease distinct?

A5. Example 6 demonstrates the difficulties in differentiating a service contract from a lease, and therefore the issue is whether there is a lease and whether a lease can be meaningfully separated from a service (ie the lease/service is distinct). If separable, the entity is required to allocate the payments required by the contract between the service components and the lease components.

Example 6: time charter

> As is common in the shipping industry, a 'time charterer' enters into a contract of freightment with a ship owner 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 ship owner (lessor) in addition to maintenance and overhaul. Food and water for captain and crew are also provided by the owner (lessor).
>
> Under the proposed definition of a lease, is time charter a lease or a service?

Appendix B: preliminary analysis of possible approaches

B1. This Appendix discusses the advantages and disadvantages for each approach on how the boards could deal with the definition of a lease.

Approach (a) Identify alternative approaches to the guidance in IFRIC 4/EITF 01-08 for differentiating between a lease and a service

B2. A fundamental rethink of what constitutes a lease might result in a clearer dividing line between service and lease contracts (although it might not).

Advantages	**Disadvantages**
Could lead to a converged answer.	It would be time-consuming. It could lead to re-exposure and/or the need for field testing (if the conclusions reached are significantly different from what we have now).
May result in a clearer dividing line between service and lease contracts.	Some think that a right-of-use approach should also be applied to non-distinct/ integral service components of lease contracts. This view could result in a significant (and very controversial) increase in the scope of the leases standard.
	There would be an additional risk of unintended consequences, because it is uncertain how practice would develop given a new definition of what constitutes a lease. Practitioners are already familiar with the current, converged criteria for determining whether a contract is a lease and have identified specific practice issues that require further analysis.

Approach (b) Carry forward the principles in IFRIC 4/EITF 01-08 but provide further guidance on critical elements and on how to apply them

Advantages	**Disadvantages**
The existing principles are familiar to practitioners.	Challenges are likely to continue to exist in identifying whether a contract is a service or a lease. It is unlikely that the additional clarity would address all of the concerns raised by constituents given the variety of fact patterns.
Feedback in the comment letters and our outreach activities have identified specific issues and fact patterns that give rise to the issues identified by practitioners. This will assist us in focusing on the specific concerns with defining a lease.	Existing guidance was written under a model under which most leases were operating leases and therefore the distinction between a lease and a service was not scrutinised to the level that it would be under the proposals in the ED.
The current converged definition of a lease is the result of relatively recent deliberations and is based upon underlying principles that are consistent with those of the *Leases* ED	

Approach (c) Retain most of the principles but reconsider some of the areas where there are known practice issues

B3. The advantages and disadvantages of this approach are broadly similar to those of approach (b), but it may address some of the challenges on defining what is a lease.

Appendix C:
Preliminary staff analysis on the two criteria relating to the definition of a lease that were carried forward from IFRIC 4/EITF 01-08

C1. This appendix includes a preliminary staff analysis on the main issues raised by respondents and from other outreach activities.

C2. The ED proposed 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.

Specified asset or assets

C3. The ED proposed the following guidance in assessing whether fulfilment of the contract depends on providing a specified asset or assets (the ‘underlying asset’) to the lessee:

(a) it may be necessary in applying the current guidance to consider whether the asset or assets are implicitly or explicitly specified.

(b) An asset is implicitly specified if it is (a) unfeasible 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.

C4. The staff have found that this guidance creates problems. It may sometimes be obvious that there is a specified asset, and what it is, when the lessor only has one underlying asset to lease (eg a tenant that leases an entire building). In other cases, it may not be so obvious. Examples 1 to 3 in Appendix A above illustrate some of these problems.

C5. However, the staff continue to think that under a lease a lessor should convey the right to use **a specified asset** because:

(a) it is supported through the feedback received during outreach activities and from the comment letters that were received;

(b) all arrangements currently accounted for as leases would continue to be accounted for as leases;

(c) this option is familiar to constituents and therefore it would be easier for constituents to understand and implement;

(d) this condition is not a main concern in applying the existing guidance; and

(e) the guidance is already converged.

C6. However, we think that further guidance could be developed relating to the 'substitutability' or 'exchangeability' of the underlying asset.

C7. In addition, the boards should clarify what the asset is that the lessee acquired (the right-of-use asset or the underlying asset).

(a) For example, in Example 1 in Appendix A, is the underlying asset a pool of cars or each individual car that is part of the pool of cars? If the underlying asset is a pool of cars, does it matter if the supplier/lessor changes the cars?

(b) In Example 2, can a component of an asset be subject to a lease?

C8. Constituents have also noted the following key considerations in determining the 'specific asset' criterion:

(a) whether the underlying asset could be easily purchased (or replaced); if so, the asset may not necessarily be specified.

(b) whether the lessee consumes the economic value of the underlying asset during the lease term (eg the lessee may not be seen as consuming the economic value of an investment property that appreciates over time).

(c) the life of the lease term in relation to the useful life of the underlying asset.

(d) whether the provision of the underlying asset is merely a conduit for providing service (eg digital television set-up boxes and modems/routers for providing internet services).

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

C9. The ED states that an arrangement conveys the right to use the underlying asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. It further states that the right to control the use of the underlying asset is conveyed if any one of the following three 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.

C10. In summary, the reasons for those conditions are:

(a) The first two conditions (a) and (b) consider the purchaser's ability to control the use of the underlying asset either through operations or physical access. These two conditions reflect the principle of the purchaser having the underlying asset available for use, with a reduced focus on the actual use or output from the underlying asset.

(b) The third condition (c) assumes that the purchaser of the output has the ability to control the use of the underlying asset when it is, in effect, able to restrict the access of others to that asset because of the significance of the output that the purchaser is taking from the underlying asset. This condition does not apply if the pricing paid by the purchaser for the significant output is fixed or based upon current market prices. This is because such pricing structures are indicative of paying for a product or service rather than paying for the right to use the underlying asset.

C11. During our outreach activities, constituents indicated that most problems associated with the control criterion arise from interpreting the third condition. In particular, the staff 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?

C12. Broadly, we think that the principles underpinning the first two conditions (a) and (b) should be retained. Furthermore, we have not heard of problems in applying them in practice and many respondents do not disagree with them.

C13. With regard to condition (c), the staff suggest three ways in which the boards could respond the concerns that have been raised:

(a) The boards could retain condition (c) because many constituents think that whether one is paying per unit of output is a crucial difference between a lease and other types of contracts. If the boards did decide to retain condition (c), they could clarify the guidance on ‘fixed price’ and ‘output’(ie Approach (b)).

(b) The boards could remove the ‘fixed price’ criterion from condition (c) (ie Approach (c)).

(c) The boards could remove condition (c) (ie Approach (c)).

If any one of these three options were to be adopted, arrangements with the existing guidance might be classified differently to the way in which they are classified now.

C14. Furthermore, some respondents questioned why there are different indicators on when an entity controls an asset (right to use the underlying asset) from the indicators in the revenue recognition ED to determine when the customer obtains control of a good or service (see paragraphs 30 - 31 in the revenue recognition ED).

Clarifying condition (c): what does fixed price mean?

C15. The principle in the pricing requirements is to distinguish paying for the actual output of the asset from paying for the time during which the underlying asset is made available for use. If the entity pays for the actual output (goods or services) only, it is not a lease. If the payments are for something other than the value of the output, it is a lease.

C16. Fixed price could include all of the prices that have been agreed between the supplier and the purchaser. This agreement could also include prices reflecting changes in interest rates, inflation or even a changing price per unit during the term of the contract.

Clarifying condition (c): what does output mean?

C17. With regard to providing guidance on what output means, we think that condition (c) could be better drafted to focus on when the purchaser is **controlling the use of the underlying asset,** rather than just focusing on one or more particular outputs.

C18. As noted above, condition (c) assumes that the recipient of the output has the ability to control the use of the underlying asset when it is able to restrict the access of others because of the significance of the output that the purchaser is taking from the underlying asset.

C19. For example, in Example 5, a customer purchases energy generated by wind turbines from a utility company. But the utility company, by virtue of operating the wind turbines, also has renewable energy credits (RECs) that also have economic value. If the customer also buys the renewable energy credits (which have economic value) or at least has the ability to receive benefits from those RECs, then the customer could be considered to control the use of the underlying asset. If the utility company is the party that determines who should receive the RECs, it could be argued that the customer's contract with the utility company does not contain a lease.

C20. Consequently, if the underlying asset produces two or three types of output, the arrangement is considered a lease if the purchaser acquires all of these output and not only one (or a portion of them). However, it is questionable how the customer knows what are all of the output from the underlying asset.

Amending condition (c): removing the 'fixed price' criterion

C21. Many respondents questioned why does pricing matter in condition (c). For example, in conditions (a) and (b), it does not matter if a purchaser is paying per unit. Therefore, the boards could consider removing the 'fixed price' criterion from condition (c). An implication is that more types of contracts would be leases.

Removing condition (c): Is right of output any different from a forward contract? Is buying all of the output produced by a specified asset the same as buying a right to use that asset?

C22. Some staff question whether the third condition – that 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 – should be withdrawn.

C23. If this criterion is withdrawn, some types of arrangements, such as take-or-pay contracts that depend on specific assets, would no longer be considered leases. However, the staff understand that most of these types of arrangements are currently classified as operating leases so the accounting will not differ, except for some disclosures.

C24. It could be argued that an entity purchasing output to be produced in the future (even though it is all of the output of the underlying asset) is in a similar position to an entity entering into a forward contract. This is because the entity does not control the right to use the underlying asset, but only a right to the output. A right to all or substantially all of the output is different from a right to use that asset. For an entity to obtain the economic benefits of an asset specified by the arrangement, the entity needs more than merely rights to substantially all of the output or other utility of the asset. Consequently, the entity is actually purchasing a service in which the supplier is producing the output, rather than controlling the use of the underlying asset.

C25. The example below illustrates the issue:

> Because Grocery Company A only sells a particular breed of organic corn, Grocery A signed a two-year contract with a farmer under which Grocery A purchases all of his corn (that is still growing in the fields) for a fixed price for all of the corn. [The specified asset is met because Grocery A is buying all of the farmer's corn and the farmer does not have other fields of corn.]
>
> Do you think this contract is a lease or a forward contract? Why? (This contract may qualify as a lease under existing requirements.)

C26. Under the existing requirements, an entity entering into a forward agreement to purchase an asset at a future date does not recognise the asset that is the subject to the contract. Instead, it has a contractual right to obtain the asset that is conditional on it paying the amount specified in the contract. Similarly, it does not have a liability for the forward purchase price, but rather a conditional obligation to pay that is conditional on the counterparty delivering the asset. The entity recognises these contractual rights and obligation as a financial asset and a liability (or a cash payment) when it has actually obtained those rights. Hence, the asset that is the subject to the contract is not recognised until the contract is executed.

C27. Similarly, in a take-or-pay contract (a transaction that is normally captured in condition (c)), prior to any performance, the purchaser only has a conditional right to receive the goods (dependent on payment) and a conditional obligation (dependent on supply) to pay for the goods.

C28. An essential distinguishing feature of a take-or-pay contract is the obligation that it imposes upon the purchaser to pay the supplier, irrespective of whether the purchaser takes up its rights to the goods or services or the right to use facilities.

(a) From the point of view of the supplier, this obligation of the purchaser is a significant right (for example, it might be the means of obtaining finance for a dedicated facility). Equally, the purchaser has a valuable right in that it has secured availability of a product at a fixed price.

(b) In some respects, this unconditional obligation of a take-or-pay contract is similar to a guarantee. Taking this into account, a simple take-or-pay contract, which is akin to a minimum purchase commitment, can therefore be split into two components: a straightforward sale and purchase agreement and a guarantee.

C29. In its basis for conclusions to the draft to IFRIC 4 (D3 *Determining whether an arrangement contains a lease*), the IFRIC noted that take-or-pay contracts were essentially future commitments.

> BC21 The IFRIC observed that if an arrangement contains a lease, and the lease is an operating lease, applying this [draft] Interpretation is likely to result in the same assets, liabilities and expenses being recognised as if no lease had been identified. … Also, the IFRIC noted that the [draft] Interpretation would often result in additional disclosure, because IAS 17 specifies that the lessor and lessee should disclose the future minimum lease payments. The IFRIC observed that, for a purchaser, the arrangements discussed in this [draft] Interpretation typically represent significant ***future commitments***, and yet these commitments are not required to be disclosed in the financial statements by standards other than IAS 17. The IFRIC agreed that by bringing such arrangements within the scope of IAS 17, users of financial statements would be provided with relevant information that is useful for assessing the purchaser's solvency, liquidity and adaptability. [emphasis added]

Contracts that contain both service components and lease components

ED proposals

C30. Paragraph B5 in the ED proposes that an entity should apply the ED *Revenue from Contracts with Customers* for a distinct service component within a contract that contains both service and lease components. If a lessee or a lessor is unable to allocate the payments between service and lease components, the lessee or lessor should apply the *Leases* ED to the whole contract.

C31. In addition, if the service component is not distinct, a lessee or a lessor that applies the performance obligation approach should account for the whole contract as a lease. The IASB tentatively decided that if the lessor applies the derecognition approach, the lessor should allocate the payments between service and lease components on a reasonable basis while the FASB tentatively decided to account for the whole contract as a lease.

C32. Many respondents agreed with the principle of separating leases from service components in a contract. However, they concerned on how to separate them when the service and lease components are not distinct or they cannot be reliably measured.

Issues raised by constituents

C33. Some situations seem to be suggesting another issue, in addition to the issues noted above (ie specified asset and right to control the use of the specified asset) to determine whether an arrangement is, or contains a lease. The question is whether, when a contract contains both service and lease components, these components should be separated when the components are very inter-related.

C34. Some complex arrangements (eg time charters and outsourcing contracts) may have both lease and service components. These components are so interlinked, so that it may be very difficult to separate them or measure reliably. In such situations where the service component is not distinct, some interested parties have proposed alternative approaches that include requiring a lessee to estimate the service component, even if such an estimate may not be reliable.

C35. Suggestions on how to deal with contracts that contain both service and lease components are:

(a) all mandatory services provided by the lessor are accounted for as a lease; or

(b) guidance should be provided similar to that in US GAAP (Topic 840-10-25-5) where guidance on how to account for services such as insurance, taxes and common area maintenance should be brought forward.

C36. Other constituents have expressed concerns relating to the proposals to separately identify service and lease components, regardless of whether the service component is distinct. They have proposed that a lessee should:

(a) perform a qualitative or a quantitative assessment, or both, to determine whether a contract should be accounted for in its entirety as either a service or lease, rather than separating the lease and service components; or

(b) focus on determining whether the lease component (payments for the right to use the underlying asset), rather than the service component, is distinct (this may change paragraph B5 of the ED). Focusing on determining whether a contract contains a lease is the same approach used in IFRIC 4/EITF 01-08 and is currently widely applied in practice.

(c) separating a contract between the service and lease component based on the fair value of each, regardless of whether it is distinct or not.

C37. We think that in whatever way we deal with services, it should be consistent with the guidance on services developed by the revenue recognition project.