Project **Leases**

Topic **Distinguishing between a lease and a purchase or sale**

Purpose

1. The purpose of this paper is to discuss whether the leases standard should provide guidance for distinguishing a lease from a purchase or sale.

2. The staff recommend that guidance should not be provided in the leases standard for distinguishing a lease of an underlying asset from a purchase or sale of an underlying asset.

3. This paper is structured as follows:

   (a) Summary of proposals in the Leases Exposure Draft (ED);

   (b) Summary of overall feedback;

   (c) Staff analysis and recommendation;

   (d) Appendix A – staff analysis on the proposed criteria to distinguish between a lease and a purchase or sale; and

   (e) Appendix B – preliminary draft wording relating to distinguishing between a lease and a purchase or sale (if necessary).

Summary of proposals in the ED

4. The ED states that:

> An entity should not apply [the leases proposals] to the following contracts, which represent a purchase or sale of an *underlying asset*:
>
> (a) a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity; and
>
> (b) a lease after the lessee has exercised a purchase option specified in the lease. A contract ceases to be a lease when such an option is exercised and becomes a purchase (by the lessee) or sale (by the lessor).

5. The application guidance in the ED further states that:

   (a) That determination is made at inception and is not subsequently reassessed.

   (b) An entity should consider all relevant facts and circumstances when determining whether control of the underlying asset is transferred at the end of the contract.

   (c) A contract normally transfers control of an underlying asset when the contract automatically transfers title to the underlying asset to the transferee at the end of the contract term.

   (d) A contract normally transfers control of an underlying asset when the contract includes a bargain purchase option. A bargain purchase option is an option to purchase the asset at a price that is expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable. If the exercise price is significantly lower than fair value, it would be reasonably certain at the inception of the lease that such options will be exercised. An entity that has a bargain purchase option is in an economically similar position to an entity that will automatically obtain title to the underlying asset at the end of the lease

term. By exercising its bargain purchase option, the transferee would be able to direct the use of, and receive the benefits from, the whole of the underlying asset for the whole of its life.

6. The accounting by lessees and lessors for purchase options, including a bargain purchase option, will be discussed in a separate paper (please refer to IASB Agenda Paper 5D/FASB Memo 143).

Summary of overall feedback

7. There was little support for providing guidance on distinguishing a lease from a purchase or sale. The majority of respondents commented that if the Boards appropriately define a lease in the leases project then the proposed guidance on this issue (commonly referred to by respondents as 'in-substance purchases or sales') would be unnecessary. They think that if a lease is appropriately defined, then contracts that meet the definition of a lease would be accounted for in the final standard on *Leases*.

8. Therefore the majority of respondents suggested that guidance on distinguishing a lease from a purchase or sale should not be carried forward into the final leases standard. Instead, they think that the Boards should clarify the definition of a lease. They think that this would (a) reduce the complexity created by the proposed guidance and (b) avoid the existence of multiple definitions of a sale across different accounting standards.

9. Some noted that the guidance in the ED for distinguishing a lease from a purchase or sale was developed by the Boards at the time when they had tentatively decided that all leases should be accounted for using the performance obligation approach for lessors. The guidance therefore ensured that 'in-substance sales' would be accounted for similarly to a sale of an asset rather than using the performance obligation approach. These respondents think that as a result of developing a derecognition approach, the guidance for distinguishing a lease from a purchase or sale is no longer necessary. That is because the derecognition approach results in accounting that would be similar to a sale of an asset.

10. Many respondents also expressed concerns with introducing the term 'trivial' in distinguishing a lease from a purchase or sale contract, noting that:

    (a) the term 'trivial' is not defined; and

    (b) the Boards have not explained how 'trivial' relates to other terms used in the ED, such as 'insignificant' or 'minor'.

11. A few respondents commented that if the Boards retain guidance on distinguishing a lease from a purchase or sale, they should focus on control, rather than a combination of risks and benefits and control. For example, they think that the Boards should clarify whether a bargain purchase option or transfer of title at the end of the lease term indicate that control has transferred from the lessor to the lessee.

Staff analysis

Is guidance needed to distinguish between a lease and a purchase or sale?

12. The staff agree with those respondents' comments that an appropriate definition of a lease in the leases project and appropriate guidance in the revenue recognition project would make guidance to distinguish between a lease and a purchase or sale unnecessary, noting that the Boards have been redeliberating lessee and lessor accounting issues, including how to appropriately define a lease, and the revenue

recognition proposals to address concerns raised by respondents to the ED and other outreach activities.

13. The staff disagree that some leases are in-substance purchases or sales of the underlying asset. In fact, the staff question what in-substance purchases or sales actually mean (although they are commonly referred to by constituents). Leases are leases and purchases/sales are purchases/sales. There are no such things as 'in-substance purchases or sales' and leases are not in-substance purchases or sales. The staff do not think that guidance defining in-substance purchases or sales is necessary. Rather, the staff think that they are two separate, different contracts—leases and purchases or sales—which should be accounted for in two ways, either as a lease, or as a purchase or sale.

14. Lease contracts can include term options, purchase options, variable lease payments, residual value guarantees and other terms which result in the lease contracts being, in substance, similar to a purchase or sale. Some leases that meet the definition of a finance lease under the new leases standard would be accounted for similar to purchases or sales. Under the proposed right-of-use model, lessees would recognise assets and liabilities for all leases, reflecting acquisition of a right-of-use asset, similar to purchase accounting. Also, the proposed derecognition model to lessor accounting is similar to sale accounting.

15. The staff think that it is unlikely that those contracts, for example contracts that contain a bargain purchase option or that transfer title at the end of the lease term, would be accounted for under the performance obligation approach to lessor accounting or as a non-finance lease (if there are two types of leases) for lessees because the substance of the contracts are similar to purchases or sales.

16. Therefore, lease contracts should be accounted for in accordance with the final leases standard (assuming a lease is clearly defined), whereas purchase or sale contracts should be accounted for in accordance with other standards (e.g. revenue recognition and property, plant and equipment (PP&E)).

17. The staff therefore think that any attempt to develop additional criteria to distinguish between leases and purchase or sale contracts would be arbitrary and thus would require additional guidance on this issue as pointed out in the below comment letter extracts:

> We do not agree with the criteria for distinguishing between a lease, and a contract that represents a purchase or a sale. We believe that the guidance to identify a purchase or sale transaction should be included in the Board's revenue recognition proposals. The inclusion of a separate set of guidance in the proposed IFRS for distinguishing a purchase or sale from a lease is unnecessary and may result in complexity and inconsistent application (CL #292).
>
> We believe that the criteria for identifying a contract as representing a purchase or sale must mirror the criteria for revenue recognition, otherwise inconsistency in reporting and structuring opportunities will result. We do not believe it is necessary or desirable to establish separate criteria in the Leases ED to distinguish a contract between the purchase and sale of an asset and a lease of an asset. The application guidance in the Revenue ED could incorporate much of the relevant guidance from the Leases ED (CL #93).
>
> We believe the proper accounting should be consistent with the guidance included in the exposure draft on revenue (CL #372).

18. Consequently, the staff think that guidance to distinguish between a lease and a purchase or sale is not necessary. Instead, the Boards should focus on developing a clear principle for the definition of a lease in the leases project and clear guidance on when to apply the revenue requirements in the revenue recognition project for lessors.

Under two accounting approaches

19. In the ED, the Boards excluded from the scope of the leases standard transactions that include either automatic title transfer or a bargain purchase option (additional discussion on these two proposed criteria is included in Appendix A).

20. The staff note that the Boards introduced this guidance to determine which leases are in-substance purchases or sales when the Boards were considering only a performance obligation approach to lessor accounting. Under the performance obligation model, an underlying asset is not derecognised and income is

recognised over time, leading to an accounting approach that could be different from sale accounting.

21. However, subsequently, the Boards discussed and proposed two accounting approaches for lessors in the ED. Once the Boards decided to consider those two approaches, some Board members started to question whether they still needed the guidance to distinguish purchases or sales from leases.

22. To the extent that a derecognition model is retained, the boundary between leases and purchases or sales becomes less relevant. This is because, under the derecognition approach to lessor accounting, the accounting would be similar to the accounting for a sale of an asset (e.g. an underlying asset is derecognised and income may be recognised at the commencement of the lease). The staff think that in applying the ED, a lessor would be required to apply a derecognition approach, rather than a performance obligation approach to account for in-substance sales.

23. At the 17 February 2011 meeting, the Boards discussed two types of leases for both lessees and lessors and a principle for identifying two types of leases. One indicator the Boards are considering for distinguishing between the two types of leases is potential ownership transfer, the same criteria to distinguish a lease from a purchase or sale in the ED (please refer to IASB Agenda Paper 5F/FASB Memo 134 from the February 2011 meeting). Those criteria are similar to the examples of situations that would normally lead to a lease being classified as a finance/capital lease in the existing standards.

24. Therefore, if the Boards also decide to introduce two approaches to lessee accounting, the accounting by a lessee for finance type leases would be similar to purchase accounting. Therefore, the staff think that there is no fundamental difference in the accounting for an arrangement accounted for as a purchase or as a finance lease for a lessee.

25. Consequently, the staff think that criteria to distinguish between a lease and a purchase or sale are not necessary. This is because:

(a) the final *Leases* standard would appropriately define a lease;

(b) the final *Revenue Recognition* standard would appropriately provide guidance on when to recognise revenue;

(c) the accounting for a purchase of an underlying asset would be similar to the accounting by a lessee under the accounting for a finance lease (if there are two types of leases for lessees) when applying the final *Leases* standard; and

(d) the accounting for a sale of an underlying asset would be similar to the accounting by a lessor under the accounting for a finance lease (if there are two types of leases for lessors) when applying the final *Leases* standard.

Staff recommendation

26. The staff think that the proposed guidance in the ED for distinguishing between a lease and a purchase should not be carried forward into the final standard. A lease contract should be accounted for in accordance with the leases standard and contracts that represent a purchase or sale of an underlying asset should be accounted for in accordance with other applicable standards (e.g. revenue recognition by lessors, PP&E by lessees).

Question 1
The staff recommend eliminating the guidance to distinguish between a lease and a purchase or sale in the leases. A purchase or sale should be accounted for in accordance with other applicable standards. Do the Boards agree?

Appendix A: staff analysis on the proposed criteria to distinguish between a lease and a purchase or sale

A1. If the Boards disagree with the above staff recommendation and prefer to retain the guidance in the ED, then the staff think that additional guidance and clarification would be necessary (the staff would bring a paper on this issue at a future meeting).

A2. The ED states that an entity should not apply the leases proposals to a contract that represents a purchase or sale of an underlying asset. The ED states that a contract represents a purchase or sale of an underlying asset when it results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity. A contract normally transfers control of an underlying asset when (a) the contract automatically transfers title to the underlying asset to the transferee at the end of the contract term; or (b) includes a bargain purchase option.

A3. Many constituents raised concerns about the proposed criteria, including:

(a) inconsistency with the proposed criteria for the recognition of revenue in the Boards' exposure draft on *Revenue from Contracts with Customers*;

(b) the lack of clear guidance on the accounting treatment for purchase or sale contracts that are scoped out of the leases standard;

(c) the definition of the term 'trivial'; and

(d) the automatic title transfer and bargain purchase option criteria.

Inconsistency with the revenue recognition ED and unclear accounting treatment

A4. Many noted that the criteria for distinguishing between leases and purchases or sales are inappropriate because they are inconsistent with the revenue recognition ED.

A5. The proposed criteria for distinguishing between a lease and a contract that represents a purchase or sale include two conditions: the transfer of (a) control of an underlying asset and (b) the risks and benefits of the underlying asset. In

contrast, the revenue recognition ED proposes the transfer of control as the sole criterion for determining when an entity recognises revenue for the sale of an asset. The staff think that this difference is because a lease generally transfers temporary control of an underlying asset during the lease term, whereas purchases or sales transfer permanent control. Therefore, by adding the assessment of risks and benefits to the control criterion, the leases proposals emphasise the legal ownership/form of the transaction, i.e. how much a lessor retains/controls residual interest of an underlying asset.

A6. The ED states that if those criteria are met, an entity should not apply the leases standard because these transactions are purchases and sales within the scope of other IFRSs and US GAAP (e.g. revenue recognition and PP&E). However, considering differences between the leases and revenue recognition EDs, the staff think that the accounting treatment for purchase or sale contracts is unclear.

A7. For example, under the revenue recognition guidance, an entity would need to assess if the revenue recognition criteria were met as of the commencement date, rather than as of the end of the lease contract (per leases). Also, there may be a situation where a contract is excluded from the leases standard because it meets the proposed criteria (e.g. due to bargain purchase options), but might not qualify for revenue recognition under the revenue recognition proposals because control is not transferred.

A8. In addition, there is inconsistency between the criteria for purchases or sales and the risks and benefits principle for determining which accounting approaches a lessor should apply as proposed in the ED, i.e. whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of a lease. Given that a derecognition approach to lessor accounting is similar to sale accounting, it is questionable how the different criteria would affect the accounting outcome.

A9. The staff think that transfer of control is the appropriate principle under which purchases or sales should be recognised. Consequently, the staff think that it is

not necessary to develop separate, different criteria in the leases standard to distinguish between a lease and a purchase or sale. The criteria should be consistent with other standards applied for the purchase or sale contracts.

Definition of the term 'trivial''

A10. The ED makes a distinction between a lease and a purchase or sale based on whether 'all but a trivial amount of the risks and benefits associated with the underlying asset' is transferred.

A11. Many respondents commented that the term 'trivial' is not defined and asked how 'trivial' relates to other terms used in the ED, such as 'insignificant' or 'minor'. In addition, a number of respondents expressed concerns over using the risks and benefits criterion, noting that it could result in structuring opportunities as a relatively unsubstantive provision could be added to a lease contract such that the lessor would retain more than a trivial amount of risk.

A12. The staff think that what distinguishes a lease from a purchase or sale is the fact that a lessee obtains control of an underlying asset during the lease term, pays the lessor for its use of the asset, and has to return that underlying asset to the lessor at the end of the lease term. That is, in a lease, control of an underlying asset is generally intended to transfer from lessor to lessee at the start of the lease, and then transfer back to the lessor at the end of the lease. Accordingly, to address those concerns over the risks and benefits criterion, the criteria should focus on whether control of an underlying asset would be transferred back to the lessor at the end of the lease, and transfer of risks and benefits could be an indicator of the transfer of control.

Automatic title transfer and bargain purchase option

A13. The ED states that a contract normally transfers control of an underlying asset when the contract automatically transfers title to the underlying asset to the transferee at the end of the contract term or includes a bargain purchase option.

A14. The automatic title transfer criterion emphasises the legal ownership of an underlying asset. Some think that when a transferee automatically obtains title to an underlying asset at the end of the lease term, it would have control of the asset for the whole of its life because it receives the economic benefits from the whole of the underlying asset. Furthermore, the transferor has no unconditional rights to the asset. Therefore, on day 1, this contract is a purchase by a lessee and a sale by a lessor. This argument is consistent with the revenue recognition proposals.

A15. However, others think that leases are leases and lease contracts can include the automatic title transfer clause. That term in a lease contract does not necessarily make the lease a purchase or sale contract. The automatic title transfer of an underlying asset would occur at the end of the lease term, and at that point, the transferee and transferor should assess whether the lease is no longer a lease, and it is in fact a purchase or sale. The lessee and the lessor will need to assess whether the arrangement is a sale for the lessor and a purchase for the lessee. If so, then the applicable guidance should be applied.

A16. The ED also states that a bargain purchase option normally transfers control of an underlying asset and therefore lease contracts with a bargain purchase option should be considered in-substance purchase and sale contracts. A bargain purchase option is an option to purchase the underlying asset at a price that is expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable. If the exercise price is significantly lower than fair value, it would be considered at the inception that such options will be exercised.

A17. The ED proposed accounting for a non-bargain purchase option only upon exercise because a contract ceases to be a lease when such an option is exercised and the contract becomes a purchase or sale.

A18. The IASB Agenda Paper 5D/FASB Memo 143 deals with the accounting for purchase options, including a bargain purchase option. In this paper, some think a bargain purchase option results in an amortisation period that equals the whole

economic life of the underlying asset and the exercise price of the bargain purchase option would be included in lease payments.

A19. Consistent with the staff analysis and recommendation in AP 5D/Memo 143, the staff think that a lease contract that includes a bargain purchase option should be accounted for in accordance with the final *Leases* standard.

A20. A transferee and transferor should assess whether a lease is terminated and it would become a purchase or sale when a lease includes automatic title transfer to the transferee at the end of the contract term or a bargain purchase option. If it is determined that the lease becomes a purchase or sale, then it should be accounted for as such in accordance with other applicable standards. The staff think that the two conditions (i.e. leases with automatic title transfer or bargain purchase option) focus more on legal form than the substance of the transaction, and the principle to distinguish between a lease and a purchase or sale should be assessing when control of an underlying asset is transferred from a lessor to a lessee.

Appendix B: preliminary draft wording relating to distinguishing between a lease and a purchase or sale

The staff do not think that any wording is necessary for distinguishing between a lease and a purchase or sale. However, if the Boards think that guidance should be included to clarify this issue, the staff recommend the following preliminary draft wording.

The preliminary draft wording in this appendix has been prepared by the staff to help the Boards in reaching decisions regarding distinguishing between a lease and a purchase or sale. The preliminary draft wording takes the wording from paragraphs B9-B10 of the ED and 'marks-up' changes to that wording to reflect the approach recommended by the staff:

Distinguishing between a lease and a purchase or sale

B1. An entity shall not apply this guidance ~~to contracts that meet the criteria for classification as a purchase or sale of an underlying asset.~~ if it is determined that contracts are a purchase or sale of an underlying asset. The purchase or sale contracts should be accounted for as such in accordance with other applicable standards (for example, property, plant and equipment and revenue recognition). ~~A contract represents a purchase or sale of an underlying asset normally if, at the end of the contract, an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset. That determination is made at inception and is not subsequently reassessed.~~

~~B2. An entity shall consider all relevant facts and circumstances when determining whether control of the underlying asset is transferred at the end of the contract. A contract normally transfers control of an underlying asset when the contract:~~

(a) ~~automatically transfers title to the underlying asset to the transferee at the end of the contract term; or~~

(b) ~~includes a bargain purchase option. A bargain purchase option is an option to purchase the asset at a price that is expected to be significantly lower than the fair value of the asset at the date that the option becomes exercisable. If the exercise price is significantly lower than fair value, it would be reasonably certain at the inception of the lease that such options will be exercised. An entity that has a bargain purchase option is in an economically similar position to an entity that will automatically obtain title to the underlying asset at the end of the lease term. By exercising its bargain purchase option, the transferee would be able to direct the use of, and receive the benefits from, the whole of the underlying asset for the whole of its life.~~