IASB/FASB Joint Meeting
1-2 March 2011

IASB Agenda reference **5B**

FASB Memo **138**

Staff Paper

Project **Leases**

Topic **Scope – exclusion for intangibles and other exclusions**

Objective

1. The purpose of this paper is to discuss the scope of the proposed lease accounting model.

2. This paper does not discuss:

   (a) investment properties;

   (b) leases between the date of inception and the date of commencement that meet the definition of an onerous contract (IASB only);

   (c) the definition of a lease, including:

      (i) how to differentiate service contracts from lease contracts,

      (ii) how to differentiate purchase/sale contracts from lease contracts,

      (iii) how to account for multi-element contracts; or

   (d) short-term leases.

   These issues have or will be discussed with the Boards in separate meetings.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

3. This paper is organized as follows:

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

   (b) Summary of overall feedback

   (c) Exclusion for intangible assets

   (d) Leases of certain items classified as inventory by a lessee

   (e) Other scope exclusions:

      (i) Leases to explore for or use natural resources, such as minerals, oil and natural gas

      (ii) Leases for biological assets (including living plants, animals)

      (iii) Leases of non-core assets

      (iv) Long-term leases of land

      (v) Service concession arrangements within the scope of IFRIC 12: *Service Concession Arrangements*

   (f) Appendix A: Proposed amendments to ED – US GAAP

   (g) Appendix B: Proposed amendments to ED – IFRS

Staff Recommendation

4. In this paper, the staff recommends:

   (a) the Boards affirm their decision that leases of intangible assets are not required to be accounted for in accordance with the leases standard except for:

      (i) right-of-use assets in a sublease; and

      (ii) for US GAAP, leases of internal-use software under Subtopic 350-40 currently analogized in current guidance.

(b) the Boards affirm their decision that leases of the following assets are not required to be accounted for in accordance with the leases standard:

  (i) leases *for rights* to explore for or use minerals, natural gas and similar non-regenerative resources. The staff recommends that the draft wording be changed slightly from the ED (see Appendices A and B) to state leases for *the right* to explore for or use of natural resources;

  (ii) leases of biological assets.

(c) in addition, the Boards should state that leases of the following are not required to be accounted for in accordance with the leases standard:

  (i) for US GAAP, leases of spare parts, operating materials and supplies that entities may classify as inventory;

  (ii) for US GAAP, leases of timber; and

  (iii) for IFRS, service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*,

(d) the Boards affirm the decision to include leases of non-core assets and long-term leases of land.

Summary of proposals in the ED

5. The ED proposes that an entity shall apply the guidance to all leases, including leases of right-of-use assets in a sublease, except:

(a) leases of intangible assets (see Topic 350 on intangibles – goodwill and other and IAS 38 *Intangible Assets*).

(b) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see Topic 930 on extractive activities – mining and Topic 932 on extractive activities – oil and gas and IFRS 6 *Exploration for and Evaluation of Mineral Resources).*

(c) leases of biological assets (see Topic 905 on agriculture and IAS 41 *Agriculture)*

Summary of feedback

6. A majority of the respondents agreed with the proposed scope exclusions in the ED. Those respondents that raised questions were generally concerned about the scope exclusion for leases of intangible assets, particularly for IFRS constituents. This is because, leases of some intangible assets are currently included within the scope of IAS 17 *Leases*; however, leases of all intangible assets are excluded from the scope of Topic 840 for US GAAP. As noted above, the tentative decision in the ED is to exclude all intangible assets from the scope of the new standard.

7. A few respondents suggested the Boards clarify whether the standard should apply when the underlying asset in the contract is:

   (a) an item classified as inventory (for example, spare parts);

   (b) a service concession arrangement (within the scope of IFRIC 12 *Service Concession Arrangements)*; and

   (c) timber (for US GAAP constituents, due to the specific scope exclusion that exists in ASC Topic 905 *Agriculture*).

8. For this reason, this memo focuses primarily on the scope exclusion for intangibles. Additionally, leases of inventory are discussed in paragraphs 28-38. Paragraphs 39- 59 of the memo contain discussion of other scope exclusions to which most respondents agreed.

Exclusion for intangible assets

General Feedback

9. Views on excluding intangible assets from the scope of the leases standard were mixed. The majority of respondents did agree that there is no conceptual basis for excluding intangible assets as stated in paragraph BC36 of the ED. However, some respondents agreed with the Boards' rationale to scope out intangible assets from the leases standard and deal with intangible assets as part of a separate project:

> While we believe that in some cases a lease of an intangible asset is not conceptually different than the lease of a physical asset, we believe that the accounting for the leasing of intangible assets should be dealt with as part of a broader project on the accounting for intangibles (CL#93).

10. Those respondents, predominately IFRS constituents, that disagreed with the proposals in the ED did so for the following reasons:

    (a) Difficulties encountered with bundled arrangements with both tangible and intangible assets.

        (i) There was concern that leases of intangible assets such as software would be accounted for differently from leases of property, plant and equipment. Respondents did not see a difference in the economic substance of a lease contract for software and a lease contract for a machine. This is complicated further when accounting for a lease contract relating to both tangible and intangible underlying assets (for example, a lease of hardware together with software or a lease of property with a gaming license).

        (ii) A few respondents identified an important point about existing US GAAP literature that currently allows constituents applying internal use software guidance to acquired assets to analogize to the leases guidance:

> The Boards should consider [...] whether the scope exclusion creates a conflict with existing literature. For example, ASC 350-40-25-16 [Internal-use software] states, *Entities often license internal-use software from third parties. Though Subtopic 840-10 excludes licensing agreements from its scope, entities shall analogize to that Subtopic when determining the asset acquired in a software licensing arrangement*. We believe that additional guidance will be necessary as it relates to the accounting for licenses of internal-use software and whether they should analogize to the prior or proposed model [emphasis and clarification added] (CL #74).

    (b) The lack of guidance available for IFRS preparers if the standard excludes intangible assets that are within the scope of IAS 17.

    (c) Concerns with the implications for lessors and how this would align with the proposals in the Exposure Draft: *Revenue from Contracts with Customers* which provides guidance on the licenses of intellectual property.

Possible Approaches for Intangibles

11. The staff thinks that there are three approaches with respect to intangible assets in the scope of leases:

    (a) **Approach A –** Include all leases of intangible assets within the scope of the leases standard.

    (b) **Approach B –** State that the proposed leases standard is not required to be applied to all leases of intangible assets except:

        (i) right-of-use assets in a sublease,

        (ii) for US GAAP, intangibles under the guidance in Subtopic 350-40 *Internal-Use Software* that analogizes to the leases standard.

    (c) **Approach C –** Represents a non-converged answer that would retain the scope of current guidance for US GAAP and IFRS. Under Approach C all leases of intangible assets are <u>excluded</u> from the proposed leases standard for US GAAP (except as described above in Approach B). However, for IFRSs, only leases of licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights would be <u>excluded</u> in the proposed leases standard for IFRS, consistent with the current scope of IAS 17.

Staff Analysis

12. A lease standard should be a comprehensive one that deals with all types of leases based on their substance rather than form. This would improve comparability and ensure consistent accounting for all leases. However, the Boards may decide to exclude some types of leases because:

    (a) The costs of applying the new leases guidance to some leases exceed the benefits, or

    (b) Other standards already address other types of leases and provide better information to users.

Approach A

13. The staff thinks that Approach A is not a viable alternative as the Boards did not tentatively conclude this in either the Discussion Paper or the ED. The staff did not identify significant support in the feedback received on the ED for applying this approach.

Approach C

14. The staff also recommends that the Boards not pursue Approach C. Although Approach C is consistent with current guidance it is not a converged answer. The staff agrees with constituent feedback that the scope of the standard should be converged as far as possible.

Approach B

15. As noted above, although some respondents think intangible assets should be within the scope of leases; many agreed with the proposed exclusion of intangible assets in the ED. Many who agreed with the proposals in the ED, urged the Boards to consider intangible assets in a separate project and noted concerns with the project timeline should the Boards decide to include leases of intangible assets in the scope of the final standard.

16. The staff also notes the difficulties in current Board deliberations with respect to defining a lease and whether a lease could include the right to use a portion of an asset or capacity of an asset (which some may think of as an underlying intangible asset). Some point out the interaction between the scope of the proposed standard and the definition of a lease. They think that following the scope as proposed in the ED could result in a contract for the capacity of an asset (intangible) being scoped out of the leases project. Therefore, the Boards should consider the inter-relationship between the scope of leases and the definition of leases.

17. If intangible assets are included within the leases standard, the Boards will have to consider whether licences or franchises should be accounted for within the leases standard. The staff thinks that this may shift the focus of the leases project from developing a lease accounting model to developing a general intangible assets accounting model. This would require additional time to develop the lease accounting model to comprehensively address intangible assets accounting[1].

IFRS specific analysis

18. A number of interested parties, especially those from IFRS jurisdictions, think that intangible assets should not be completely scoped out of the leases standard (at least for IFRS). Since not all leases of intangible assets are excluded from the scope of IAS 17, those interested parties think that additional work would be necessary to fully understand the implications of excluding all intangibles from the scope of the leases standard.

19. Those that supported including intangible assets within the scope of the leases standard agreed with the Boards that conceptually, there is no reason to exclude them. Leases of intangible assets convey a right to use an asset. The fact that the underlying asset does not have physical substance should not affect the accounting model.

20. To address those concerns, the Boards could revise the wording in the ED, that is, rather than excluding leases of intangibles from the scope, state that entities are not required to apply the leases standard to leases of intangible assets. If the Boards make this revision, the staff thinks that IFRS constituents could apply the new leases guidance by application of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to some leases of intangible assets until the Boards fully reconsider intangible asset accounting.

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[1] In 2008, both Boards considered whether to add to their agendas a project on intangible assets but decided not to. Subsequently, the IASB put a project on intangible assets as part of its research agenda. As this project is not active, we do not anticipate that the requirements and guidance on how to account for intangible assets would change in the near term.

21. At the January 2011 IFRS Interpretations Committee Meeting, the Interpretations Committee considered the application of IAS 8 to the development of an accounting policy by analogy[2]. That paper states that in the development of an accounting policy by analogy, management should:

    (a) identify the principles in IFRSs that could be analogized to the transaction or event analyzed;

    (b) consider and understand any scope exclusions in IFRSs; if a transaction has been scoped out, then the reason for that scope exclusion should be identified. This reason might prevent application by analogy, or may require some modification of the policy to take account of the reason for the scope exclusion;

    (c) use judgment to analyze the applicability of IFRSs by analogy, where appropriate, to develop an accounting policy that results in relevant and reliable information;

    (d) justify why such principle applies to the transaction analyzed and apply the principle in full, unless this will not produce reliable and relevant information; and

    (e) if application by analogy is not feasible, consider other sources in the IAS 8 hierarchy (The Interpretation Committee agreed that the principles in IAS 8 are clear regarding the use of management's judgment in developing and applying accounting policies, when a particular event, transaction or other condition is not specifically addressed by IFRSs).

22. From the IAS 8 hierarchy noted above, if leases of intangible assets are not required to be accounted for in accordance with the leases standard, it may be appropriate for an entity to apply the leases guidance, in accordance with the hierarchy in IAS 8, to account for some leases of intangible assets.

[2] Agenda Paper 5 for the January 2011 IFRS Interpretations Committee Meeting

23. This approach would be similar, for example, to IFRS 3 *Business Combinations* which scopes out a business combination of entities or businesses under common control. However, because of the reason for that scope exclusion (that is, it was because of the timing of the project, not because of a technical reason), in practice, people apply IFRS 3 to a business combination of entities or businesses under common control.

24. Therefore, the staff thinks that until any considerations on intangible assets accounting are further developed, IFRS preparers could apply the leases standard to those leases of intangible assets which are presently accounted for in accordance with IAS 17 because of the IASB's reason for not requiring entities to apply the leases guidance to leases of all intangible assets.

25. In addition, if the Boards were to confirm their decision not to require leases of all intangible assets to be within the scope of the final leases standard, the staff thinks that it would not result in a significant change in practice. This is because:

    (a) It is consistent with current US GAAP requirements.

    (b) IAS 17 includes within its scope some, but not all, leases of intangible assets. However, in practice few leases of intangible assets are accounted for under IAS 17. From the feedback received from working group members before publishing the ED and outreach performed after publication of the ED, the staff did not identify a significant number of leases of intangible assets that are presently accounted for within IAS 17 (IAS 17 excludes licensing agreements which excludes most leases of intangible assets). Some transactions that could be viewed as a lease of an intangible asset are accounted for by lessees under IAS 38 *Intangible Assets*. Consequently, the staff thinks, based on the lack of comment letter responses, that not requiring leases of intangibles to be within the scope of the lease standard would not represent a significant change for most IFRS constituents.

Staff Recommendation

26. The staff recommends Approach B, that is, leases of intangible assets should not be required to be accounted for in accordance with the proposed guidance on leases because:

    (a) Any consideration of leases of intangible assets should be done separately and comprehensively;

    (b) It is a converged answer. Some respondents expressed concerns that existing guidance is not converged as IAS 17 currently includes some intangible assets within its scope while Topic 840 applies only to leases of tangible assets.

    (c) Although IAS 17 includes within its scope some leases of intangible assets, in practice few leases of intangible assets are accounted for under IAS 17 and thus not requiring leases of intangibles to be accounted for in accordance with the final leases standard will not represent a significant change for IFRS.

    (d) Additional time would be required to develop the lease accounting model (particularly in US GAAP) to understand all implications of including intangible assets in the scope of the leases standard as this would be a different scope than proposed in the ED.

    (e) In making this recommendation the staff acknowledges that there is no conceptual basis for excluding leases however, it is practical to do so.

27. The staff recommends that entities should not be required to apply the leases standard to leases of intangible assets. However, the staff thinks that when applying IFRSs, an entity may apply IAS 8, leading to the application of the leases guidance to some leases of intangible assets. Additionally, entities will still be allowed to analogize internal-use software licensing agreements to the leases guidance as it is done in current practice under US GAAP.

Question 1
The staff recommends that an entity should not be required to apply the leases standard to leases of intangible assets, except for those leases of internal-use software (US GAAP) and a right-of-use asset in a sublease. Do the Boards agree? Why or why not?

Leases of certain items classified as inventory by a lessee

Summary of Feedback

28. As noted above, some respondents pointed out that based on the definition and exclusions proposed in the ED, certain items classified as inventory by a lessee would be in the scope of the guidance. Presently, Topic 840 excludes leases of inventory from the scope as a non-depreciable asset, however IAS 17 does not mention leases of inventory, only noting that IAS 17 does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. Feedback received from IFRS constituents during the comment letter period did not highlight lease arrangements including inventory.

29. A few respondents, predominantly US GAAP constituents, asked the Boards to specifically exclude leases of certain items classified as inventory from the scope, or to clarify whether a lease of inventory is within the scope of the ED. One respondent said:

> Based on the exclusions specified in the proposed guidance and the boards´ deliberations, we believe that this standard will essentially apply to leases of property, plant and equipment. However, as current US-GAAP specifies that only leases of property, plant and equipment are subject to lease accounting standards and the proposed standard uses a scope that includes all leases with specific exclusions, certain scope changes could occur. For example, it would appear that, based on the definition and exclusions included in the Exposure Draft, *inventory could be the subject of a lease for accounting purposes. Existing lease accounting guidance does not currently apply to inventory. While we do not believe it was the boards' intent to expand the contracts considered leases beyond those considered leases under current accounting*, companies should assess their arrangements to determine if the change in description of the scope of lease accounting could result in arrangements that were not previously considered leases to be within the scope of the Exposure Draft [Emphasis added] (CL #107).

30. Additionally, a private company respondent noted that there is a growing trend of leasing inventory:

> Companies may lease tires for earth moving equipment, jet engines, and spare parts. The company has a liability related to the arrangement and controls the inventory at its location. The items remain as inventory until the company decides to use the item, at which time the company installs the item and pays the lessor for it. In many cases, while the items exist in the lessee's inventory, the lessor has the right to substitute similar assets (CL #686).

Staff Analysis

31. Under IAS 2 *Inventories*:

> *Inventories* are assets:
>
> (a) held for sale in the ordinary course of business;
>
> (b) in the process of production for such sale; or
>
> (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

32. Under Topic 330 *Inventories*, inventories are defined very similarly to IAS 2.

> The aggregate of those items of tangible personal property that have any of the following characteristics:
>
> a. Held for sale in the ordinary course of business
>
> b. In process of production for such sale
>
> c. To be currently consumed in the production of goods or services to be available for sale.
>
> The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

33. The staff thinks that this issue is relatively narrow although we are aware of arrangements in the airline industry and other heavy manufacturing industries where leases of inventory are present. Such leases are generally of spare parts or other operating supplies that such entities currently classify as inventory. Additionally, the staff thinks that in some cases, leases of inventory may not meet the definition of a lease or may be able to apply the short-term lease guidance.

34. However, this matter is further complicated due to the differing starting points of the scope of Topic 840 (property, plant and equipment (land and/or depreciable property) and includes an explicit exclusion for inventory) and IAS 17 (all assets). As a result, leases of inventory are currently in the scope of IAS 17 while excluded from the scope of Topic 840.

35. The staff have considered three approaches:

    (a) **Approach A:** Retain the guidance in the ED which would require leases of inventory to be in the scope of lease accounting;

    (b) **Approach B:** Modify the ED to include a scope exclusion for all items of inventory; or

    (c) **Approach C:** Modify the ED to include a narrow scope exclusion for certain types of inventory (spare parts, operating materials and supplies that may be presented as inventory).

Staff Recommendation

36. The staff strongly recommends the Boards reach a converged answer, with all staff agreeing that there is no conceptual reason to exclude leases of certain items lessees classify as inventory. The staff reject Approach B because of potential application challenges that may exist in distinguishing some items of inventory (for example some finished goods) from items of property, plant and equipment. Despite this recommendation, the staff is split on how this converged answer should be achieved.

37. Some staff agree with Approach A, and do not believe a scope exception for leases of inventory is necessary. Those that think a scope exception is not necessary think that:

(a) from the feedback received, it seems that in practice few leases of inventory exist and few arrangements (based on current IFRS practice) may be accounted for under the leases standard. Therefore there is no need to add an additional scope exception into IFRS that does not exist presently in IAS 17.

(b) either the definition of a lease or the short-term lease election would appropriately address many arrangements that contain leases of inventory. When a lease of inventory meets the definition of a lease and is not a short-term lease, the arrangement should be accounted for consistently with leases of property, plant and equipment.

(c) adding a scope exclusion based on a subset of inventory, will create additional application challenges in determining which leases of inventory are required to be accounted for in accordance with the leases standard and which leases of inventory are outside of the scope.

(d) it creates a potential inconsistency between the scope of the standard for lessees and lessors. An underlying asset may be recognized as a subset of inventory by a lessee and accounted for outside the scope of the final leases standard. However, the underlying asset may be recognized as property, plant and equipment by the lessor and accounted for in accordance with the final leases standard.

38. Other staff acknowledge the above arguments for including inventory within the scope of the leases standard. However, these staff agree with Approach C and think a narrow scope exception is necessary because:

(a) for cost-benefit reasons, leases of spare parts, operating materials and supplies should not be required to be accounted for under the leases standard. The staff thinks that any lease arrangements currently accounted for under IAS 17 are likely operating leases and as such lease asset and liabilities are not presently reported.

(b) it would be more consistent with the scope of current US GAAP.

(c) the short-term nature of any such arrangements, means that they would generally qualify for the short-term lease election in the proposed leases standard. Therefore, it would be cost-beneficial not to require entities to identify arrangements which, even if they meet the definition of a lease, would likely be accounted for in accordance with the simplified guidance proposed for short-term leases.

(d) any inconsistencies between lessees and lessors created as a result of a scope exception are present today in US GAAP.

Question 2

Would the Boards like provide a scope exclusion for leases of spare parts, operating materials and supplies an entity may classify as inventory (Approach C) or retain the guidance from the ED (Approach A)?

Why or why not?

Other scope exclusions

39. The ED outlined the following additional items when considering the scope of the new leases standard, which are discussed in more detail below:

(a) leases to explore for or use natural resources, such as minerals, oil and natural gas;

(b) leases for biological assets (including living plants, animals);

(c) leases of non-core assets; and

(d) long-term leases of land.

40. Respondents also asked the Boards to consider application of the leases standard to service concession arrangements within the scope of IFRIC 12.

Leases to explore for or use natural resources, such as minerals, oil and natural gas

41. The majority of respondents agree with the exclusion of leases to explore for or use natural resources. Some respondents requested additional clarification of the reasons for the exclusion.

42. Consistent with the proposals in the ED the staff thinks that leases to explore for or use natural resources, such as minerals, oil and natural gas should be excluded because:

   (a) Accounting practices for exploration and evaluation assets are diverse and they differ from accounting for other types of assets. For example, some question if some of the exploration and evaluation assets are actually assets as defined in the conceptual framework. Consequently, we do not think the Boards' decisions on leasing transactions should be applied to these types of transactions.

   (b) These industries are specialized, and so the Boards may not be able to comprehensively address the challenges within a tight timeframe to improve existing leases standards.

   (c) In 2011 the IASB plans to make a decision on whether a project for extractive activities should be added to the agenda. The staff thinks that the extractive activities project should address leases to explore for or use natural resources rather than the leases guidance.

43. The staff recommends that the draft wording be changed slightly (see appendix A) to include leases for *the right* to explore for or use natural resources.

> We recommend that the boards offer additional guidance with regard to the scope exclusion related to "…leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources." According to the existing lease standards, the scope excludes "…lease agreements concerning the *rights to* explore for or to exploit natural resources…" Therefore, although the boards' intent may have been to retain the original definition and scope of leases, this modified language appears to have altered the scope in such a way that one might interpret our drilling contracts to qualify for the scope exclusion since our contracts are for services and equipment used to explore for the noted resources, which may have been the intended interpretation of the guidance [Emphasis added] (CL#482).

Leases for biological assets (including living plants, animals)

44. Leases of biological assets generally include leases of vineyards and leases for breeding purposes.

45. A few respondents suggested that leases of biological assets should be included within the scope of the proposed leases standard because:

    (a) It would ensure that leases of biological assets are comparable to other types of leases.

    (b) It could result in converged accounting. At present, the measurement requirements in IAS 41 *Agriculture* and ASC Topic 905 *Agriculture* differ. IAS 41 is fair-value-based but allows entities to use cost less accumulated depreciation or impairment under some circumstances. On the other hand, ASC 905 is cost-based, but allows fair value under some circumstances.

46. The majority of respondents agree with the Boards to exclude biological assets from the scope of the guidance. This is because leases of biological assets would not otherwise be comparable with other owned biological assets. Some may also view that biological assets are specialized and it is better that the specific standards that deal with biological assets should also address leases of biological assets.

47. One concern raised by a few US respondents is the exclusion of certain "agricultural assets," specifically growers of timber, from the scope of Topic 905. At present leases of timber are excluded from the scope of Topic 840. However, the ED proposes only to exclude biological assets within the scope of Topic 905, which specifically excludes timber. Accordingly, a lease of timber is within the scope of the ED when it had not previously been in the scope of Topic 840. This is further explained by a US GAAP preparer:

> The Exposure Draft, however, does not explicitly scope out timber. Although paragraph 5(c) of the Exposure Draft scopes out leases of biological assets, we believe there is ambiguity as to whether timber is accounted for as a biological asset under US GAAP.
>
> The ambiguity stems from the fact that the term biological asset is not defined under US GAAP; it is only defined under International Accounting Standards. Exception 5(c) of the Exposure Draft references Topic 905, Agriculture for guidance on the leases of biological assets. However, ASC 905-10-15-4 states that Topic 905, Agriculture does not apply to timber. One may question whether scope exception 5(c) applies to all biological assets, or to only those biological assets accounted for under Topic 905, Agriculture. To add clarity to the scope of leases of timber, we recommend that the Board:
> - Define biological assets in Topic 840 to include all living animals or plants.
> - Clarify that scope exception 5(c) applies to all biological assets, not just those included in Topic 905, Agriculture (CL#532).

48. The staff thinks this was a drafting oversight for US GAAP purposes and not the intention as timber is excluded from current guidance. Additionally, the staff notes that IAS 41 defines biological assets to include trees in a forest and would exclude timber. The staff thinks that timber should remain excluded from the scope of the new leases standard for US GAAP purposes but do not think it is necessary to add an additional scope exception to IFRSs. The proposed wording to exclude timber is included in Appendix A and is only necessary for US GAAP.

49. The staff thinks that leases of biological assets (including timber) should be excluded from the scope of the leases standard because:

    (a) It ensures relevant requirements pertaining to biological assets are found in one place.

    (b) It is more familiar for constituents because it is consistent with current guidance.

    (c) The measurement of leases in the ED is principally cost-based. However, for IFRS constituents, we think that the current requirements to measure leases of biological assets at fair value better reflects the economics of leases of biological assets. It could otherwise be considered a step backwards to require cost based accounting as proposed under the ED for such transactions.

Leases of non-core assets

50. The ED proposes to include leases of non-core assets within the scope as neither IFRSs nor US GAAP distinguish core and non-core assets.

51. Some respondents proposed that non-core assets (for example, not essential to the operations of a business) should be excluded from the scope. Reasons given include:

    (a) Users of financial statements are not interested in having an asset and a liability for non-core asset leases.

    (b) The cost and complexity to gather and compile information for leases of items such as fax machines, computers, photocopiers, etc, will outweigh the benefit to users of financial statements.

52. The feedback from private companies was consistent with the general concerns raised above. Additionally, the private companies encouraged the Boards to exclude leases of non-core assets because these entities generally have fewer resources.

> We believe a distinction should be made to exclude small (non-core) assets, such as office copiers, vehicles and postal machines that exist in nearly all businesses and for which there doesn't appear to be confusion among financial statement readers (CL #111).

53. The staff thinks that defining non-core is difficult and many items noted as non-core could be resolved by applying the materiality threshold in IFRS and US GAAP.

54. The staff does not think that there is any justification for different accounting for leases of core and non-core assets. This issue was also discussed in February 2011 when the boards discussed principles relating to the definition of a lease (see paragraphs 6-8 of IASB Agenda Paper 5D/ FASB Memo 132). The staff therefore recommends that leases of non-core assets should continue to be included in the scope of the proposed guidance.

Long-term leases of land

55. Some regard long-term leases of land as economically similar to the purchase or sale of land and as a result some think these transactions should be excluded from the scope of the proposed guidance. However, as paragraph BC38 of the ED states:

    (a) leases are not purchases or sales of the land, no matter how long the lease. The lessor retains title to the land during the lease term and regains possession of the land at the end of the lease term. Because the value of land generally does not decline with time, the title to the land is likely to have a significant value at the end of the lease term, regardless of the length of the lease, and can be released at a current market rate.

    (b) there is no conceptual basis for differentiating long-term leases of land from other leases. Inevitably, any definition of a long-term lease of land would be arbitrary.

56. The staff do not think there was significant feedback on the ED requesting that long-term leases of land should be excluded from the scope of the leases standard. Therefore, the staff recommends long-term leases of land continue to be included in the scope of the proposed guidance.

IFRIC 12: Service Concession Arrangements

57. Some respondents asked the Boards to clarify their intent for IFRIC 12 *Service Concession Arrangements.*

> While IFRIC 4 (which the ED proposes to replace) scopes out arrangements falling within the scope of IFRIC 12 *Service Concession Arrangements*, the ED does not propose to scope out such arrangements. Therefore service concession arrangements appear to be within the scope of the proposal (CL#39).

58. The staff thinks that the Boards did not intend to include service concession arrangements in the scope of the leases standard as IFRIC 4 scopes out those arrangements. Therefore, the staff recommends clarifying that service concession arrangements under IFRIC 12 continue to be scoped out of the leases guidance as it is consistent with current practice.

Staff Recommendation

59. The staff was not convinced by respondents to change the scope proposed in the ED for the other exclusion discussed above, except to exclude from the scope of the leases standard, leases of timber (US GAAP only) and service concession arrangements within the scope of IFRIC 12 (IFRS only). As a result, the staff recommends that the scope remain as proposed in the ED, with a few clarifications including the addition, for US GAAP, of scope exclusions for timber, and, for IFRSs, service concession arrangements within the scope of IFRIC 12.

Question 3

The staff recommends that an entity should apply the leases guidance to all leases, including leases of *right-of-use assets* in a *sublease,* leases of non-core assets and long-term leases of land. An entity is not required to apply the guidance to leases:

a) for rights to explore for or use natural resources such as minerals, oil, natural gas and similar non-regenerative resources,

b) for biological assets, including(US GAAP only) timber (see Topic 905: *Agriculture* and IAS 41: *Agriculture*)

c) for IFRSs only, service concession arrangements within the scope of IFRIC 12.

Do the Boards agree? Why or why not?

Appendix A: proposed amendments to the ED – US GAAP

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards in reaching decisions regarding the scope of the leases standard. The Boards have not yet made decisions about the views reflected in this appendix and, therefore, the wording is subject to change. The wording in this appendix shows marked changes from what was proposed in the Leases ED.

Scope

A1. An entity shall apply this guidance to all leases, including leases of *right-of-use assets* in a *sublease*. The following assets are not required to be accounted for in accordance with the leases standard ~~except~~:

a. Leases of intangible assets (see Topic 350 on intangibles – goodwill and other) except leases of internal use software (see Subtopic 350-40);

b. Leases for the right to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see Topic 930 on extractive activities – mining and Topic 932 on extractive activities – oil and gas);

c. Leases of biological assets including leases of timber (see assets within the scope of Topic 905: *Agriculture*);

d. Leases of non-depreciating spare parts, operating materials, and supplies that entities may treat as inventory.

Appendix B: Proposed amendments to the ED – IFRS

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards in reaching decisions regarding the scope of the leases standard. The Boards have not yet made decisions about the views reflected in this appendix and, therefore, the wording is subject to change. The wording in this appendix shows marked changes from what was proposed in the Leases ED. The wording shaded in grey below represents wording in the ED however is it not covered in this Board paper and will be the subject of a future meeting.

B1. An entity shall apply this guidance to all leases, including leases of *right-of-use assets* in a *sublease*. <u>The following assets are not required to be accounted for in accordance with the leases standard</u> ~~except~~:

a. Leases of intangible assets (see IAS 38 *Intangible Assets*)<u>.</u>

b. Leases <u>for the right</u> to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see IFRS 6 *Exploration for and Evaluation of Mineral Resources*).

c. Leases of biological assets (see IAS 41 *Agriculture*).

d. Public-to-private service concession arrangements within the scope of IFRIC 12: *Service Concession Arrangements.*

e. Leases between the *date of inception* and the *date of commencement* of a lease if they meet the definition of an onerous contract (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets).* (This issue will be discussed at a future meeting)

B2. An entity shall apply this IFRS to *investment property* that it holds under a lease. However:

a. After initial recognition, a lessee may measure a right of use asset in accordance with the fair value model in IAS 40 *Investment Property*. The lessee shall recognize in profit or loss changes in the liability to make lease payments arising after initial recognition in accordance with IAS 40.

b. A lessor shall apply IAS 40 and not this IFRS to leases of investment properties that are measured at fair value in accordance with IAS 40.