	IASB/FASB Meeting **Week commencing September 19, 2011**	IASB Agenda reference	**2A**
Staff Paper	***Education session for week commencing September 5, 2011***	FASB Agenda reference	**197**

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Project	**Leases**
Topic	**Scope - inventory**

Objective

1. The objective of this paper is discuss whether:

   (a) A right-of-use asset under a lease arrangement could simultaneously *also* meet the definition of inventory; and

   (b) Assets such as non-depreciating spare parts, operating materials, and supplies associated with the leasing of another underlying asset should be excluded from the scope of *Leases.* Such assets may be treated as "inventory" and excluded from lease accounting under existing practice.

2. This paper is arranged as follows:

   (a) Background

   (b) Definition of inventory vs. definition of a lease

      (i) Lessors

      (ii) Lessees

   (c) A scope exclusion as a practical expedient

   (d) Appendix – Fact patterns for potential leases of inventory

Background

3. At the joint meeting on March 2, 2011, the Boards discussed and made tentative decisions about the scope of *Leases*. As part of that discussion, the Boards directed the staff to perform additional research and present an analysis at a future meeting of whether the following are within the scope of the leases standard:

   (a) Leases of internal-use software in accordance with Subtopic 350-40, Intangibles–Goodwill and Other Internal-Use Software, of the *FASB Accounting Standards Codification®* (ASC). This topic will be discussed in a future meeting as a consequential amendment issue.

   (b) Leases of "inventory."

4. The staff notes that the question of whether or not "inventory" should be within the scope of the leases guidance is exacerbated by the current scopes of IAS 17 and Topic 840. The scope of IAS 17 does not have a scope exclusion for "inventory," while the scope of Topic 840, specifically ASC 840-10-15-15, explicitly excludes "inventory" (e.g., equipments parts inventory) as being subject to a lease because it is not property, plant, and equipment (PP&E) (that is, it is not land or a depreciable asset).

5. Similar to IAS 17, all lease transactions are in the scope of the proposed guidance in the *Leases* Exposure Draft (ED) except for those specifically excluded; "inventory" was not among the exclusions in the ED. Therefore, since both standards currently have different starting positions in their respective scopes (that is, IAS 17 starts with all transactions in-scope and Topic 840 starts with all arrangements that convey the right to use *PP&E* in-scope), it is important to determine whether such a decision on "inventory" would result in a change in practice for those preparing and using financial statements under each set of standards, and if so, whether that change in practice is appropriate.

Definition of inventory vs. definition of a lease

6. The staff thinks that the first issue for the Boards to consider is whether a right-of-use asset under a lease arrangement could simultaneously also meet the definition of inventory.

7. The staff does not think, based on the definition of a lease and the definition of inventory, that a right-of-use asset under a lease arrangement could simultaneously also meet the definition of inventory. Provided below are the definitions of inventory under US GAAP and/or IFRSs, respectively:

   (a) Topic 330 *Inventories* defines inventories as:

   > 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.

   (b) IAS 2 *Inventories* defines inventories as 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

8. Based on the definitions of inventory in paragraph 7 above, the staff discusses:

   (a) For lessors, why it does not think that a lessor could have inventory out on a lease; and

   (b) For lessees, why it does not think that a right-of-use asset subject to a lease agreement could also meet the definition of inventory.

Lessors

9. The staff does not think that a lessor could have inventory out on a lease. That is because an underlying asset, though possibly classified as inventory *before* lease commencement or *after* lease expiry:

   (a) Could not meet the definition of inventory *while out on lease*. For example, an automaker may classify a manufactured automobile as inventory before it sells or leases the automobile, but once the automobile becomes subject to the lease, it is no longer (i) held for sale in the ordinary course of business, (ii) in the process of production for sale, or (iii) to be consumed in the production process for goods or services to be made available for sale. During the lease term, the automobile would not meet the definition of inventory under Topic 330 or IAS 2.

   (b) Would be reclassified as a right to receive lease payments and a residual asset under the "receivable and residual approach", tentatively decided at the July 2011 joint meeting. The underlying asset does not remain on the lessor's books under this approach. Therefore, while possibly classified as inventory before the lease, the underlying asset would no longer be classified as such after lease commencement. The staff notes that presentation of the residual asset will be discussed with other lessor presentation and disclosure issues at a future meeting.

10. Therefore, the staff thinks that the question of whether "inventory" should be within the scope of the leases guidance is not an issue for lessor accounting; the staff does not think that a lessor could have "inventory" out on lease.

Lessees

11. Transactions involving assets treated as inventory under existing practice have raised questions on the lessee/customer side of lease accounting. The Boards questioned how such arrangements were structured at the March 2011 joint meeting and instructed the staff to bring back the issue after gaining a better understanding.

12. In response, the staff performed outreach with preparer and accounting firm constituents to discuss current arrangements marketed or labeled as "leases of inventory" or that might be considered to be accounted for under lease accounting. The staff also asked these constituents whether any such arrangements are *currently* being accounted for as leases under IFRSs (because inventory is not excluded from the scope of IAS 17), since no such examples would be leases under US GAAP today (because inventory is scoped out of Topic 840).

13. The following summarizes the staff's findings in the outreach:

    (a) Transactions subject to being assessed for the definition of a lease when the underlying asset would meet the definition of inventory if owned by the lessee/customer were not prevalent under either set of standards.

    (b) Constituents did not have any examples of transactions for lease arrangements subject to lease accounting under IAS 17 for underlying assets that *also* met the definition of inventory *while under that lease arrangement*.

    (c) Constituents that had experience with potential contracts to lease "inventory" under US GAAP thought that these transactions did not meet the definition of a lease and should not be accounted for under Topic 840. Those constituents also stated a preference to continue accounting for such transactions under Revenue Recognition.

    (d) Transactions originally considered to possibly be for a lease of an underlying asset classified as inventory were sometimes incorrect. In these transactions, had the underlying asset been owned and used in the same manner as under the lease contract, the underlying would have been classified as *PP&E* by the lessee/customer and it was therefore incorrect that these transactions were considered leases of "inventory". The staff thinks that some of the difficulty with assessing these types of transactions may result from incorrect classification of the underlying asset as inventory.

(e) Transactions referred to as "leases of inventory", but which do not meet the definition of a lease, are generally accounted for as product financing arrangements in US GAAP today, subject to the guidance in Subtopic 470-40 (formerly FAS 49). Under Subtopic 470-40, the customer/lessee would recognize the inventory and a liability for financing of the inventory.

14. Additionally, the staff included in the Appendix to this paper several example fact patterns that represent the most common examples that the staff encountered during its outreach. The staff analyzed whether such transactions would meet the definition of a lease. These analyses are based on the tentative decisions and wording that resulted from the main components of the definition of a lease included in Agenda Paper 1D/FASB Memo 158 and discussed at the April 2011 joint Board meeting.

15. Based on its outreach and its assessment of the examples provided in the Appendix to this paper, the staff thinks that, of the transactions it examined and other similar transactions:

(a) Few, if any, would meet the definition of a lease, as tentatively decided at the April 2011 joint meeting, and most of these transactions would therefore not be subject to the final leases guidance; and

(b) Those that *do* meet the definition of a lease would *not* be for an underlying asset that simultaneously meets the definition of inventory.

16. Furthermore, some staff members think that if a lessor in a transaction could not have inventory out on lease, as discussed beginning in paragraph 9 of this paper, then a lessee could not have a lease of inventory and would not be subject to the final leases guidance.

Question 1
The staff does not think that an underlying asset subject to a lease arrangement could simultaneously *also* meet either of the definitions of inventory provided in paragraph 7 of this paper. Do the Boards agree?

A scope exclusion as a practical expedient

17. However, despite its conclusions in paragraphs 10, 15, and 16 of this paper, the staff thinks it is necessary to consider a scope exclusion for assets such as non-depreciating spare parts, operating materials, and supplies associated with the leasing of another underlying asset. That is because:

    (a) Several members of the Boards expressed concern over the accounting for arrangements for (mostly) immaterial assets like non-depreciating spare parts, operating materials, and supplies that are associated with the leasing of another underlying asset and that would otherwise meet the definition of a lease.

    (b) A scope exclusion would avoid a change in practice for US GAAP constituents and probably many IFRS constituents who never considered the need to assess an arrangement for spare parts and other similar assets for the definition of a lease.

    (c) A scope exclusion would provide relief from the costs of applying the lease accounting model to account for those types assets. Such costs would include, among others, the costs to assess transactions for spare parts and other similar assets for the definition of a lease and for materiality. The staff notes in paragraph 13-15 that it did not encounter any such transactions that the staff thinks had appropriately been assessed to be a lease and it does not think that the conclusion of those assessments would differ as a result of the definition of a lease tentatively decided at the April joint meeting.

Alternatives and recommendation

18. The staff is presenting the following two alternatives for the Boards to consider:

    (a) Alternative A: Do not provide a scope exclusion from the final leases guidance for non-depreciating spare parts, operating materials, and supplies associated with the leasing of another underlying asset; or

    (b) Alternative B: Provide a scope exclusion from the final leases guidance for those types of assets (spare parts, etc.).

19. Based on the arguments and conclusions described in paragraphs 13-16 in this paper and the results of its analyses of the definition of a lease in the Appendix, the staff recommends Alternative A for *no* scope exclusion.

20. The staff notes that if the Boards agree with Alternative B and provide a scope exclusion for non-depreciating spare parts and other similar assets, then the staff must bring a paper to a future Board meeting to appropriately define and identify arrangements for the types of assets that the Boards wish to exclude from the scope of the final leases guidance.

Question 2
The staff recommends that *no* scope exclusion for non-depreciating spare parts and other similar assets should be included in the final leases guidance and that arrangements for such assets should be in the scope. Do the Boards agree with the staff recommendation?

Appendix A – Fact patterns for potential leases of inventory

A1. In this appendix, the staff presents its views on several example transactions. These views are based on the limited facts and circumstances provided, which may not reflect all of the details of a transaction relevant to analysis.

Example 1 – spare parts

Vendor A is entering into a 5-year parts management arrangement (the "Prime" arrangement) with Producer B. Prime provides ready access to a pool of parts and spares to meet Producer B's inventory management requirements, creating a "virtual parts cabinet". The parts are stored either at Producer B's location, at one of Vendor A's facilities or at a distributor's facility. The inventory is owned and managed by Vendor A, but Producer B is able to have immediate access to the inventory to fulfill its repair needs at any time of day, throughout the 5-year term. The management of the inventory (by Vendor A) involves ordering and shipping replenishment parts, managing the maximum and minimum on-hand levels and reorder points, and managing repairs of the replacement parts. The benefits to Producer B include immediate access to spares without having to make an upfront capital investment.

Producer B will pay a monthly fee for the Prime arrangement and a separate amount for each item removed from the inventory of products and used by Producer B. At the end of the agreement, Producer B will have the option to purchase the pool of inventory, renew for an additional term, or return any inventory on their site. There is no requirement to return a certain quantity of the parts in the pool to Vendor A.

Specified asset	*No* Vendor A has substantive rights to substitute any part in the pool, as it manages the inventory to handle ordering and replacing. It is practical and economically feasible for Vendor A to substitute, especially when the parts are stored at a distributor's facility or a facility controlled by Vendor A. Substitution does not require Producer B's consent.

Right to control the use of the underlying asset	*No* Vendor A manages and controls the parts in the arrangement. Producer B has no ability to receive the benefit from the use of a part until it picks the part out of the pool and purchases it (because Producer B cannot use a part before then). Until that point, other than the convenience of location, there is nothing to create an economic benefit for Producer B. The fact that Producer B can preclude others from using the assets may provide some evidence towards its ability to the direct the use. However, Producer B cannot direct the use until it picks a part.
Does the contract contain a lease?	***No*** Producer B pays Vendor A a monthly holding fee; it appears to be paying for a "right to access" with a purchase option for each individual part. Use of a part requires its purchase, which is not reflective of conveying a right to use.
Should the underlying asset be classified as inventory?	***Yes*** It can be viewed that the parts are held to be consumed in the production of a good or service to be available for sale. Another view is that Producer B does not control and hold the parts for any period of time; as soon as a part is purchased it is used and so the parts are *not* inventory.

Example 2 – precious metals Manufacturer C enters into a contract with Vendor D for X units of palladium over the next 3 years. Manufacturer C builds palladium into its products that it sells to independent customers. Manufacturer C pays Vendor D a fixed, monthly payment over the contract term. At the end of year 3, Manufacturer C must return X units of palladium to Vendor D. Manufacturer C may accomplish this by returning the same palladium, buying palladium in a market transaction and returning X units of the purchased palladium, or paying the current market price at that date for the difference between the X units of palladium and the amount of units it *can* return.	
Specified asset	*No* The asset is not physically distinct, nor is it explicitly or implicitly identifiable; Manufacturer C has to return an asset of the *same specification* to Vendor D.
Right to control the use of the underlying asset	*Yes* Manufacturer C has the ability to both receive the benefit from the use of the palladium and to direct the use of the palladium.
Does the contract contain a lease?	***No*** Manufacturer C may explicitly identify the palladium it receives under the contract, but because it can return *any* palladium to Vendor D, there is no specified asset in the contract and thus no right to use is conveyed.
Should the underlying asset be classified as inventory?	***No*** The palladium may or may not be held to be consumed in the production process; it is possible for Manufacturer C to return the exact same palladium under the contract, which means it is possible that the palladium will *not* be consumed. Thus, since the palladium is not indefinitely

	held to be consumed, it cannot be inventory.

Example 3 – real estate

Developer E in Hong Kong enters into a 99-year lease with Owner F for land and an existing building on that land. Developer E makes regular, even rental payments to Owner F over the lease term. Developer E renovates the building extensively, but otherwise retains the original building instead of demolishing it and constructing a new one. Once the renovations are completed, Developer E leases the renovated building (whether as a whole or as apartments, floors, units, etc.) to tenants and collects rental income. At the end of the 99-year lease, control of the land and building reverts back Owner F, who retains title to the property throughout the lease term. Developer E is a lessee in a head finance lease throughout the 99-year lease term and thereby recognizes an asset. Additionally, Developer E is a sublessor of the property and/or its portions once renovations are complete and it enters into contracts for rental income.

Specified asset	*Yes* The land and building are explicitly identified in the contract and physically distinct.
Right to control the use of the underlying asset	*Yes* Developer E has the ability to direct the use of the land and building throughout the 99-year lease term, evidenced by the renovation work. Developer E also has the ability to receive substantially all of the benefit from the use of the land and building throughout the lease term, as Developer E can recover its investment in the lease of the property and its renovation through rental income over the 99-year lease term.
Does the contract	***Yes***

contain a lease?	Developer E has entered into a contract for the right to use the land and building for a specified time.
Should the underlying asset be classified as inventory?	***No*** Real estate cannot meet the definition of inventory under US GAAP (i.e., it is not tangible, personal property). Under IFRSs, the land and building is precluded from meeting the definition of inventory and is instead investment property, per the guidance in IAS 40: 8. The following are examples of investment property: (a) … (b) … (c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases. (d) a building that is vacant but is held to be leased out under one or more operating leases. (e) property that is being constructed or developed for future use as investment property 9. The following are examples of items that are not investment property and are therefore outside the scope of this Standard: (a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see IAS 2 Inventories), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale. (b) … (c) … (d) [deleted] (e) property that is leased to another entity under a finance lease