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Project	Leases
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Introduction

1. This paper continues the discussion from the October 2014 joint board meeting as to whether the definition of a lease should include a requirement that a customer must have the ability to derive the benefits from directing the use of an identified asset on its own or together with other resources that are sold separately. This is incremental to the discussion and analysis provided in Agenda Paper 3A/FASB Memo No. 299 that was presented at the October 2014 board meeting. This paper contains additional analysis on this issue, which is intended to address concerns and questions that were raised by board members at the October 2014 board meeting.
2. This paper does not reproduce all of the analysis contained in Agenda Paper 3A/FASB Memo No. 299, nor does it revisit the other core features of the definition of a lease for which tentative decisions have been reached. Therefore, it may be helpful to refer back to that paper for a more detailed description of the lease definition guidance, including the staff analysis and recommendations.

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3. This paper includes three alternatives for the boards to consider in determining whether, and if so how, to include a requirement that a customer must have the ability to derive the benefits from directing the use of an identified asset on its own or together with other resources that are sold separately *or* that can otherwise be sourced in a reasonable period of time (‘ability to derive the benefits’ requirement) in order for a contract to contain a lease. These three alternatives are:
- (a) *Alternative 1*: Consistent with Alternative A in the October 2014 board paper, Alternative 1 would include the ‘ability to derive the benefits’ requirement in the definition of a lease, but is rearticulated to address feedback from the October 2014 board meeting.
 - (b) *Alternative 2*: This alternative was not presented in the October 2014 board paper. Alternative 2 would apply the ‘ability to derive the benefits’ requirement to only those contracts in which the asset is *incidental to the delivery of services* (ie when the asset component is substantially less significant than the service component(s) in the arrangement).
 - (c) *Alternative 3*: Consistent with Alternative B in the October 2014 board paper, Alternative 3 would *not* include the ‘ability to derive the benefits’ requirement in the definition of a lease.

Background

4. The boards have tentatively decided that a lease should be defined as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” An entity would determine whether a contract contains a lease by assessing whether:
- (a) The use of an identified asset is either explicitly or implicitly specified. A contract would not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfil the contract. A supplier would have the substantive right to substitute an asset if:
 - (i) It has the practical ability to substitute the asset; and

- (ii) It can benefit from exercising that right of substitution.
 - (b) The customer controls the use of the identified asset. A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to:
 - (i) Direct the use of the identified asset; and
 - (ii) Obtain substantially all of the economic benefits from directing the use of the identified asset.
- 5. The boards decided that a customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use. If neither the customer, nor the supplier, controls how and for what purpose the asset is used throughout the period of use, the customer is considered to have the right to direct the use of the identified asset in either of the following circumstances:
 - (a) The customer has the right to operate the asset or to direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions); or
 - (b) The customer designed the asset, or caused the asset to be designed, in a way that predetermines during the period of use:
 - (i) How and for what purpose the asset will be used; or
 - (ii) How the asset will be operated.
- 6. In addition, the boards decided that a supplier's protective rights over the identified asset typically define the scope of the customer's use of the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset.
- 7. The boards did not decide whether, in addition to the requirements described above, a customer must have the ability to derive the benefits from directing the use of an identified asset on its own or together with other resources that are sold separately (by the supplier or any other supplier) or that can otherwise be sourced in a reasonable period of time in order for a contract to contain a lease. At the October 2014 board

meeting, the board members discussed the issue at length. The board members' feedback is summarised as follows:

- (a) Some board members were attracted to the idea that a customer must have the ability to derive the benefits from directing the use of an identified asset in order to recognise lease assets and lease liabilities. These board members expressed the view that an asset may not exist at the beginning of the period of use if the customer cannot obtain benefits from directing the use of the asset without the supplier's *continuing* involvement.
- (b) Several board members questioned what the practical difference would be between including an 'ability to derive the benefits' requirement and not including such a requirement. The discussion indicated that any difference in the lease/non-lease conclusion may be quite narrow. Indeed, the discussion did not identify any particular contracts for which an entity would reach a different conclusion about whether a contract contains a lease after considering the 'ability to derive the benefits' requirement, if that requirement was applied as intended. However, this was at least partially because board members and staff were unable to ascertain with certainty whether, for example, particular types of services are, or are not, sold separately. Some board members noted that they would expect almost any good or service to have the capacity to be outsourced to a third party.
- (c) A number of board members expressed concerns about the consequences of including an 'ability to derive the benefits' requirement. Their concerns included the following:
 - (i) Introducing an additional requirement regarding asset recognition in the context of a lease that does not exist when a customer purchases an asset. They noted that there is no equivalent 'ability to derive the benefits' requirement to determine when to recognise an item of purchased property, plant and equipment (PP&E) or an intangible asset. Those board members did not understand why a customer would recognise an item of PP&E (and separately account for

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specialised services) if control of the item transferred to the customer but potentially would not recognise a ROU asset (and separately account for those same specialised services) if control of the ROU asset transferred to the customer. Those board members think that entities can, and at times do, purchase PP&E together with specialised services without regard for whether they could derive the benefits from the PP&E without the supplier's services.

- (ii) The possibility of arriving at a different lease/non-lease conclusion for identical contracts that give the respective customers the same contractual rights because of differences in the resources and geographical location of individual customers.
- (iii) The possibility of arriving at a different lease/non-lease conclusion because of the supplier's business model (ie whether a supplier sells goods or services separately or only as a bundled package), and having this conclusion change over time depending on changes to the supplier's business model.
- (iv) Other unintended consequences related to introducing a requirement that would be inherently subjective combined with there being a significant incentive to use that requirement to retain off-balance-sheet accounting for contracts. Particular concerns were raised about some of the terminology used in the Alternative A drafting, including 'readily available', 'substantial portion', and 'reasonable period of time.'

8. Some board members that expressed at least some measure of support for including the requirement had the following reasons for doing so:

- (a) The conceptual definition of an asset includes the requirement that the entity controls an economic resource or benefit as a result of a past event or transaction (in this case, from the supplier's performance of making the

underlying asset available for the customer's use). These board members expressed support for the notion that this requirement is not met if the customer cannot derive the benefits from its rights to direct the use of the identified asset on its own or together with other resources that are sold separately (and therefore, are available separate from the right to use the identified asset).

- (b) Although these board members acknowledge the point raised by some other board members with respect to PP&E, they suggest that, in practice, entities do not purchase PP&E if they cannot obtain future economic benefits from that PP&E on its own or together with other resources that are sold separately. Any supplier that sells equipment and also provides services such as operations or maintenance will also generally sell such services separately through renewals of those services (for example, to customers that purchased the equipment in a bundled transaction in the past or customers that purchased the equipment through resale).
 - (c) Some board members were not concerned that an entity might reach different lease/non-lease conclusions for identical contracts based on the customer's resources and/or the supplier's business model. In those cases, they think that those different conclusions may reflect a substantive economic difference.
9. At the end of the October 2014 board meeting, the boards directed the staff to further analyse the potential 'ability to derive the benefits' requirement, considering the feedback received from board members at the October 2014 board meeting.

Staff analysis

10. The three alternatives discussed in this paper address feedback received from board members at the October 2014 board meeting in different ways:
- (a) *Alternative 1*: Consistent with Alternative A in the October 2014 board paper, this alternative has been rearticulated using different terminology to address board members' concerns about judgemental or subjective terms.

- (b) *Alternative 2*: This alternative attempts to address board member concerns about the possible unintended consequences of Alternative A in the October 2014 board paper. This alternative aims to address these concerns by applying the ‘ability to derive the benefits’ requirement to only those contracts in which the asset is *incidental to the delivery of services* (ie when the asset component is substantially less significant than the service component(s) in the arrangement).
- (c) *Alternative 3*: Consistent with Alternative B in the October 2014 board paper, this alternative provides the boards with the option to not include the ‘ability to derive the benefits’ requirement in the definition of a lease.

Alternative 1

11. Alternative 1 is based on Alternative A in the October 2014 board paper, but rearticulated to address board member feedback.
12. Alternative 1 retains the core premise of Alternative A that was presented in the October 2014 paper. That core premise is that a contract does not contain a lease if a customer controls the right to use an identified asset that it is unable to use (or otherwise derive the benefits from directing the use of) without the supplier’s continued performance. Alternative A considered the resources available to the specific customer in question when assessing whether that customer could derive substantial benefits from use on its own or together with other readily available resources (for example, the customer would consider whether it owns similar assets). Alternative A also ignored any contractual prohibitions, for example, on the customer obtaining another supplier for the services or subleasing the underlying asset. Alternative A viewed those restrictions as irrelevant to the question of whether the right of use obtained by the customer at contract commencement is an asset.
13. The October 2014 board paper noted that there were similarities between Alternative A and the ‘assets incidental to a service’ proposal in the 2013 ED; however, that paper did not go into detail about those similarities. Alternative A (and Alternative 1 in this paper) would be very similar to the *first* part of the ‘assets incidental to a service’

proposal in the 2013 ED, which stated that ‘a customer does not have the ability to derive the benefits from use of an asset if the customer could obtain the benefits only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers’.

14. The background discussion earlier in this paper outlines the conceptual and unintended consequence concerns some board members expressed about Alternative A during the October 2014 board meeting. In addition to these broader concerns, some board members expressed concerns about the articulation of Alternative A. Some board members thought that the use of particular terms in Alternative A would require significant judgement and could lead to inconsistent outcomes in applying the requirements. Alternative 1, presented herein, is intended to address some of those concerns by both:
- (a) Revising how this alternative is articulated, and
 - (b) Emphasising some key aspects that may not have been clear in the October 2014 board paper.

In so doing, it also potentially addresses at least some of the concerns expressed regarding whether this guidance would be applied in an unintended manner.

15. Some board members raised concerns about the use of potentially subjective terminology such as ‘readily available’ in Alternative A. Although this term is also used in the boards’ new revenue recognition standard, some board members were concerned that there would be additional stress placed on the term in the context of the definition of a lease. This is because the application of that term could determine whether an entity recognises lease assets and lease liabilities (and for some lessors, whether the contract is accounted for as a Type A lease – which will be accounted for in the same manner as an existing finance (IFRS) or sales-type/direct-financing (US GAAP) lease - or a service contract, which have substantially different accounting). These board members seemed concerned that ‘readily available’ might be interpreted more narrowly than intended. For example, there was a concern that some might conclude that a service that is sold separately by even multiple suppliers in one region

may not be considered ‘readily available’ to a customer operating in another geographic area. This was not the staff’s *intended* interpretation of Alternative A.

16. The staff think that including a consideration of the geographical location of goods or services that are sold separately would effectively introduce a cost aspect to the definition of ‘readily available.’ The staff think this cost aspect would add too much subjectivity to the analysis. This is because almost anything that is sold separately can be obtained in almost any circumstance for the right price. Consequently, the question would then become what is the level of cost that would mean a resource that is sold separately is not ‘readily available’ to the customer. The staff think that there would be significant subjectivity in determining what that level of cost would be.
17. In order to address concerns about the use of the term ‘readily available’, Alternative 1 would not retain the use of that term. Instead, Alternative 1 relies solely on that term’s underlying principle. Alternative 1 would state that, in order to meet the definition of a lease, a customer must have the ability to derive the benefits from directing the use of an identified asset on its own or together with other resources (eg a good or service) that are sold separately (by the supplier or any other supplier) ***or*** can otherwise be sourced in a reasonable period of time (eg by hiring an employee or an independent contractor). This clarification, including the increased emphasis on the “***or***” embedded in the provision, would hopefully address some of the concerns raised at the October 2014 board meeting. It would clarify that, if *any* supplier delivers the goods or services necessary to derive the benefits from the right of use separately, then an entity cannot argue that the services are so specialised that the entire contract is a bundled service contract (ie the right of use has substance independent of the services). This would be the case regardless of where that supplier is located in the world or whether one supplier is more costly than another. It would also clarify that the ‘reasonable period of time’ provision does not apply to a resource that is presently sold separately by the supplier or any other supplier. When the customer can obtain the resources necessary to derive the benefits from use of the identified asset other than from the supplier, the customer is economically contracting for both (i) a right to use an identified asset *and* (ii) the other goods or services

provided by the supplier. Accordingly, the contract would contain a lease (provided the contract met the other criteria in the definition of a lease).

18. The staff think that Alternative 1 retains the basis that some board members supported in Alternative A from the October 2014 board meeting, but would help to address board member concerns about arriving at a different lease/non-lease conclusion in different jurisdictions. It would also partially address concerns about subjectivity and structuring associated with Alternative A that were raised by some board members at the October 2014 board meeting. The staff think that eliminating the use of the term ‘readily available’ should narrow the judgements that some thought an entity might need to make when assessing whether the customer has the ability to derive the benefits from directing the use of an identified asset.
19. Nonetheless, because Alternative 1 is not substantively different from Alternative A that was proposed in October 2014, Alternative 1 would not address some of the concerns about an ‘ability to derive the benefits’ requirement that were raised by some board members at the October 2014 board meeting. Alternative 1:
 - (a) Could still result in a different lease/non-lease conclusion depending on customer resources and supplier business model,
 - (b) Would contain a different requirement for lease asset recognition as compared to purchase accounting, and
 - (c) Would require the application of judgement when making the ‘ability to derive the benefits’ assessment. There would be an incentive for entities to argue that the particular asset being used in a contract is so unique and specialised that no one other than the supplier could provide the accompanying goods or services.
20. Finally, Alternative 1 would not address the cost-benefit concerns raised about Alternative A in the October 2014 board paper. Some board members questioned the benefit of including an ‘ability to derive the benefits’ requirement. This is because the staff have not identified any common class of contracts that would be classified as a service only because of the extra requirement in Alternative 1 that would not be classified as a service when applying the remainder of the definition of a lease

guidance. This is because most goods and services offered together with a lease are also sold separately by one or more suppliers. Nonetheless, the staff acknowledge that we cannot evaluate the possible outcomes in every scenario, particularly for future contracts. The staff have previously described the type of contracts (such as those for highly-specialised equipment) that this alternative would be likely to capture. Therefore, the staff think that there could be *some* contracts for which this alternative would affect the lease/non-lease conclusion (even if that population is narrow). The staff note, however, that a few constituents have contacted the staff following the October 2014 board meeting. Those constituents have expressed the view that they think this additional requirement is not likely to have any significant effect on the population of contracts that are determined to contain a lease if it were applied as they think it is intended.

Alternative 2

21. Alternative 2 would conclude that when a customer controls the right to use an identified asset, it is appropriate to reach a conclusion that the contract is entirely for services only when the asset is *incidental to the delivery of services*. An asset would be incidental to the delivery of services when:
 - (a) The customer does not have the ability to derive the benefits from directing the use of an identified asset (as described in Alternative 1 above), and
 - (b) The asset component of the contract is substantially less significant than the service component(s) in the arrangement.
22. When assessing whether the asset component is substantially less significant than the service component, Alternative 2 would require that an entity exclude any goods or services that are sold separately by the supplier or any other supplier. This would prevent additional and separate services being added to a contract solely to reach a service conclusion.
23. Alternative 2 would retain the rationale behind the ‘ability to derive the benefits’ requirement in Alternative 1, but would narrow the population of contracts that might be considered service arrangements in their entirety compared to Alternative 1. It

would do so by focussing on the specialised services being provided by the supplier—those services that are *essential* to the customer in terms of deriving the benefits from use of the asset. In essence, Alternative 2 would retain the concept of an asset being incidental to the delivery of services that was proposed in the 2013 ED, but define ‘incidental’ both in terms of size (ie as a proportion of the entire contract) as well as how integrated the services are with the use of the asset.

24. By adding an extra condition (ie that the asset component is substantially less significant than the service component) to the Alternative 1 requirements, Alternative 2 would address some of the board members’ concerns about unintended consequences. For example, compared to Alternative 1, it would be more difficult for an entity to argue that a contract is entirely for services because of the uniqueness of the asset and the specialisation of the services. To do so, the entity would also need to provide evidence that the asset component of a contract is substantially less significant than the specialised goods or services provided by the supplier.
25. Additionally, Alternative 2 could be thought of as consistent with the overall objective of Alternative 1—ie it would attempt to identify contracts that are entirely for services and, yet, for which the customer controls the right to use an identified asset. Some have also expressed the view that the extra guidance in Alternative 2 would be helpful in reaching a conclusion that, for example, some contracts for internet or television services that involve the use of assets do not contain a lease.
26. Because Alternative 2 retains the requirements of Alternative 1 but adds an extra condition, all of the concerns expressed above about Alternative 1 substantially remain except that Alternative 2 may *limit* the potential for unintended consequences. This is because there could be arrangements that would not be considered leases under Alternative 1 that may not meet the incidental asset requirement included in Alternative 2.
27. Nonetheless, the following concerns could be raised about Alternative 2:
 - (a) For those that suggest Alternative 1 is not cost-beneficial because it would be likely to affect only a small sub-set of contracts, Alternative 2 would

include an additional criterion (and, thus, additional judgement) but would affect an even smaller sub-set of contracts.

- (b) Those that support the concept underlying Alternative 1 may view Alternative 2 as creating an additional requirement that is unrelated to that concept. This is because the comparative size of the service and asset components in a contract does not affect the evaluation of whether the customer is capable of deriving the benefits from use of the identified asset. Those supportive of Alternative 1 might suggest that the cost of the asset (which might have a corresponding effect on how significant the service component is in relation to the asset component) should not influence the question of whether the customer's right of use obtained at contract commencement is, or is not, an asset.
- (c) Lastly, the October 2014 board paper (paragraph 59) outlined the key feedback received on the 'assets incidental to a service' proposal in the 2013 ED, which is similar in concept to Alternative 2 (although articulated somewhat differently). Most of those concerns related to the judgement that would be required to apply the proposal. The staff think it is likely that constituents would raise similar concerns about Alternative 2. Those concerns would include interpreting when the asset component is substantially less significant than the service component and, therefore, 'incidental'. Lessors should generally be able to make this judgement with relative ease based on how they price their contracts. However, lessees would generally have much less information, so would have to either (i) make more subjective judgements in this regard or (ii) obtain proprietary information from lessors. In saying that, the staff would anticipate that, in most cases, it would be clear whether the asset component of a contract is substantially less significant than the service component of the contract. The staff also note that an entity would need to make this evaluation only if it had already concluded that the customer does *not* have the ability to derive the benefits from use of the identified asset on its own or together

with resources that are sold separately (*or* that can otherwise be sourced in a reasonable period of time).

Alternative 3

28. Alternative 3 is effectively unchanged from Alternative B in the October 2014 board paper. Under Alternative 3, the lease definition guidance would not include an ‘ability to derive the benefits’ requirement.
29. Alternative 3 would conclude that a lease exists when a customer has the right to both:
- (a) Direct the use of an identified asset, and
 - (b) Obtain substantially all the benefits from directing the use of the identified asset.
30. Alternative 3 would inherently address the concerns some board members expressed about Alternative 1 (many of which would also exist in Alternative 2). That is, Alternative 3 would address the following concerns:
- (a) The additional judgement and subjectivity associated with adding an ‘ability to derive the benefits’ requirement for little change in the lease/non-lease conclusion.
 - (b) The potential for unintended consequences that might arise with either Alternative 1 or Alternative 2. The staff continue to think that there would be a significant incentive for entities to stretch these alternatives in order to reach conclusions that some classes of contracts are not leases, even if the boards clearly communicate their intent.
 - (c) Arriving at a different lease/non-lease conclusion depending on customer resources or supplier business model. For example:
 - (i) Two customers could arrive at a different lease/non-lease conclusion for contracts that give them the same contractual rights.
 - (ii) A supplier could arrive at a different lease/non-lease conclusion for two identical contracts depending on the

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resources of the individual customers that are party to the contracts. This would create a fundamental change in principle compared to existing lessor accounting, under which such an outcome is not possible.

- (d) Creating different ‘control’ or asset recognition requirements for leased assets compared to purchased assets. Put another way, under Alternative 3, if a customer has exclusive use of an asset for a period of time, and can direct the use of the asset, the customer controls the right to use the asset and should recognise that right on its balance sheet.

Question for the boards

- 1) Which of the above alternatives (1, 2, or 3) do the boards prefer?