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Project	Leases		
Paper topic	Definition of a Lease		
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Introduction

1. The purpose of this paper is to discuss the assessment of whether a contract contains a lease and does not discuss:
   - (a) Distinguishing between leases and purchases; and
   - (b) Separating lease and nonlease components, which would happen after an entity has concluded that a contract contains a lease. Agenda Paper 3B/FASB Memo No. 283 discusses separating lease and nonlease components.
2. This paper is structured as follows:
   - (a) Summary of staff recommendations
   - (b) Background
   - (c) Feedback received on the 2013 ED
   - (d) Staff analysis
     - (i) Clarifications relating to the 'identified asset' concept

(ii) Clarifications relating to the 'right to control the use of an identified asset' concept

(e) Staff recommendation and question for the boards

(f) Appendix A: The proposals in the 2013 ED.

Summary of staff recommendations

3. The staff recommend the following regarding the definition of a lease:

(a) Retain the principles in the 2013 ED supporting the definition of a lease that require an entity to determine whether a contract contains a lease by assessing whether:

(i) Fulfilment of the contract depends on the use of an identified asset; and

(ii) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

(b) Clarify the following regarding whether fulfilment of the contract depends on the use of an identified asset:

(i) Fulfilment depends on the use of an identified asset when the supplier has no *practical ability* to substitute an alternative asset or the supplier would not *benefit* from substituting an alternative asset; and

(ii) A customer would presume that fulfilment of the contract depends on the use of an identified asset if it is impractical for the customer to determine either: (1) whether the supplier has the practical ability to substitute an alternative asset, or (2) whether the supplier would benefit from the substitution.

(c) Clarify the following regarding the right to control the use of an identified asset:

(i) Focus the assessment on the ability to affect the *potential cash flows* to be derived from use of the asset during the period of use;

(ii) Add guidance regarding which decisions most significantly affect the potential cash flows to be derived from use; and

(iii) Remove the guidance in the 2013 ED regarding assets that are incidental to the delivery of services.

Background

4. The 2013 ED defined a lease 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) Fulfilment of the contract depends on the use of an identified asset; and

   (b) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

5. The 2013 ED's definition of a lease and its emphasis on whether a customer obtains the right to control the use of an underlying asset are consistent with existing guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease* and Topic 840 - *Leases*. However, the 2013 ED proposed to change the existing application guidance on the definition of a lease to:

   (a) Align the concept of control more closely with the control principle in the forthcoming revenue recognition standard and in existing consolidation requirements; and

   (b) Address practice issues that were raised about the definition of a lease in IFRIC 4 and Topic 840 (specifically, EITF Issue 01-8).

6. Many of the changes the boards made in the 2013 ED resulted from issues raised in feedback received on the 2010 ED, which retained the requirements included in IFRIC 4 and Topic 840 with minor changes to the wording of those requirements.

7. Appendix A contains the definition of a lease guidance proposed in the 2013 ED.

Feedback received on the 2013 ED

8. Generally, most constituents stated that the proposed definition of a lease in the 2013 ED was an improvement compared to the 2010 ED and to existing guidance. Many constituents find the additional guidance in the 2013 ED to be helpful.

9. However, in providing feedback on the proposed definition of a lease, many constituents stressed the increased importance of, and pressure on, that definition. That is because, under the 2013 ED, the accounting for leases would be significantly different from services because a lessee would recognise all leases (other than short-term leases) on its balance sheet, while the accounting for services would remain unchanged. Under existing requirements, the accounting for an operating lease is similar to the accounting for a service. Consequently, the existing dividing line between a lease and a service is not subject to the same level of scrutiny as would be the case under the proposals.

10. Many constituents support the proposal to more closely align the control concept in identifying a lease with the control concept in the boards' forthcoming revenue recognition standard and existing consolidation guidance.

11. Although most constituents support the overall direction of the proposed definition of a lease, the majority of constituents do not think the boards have provided adequate guidance to support consistent application of that definition. Most of the concerns relate to the following:

    (a) Assessing whether substitution rights regarding an otherwise identified asset are *substantive*. [paragraphs 8-11 in Appendix A]

    (b) Determining whether a contract conveys the *right to control the use* of an identified asset. [paragraphs 12-19 in Appendix A]

12. Of those constituents that requested additional guidance on determining whether a supplier's substitution rights are substantive:

(a) Some question if those substitution rights should be based on the supplier's *right* to substitute or, instead, should be based on the *occurrence* or *likelihood* of that substitution. For example, some constituents suggest that an identified asset should remain an identified asset until it is substituted by another asset.

(b) Others question the use and definition of *substantive*. Some of these constituents stated that the supplier's right to substitute is substantive even if customer consent is required for substitution or questioned what level of consent would be required to mean that a substitution right is not substantive. Others added that additional guidance is needed to explain what would constitute "barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets in place of the asset". These constituents principally question how significant those barriers would need to be and note that in most, if not all, scenarios, there would always be a cost involved with substituting assets.

(c) Others indicate that the guidance would be difficult for a customer to apply because it would require information from the supplier's perspective.

13. Many constituents stated that additional guidance is required for entities to appropriately and consistently determine whether a customer has the *ability to direct the use* of an identified asset. A number of constituents commented that particular types of contracts or transactions, including charter arrangements in the shipping and oil and gas industries, power purchase agreements, and subcontracted manufacturing service arrangements, may be difficult to assess in that respect. In their view, the examples provided in the 2013 ED are not as helpful as they could be because:

(a) They do not address more complicated scenarios; and

(b) The analysis in the examples is not sufficiently linked to the proposed guidance to explain how that guidance should be applied.

14. Constituents raised the following specific concerns about directing the use of an asset:

(a) Which decisions constitute "decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset”? Does the timing of decisions affect whether the customer has the ability to direct the use of the asset?

(b) How should decisions be weighted when both the customer and the supplier have the ability to be involved in the substantive decision-making about the use of the asset?

(c) What level of customer involvement in the design of the asset is enough to be considered as having the ability to direct the use of the asset?

(d) How determinative is the physical operation of the underlying asset to the benefits that can be derived from its use?

15. Other constituents commented that the term *incidental*, as it relates to determining whether an asset is incidental to the delivery of services, is not clearly defined and may be difficult to interpret and apply consistently in practice. Some suggested expanding the notion of incidental assets to exclude from the scope of the requirements contracts that are essentially for the provision of services. Others interpreted the guidance to assume that failure to meet the narrow description of assets incidental to the delivery of services would result in the conclusion that the contract contained a lease.

16. Consequently, some constituents question whether the proposed definition of a lease is overly subjective and difficult to apply in practice. Some are concerned about the costs and the level of judgement needed to apply the definition. Those constituents think that, in the absence of additional guidance, there would be significant structuring opportunities to avoid concluding that a contract is, or contains, a lease.

17. Most of these constituents think it would be helpful if the boards could either align the language to be more consistent with other existing non-lease guidance (such as using language in IFRS 10 *Consolidated Financial Statements* or Topic 810 - *Consolidations*) or provide additional examples and implementation guidance to further explain how the boards intend the definition to be applied.

18. Many constituents recommend that the boards define what constitutes a service. These constituents stated that providing a definition for both a service as well as a lease would help eliminate confusion between the two transactions.

19. Some preparers and others recommend retaining the definition of a lease in existing guidance with either no change or minimal change. These constituents emphasise that the existing definition of a lease is understood and applied consistently in practice. Some also think that retaining a definition that is familiar to preparers would help reduce implementation costs and complexity, while also ensuring that what most users view as leases are captured by the final leases standard.

Staff analysis

20. The staff are of the view that the general definition of a lease proposed in the 2013 ED and the accompanying principles are appropriate and should be retained in the final leases standard, while improving the related application guidance. The focus on the notion of control as being determinative of the recognition of assets (and, consequently, liabilities in the context of a lease) is consistent with the boards' Conceptual Frameworks. The control principle provides a logical explanation as to why a lessee should recognise lease assets and lease liabilities. In essence, a lessee obtains a right-of-use (ROU) asset at lease commencement when it obtains control of the use of the underlying asset for the term of the lease.

21. What distinguishes a lease from a service is determining whether the customer or the supplier controls the use of the underlying asset for the period of use. Assets are used by every supplier in delivering services to a customer. Accordingly, when the *supplier* controls the use of the asset during the period of use, the contract is for services—the supplier uses the asset to deliver services to its customers. In contrast, if the *customer* controls the use of the asset during the period of use, the supplier does not. In that case, the customer has obtained the right to use the underlying asset and the contract contains a lease.

22. The staff support retaining much of the application guidance in the 2013 ED regarding the definition of a lease, which:

    (a) Is more consistent with the guidance about control in the boards' consolidation requirements and in the forthcoming revenue recognition standard than existing guidance on the definition of a lease in IFRIC 4 and Topic 840; and

(b) Addresses practice issues that were raised about the definition of a lease in IFRIC 4 and Topic 840.

23. Accordingly, the staff recommend retaining the definition of a lease in the 2013 ED, and that an entity would be required to assess whether a contract contains a lease by assessing whether:

(a) Fulfilment of the contract depends on the use of an identified asset; and

(b) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

24. An entity would make that assessment at lease inception and would reassess whether a contract contains a lease only in the case of a contract modification.

25. The staff do not recommend including a definition of a service in the final leases standard. The boards considered developing such a definition as part of the revenue recognition project but concluded that it would be difficult to clearly define a service. In addition, if the final leases standard were to include a definition of both a lease and a service, there is a risk that there would be contracts that meet neither or both definitions.

26. Nonetheless, given the feedback received on the 2013 ED, the staff recommend clarifying specific aspects of the guidance about the definition of a lease, discussed later in the paper.

27. The staff note that both under existing guidance and the proposals in the 2013 ED the staff would expect the assessment of whether a contract contains a lease to be a straightforward one for the vast majority of contracts. For some contracts, however, this determination can require more detailed analysis, particularly when both parties have decision-making rights with respect to the use of the asset during the period of use.

28. Consequently, the changes that the 2013 ED proposed to the existing guidance on the definition of a lease, and the further clarifications recommended in this paper, are meant to:

    (a) Ensure that the guidance supports the lease assessment for straightforward contracts; and

    (b) Provide assistance when assessing more complicated contracts for which it is not obvious whether they are entirely for services or contain a lease.

Clarifications relating to the 'identified asset' concept

29. The 2013 ED proposed that a contract involves the use of an identified asset if the supplier does not have a substantive right to substitute the asset (ie it is impractical or uneconomical to fulfil the contract through the use of one or more alternative assets). The staff recommend retaining this concept. If a supplier has a substantive right to substitute the asset used in fulfilling the contract, the customer would not control the use of an identified asset. The customer would not be able to direct the use of, or derive the economic benefits from use of, the asset originally used in fulfilling the contract. The *supplier* would decide which asset would be utilised to fulfil the contract at any time during the period of use, and would therefore determine how and for what purpose the asset is used. Consequently, the contract would *not* contain a lease.

30. Nonetheless, to address the feedback received on the 2013 ED, the staff recommend clarifying the guidance that would apply to determining when a supplier has a substantive right to substitute an asset.

31. The staff would propose clarifying in the final leases standard that a supplier must first have the practical ability to substitute an alternative asset in order to conclude that a substitution right is substantive. A supplier would not have the practical ability to substitute an alternative asset if the customer could prevent him from exercising that right or if an alternative asset is not expected to be readily available and could not be sourced by the supplier within a reasonable time period. This focus on practical ability would be consistent with the guidance in IFRS 10 and Topic 810 stating that an

entity must have the practical ability to exercise a right in order for that right to be substantive.

32. Additionally, the staff recommend clarifying that, in order for a substitution right to be substantive, the supplier must be able to *benefit* from exercising the substitution right (that is, the benefits associated with substitution would be expected to outweigh the costs associated with substitution). The staff note that this would be consistent in concept with the guidance in IFRS 10 and Topic 810, which states that an entity should consider whether a party holding a substitution right would benefit from exercise of that right in making the determination of whether that right is substantive. The staff think there are a number of advantages to this clarification:

    (a) It will provide a more objective way to make the assessment as to whether substitution rights are substantive than the proposal in the 2013 ED. Many constituents requested additional guidance on how to determine when the costs associated with substitution would be so high that they would create barriers or economic disincentives, and at what level those costs should be assessed (ie relative to the contract or as an absolute amount). If the guidance states that for a substitution right to be substantive, a supplier must expect to benefit from substituting the asset, the staff think it would provide more clarity about how to make that assessment—ie an entity would compare the expected costs and benefits associated with substitution. A lessor would generally not be expected to exercise a right against its economic interest; and therefore an uneconomical substitution right would generally not be substantive.

    (b) It should simplify the assessment from what was proposed in the 2013 ED. This is because, in many cases, it is likely to be clear that the supplier would not benefit from exercise of a substitution right during the period of use because of the costs associated with substitution.

    (c) It would be difficult for a nonsubstantive substitution right to be written into a contract for the sole purpose of classifying the contract as a service contract. This is because an entity would have to be able to support the assertion that the supplier would benefit from exercising a right of substitution.

33. The clarifications discussed above would not address one of the other main criticisms of the proposals in this area in the 2013 ED—ie that the assessment of whether a substitution right is substantive would be difficult for the customer to make if the customer has little knowledge of the costs of substitution that would be incurred by the supplier. The staff acknowledge this concern. The staff think that, in some cases, it could be difficult for a customer to know enough about a supplier's operations to estimate the costs or benefits associated with substituting assets, especially without knowledge of alternative assets available to the supplier. However, in other cases the staff think that there would be information readily available from which the customer can make a reasonable assessment. Nearly all substitutions of one asset for another would carry some measure of cost. Although benefits may be harder for the customer to objectively measure, it would only infrequently be in the *customer's* interest to grant a supplier rights that would significantly benefit the supplier. Moreover, the staff think it would be obvious to the customer when there are substitution rights that significantly benefit the supplier.

34. Because information in this respect will be *less* available to the customer than to the supplier, the staff would propose adding guidance to the final leases standard stating that, if it is impractical for the customer to determine whether a supplier's right of substitution is substantive, it should assume that any substitution right is not substantive. The staff think that this would address the criticism that it could be very difficult in some cases, if not impossible, for a customer to determine whether a supplier's right of substitution is substantive. At the same time, it would allow a customer to make that assessment if it is able to do so.

Clarifications relating to the 'right to control the use of an identified asset' concept

35. The 2013 ED proposed that a contract conveys the right to control the use of an identified asset if the customer has the ability to do both of the following:

(a) Direct the use of the identified asset (by having the ability to make decisions about use of the asset that most significantly affect the economic benefits derived from use of the asset); and

(b) Derive the benefits from use of the identified asset (by having the right to obtain substantially all of the potential economic benefits from use of the asset).

36. The staff recommend various clarifications to the guidance in the 2013 ED regarding how to identify whether a customer has the ability to direct the use of an identified asset and derive the benefits from use of that asset. Broadly, the staff think that these would:

(a) Provide clarifications in areas that have been identified as problematic when interpreting the proposals in the 2013 ED;

(b) Emphasise that the lease assessment should be done on the basis of the decisions and benefits associated with the *use* of an underlying asset *over the period of use*; and

(c) Where appropriate, incorporate additional guidance from the consolidation requirements and forthcoming revenue recognition standard to further clarify the concepts in the application guidance.

Economic benefits

37. The 2013 ED proposed that, in order to have the ability to control the use of an identified asset, an entity must have the right to obtain substantially all of the potential economic benefits from use of that asset throughout the period of use. One clarification that the staff think would be helpful is to align the definition of 'economic benefits' more closely with the definition of control used in the forthcoming revenue recognition standard.

38. The November 2011 Exposure Draft *Revenue from Contracts with Customers* defined benefits from an asset as 'the potential cash flows that can be obtained directly or indirectly in many ways' and provided a list of examples of ways of obtaining potential cash flows, such as using the asset to produce goods or provide services,

using the asset to enhance the value of other assets, and holding the asset. Not all of the examples put forth in the forthcoming revenue recognition standard would apply to the potential cash flows that could be derived from leasing an asset because the lessee does not own the underlying asset. However, some of these examples apply equally to leasing an asset and owning an asset. For example, a lessee can derive potential cash flows from:

(a) Using the asset to produce goods or provide services;

(b) Using the asset to enhance the value of other assets; and

(c) Subleasing the asset.

39. The staff think that defining benefits in the context of the potential cash flows that can be derived from use of the underlying asset, and including more of an emphasis on those cash flows when considering the decisions that most significantly affect the economic benefits to be derived from use, would be beneficial because it would:

(a) Provide more clarity regarding which decisions can most significantly affect the economic benefits to be derived from use of an asset during a period of time, addressing constituent requests for clarifications in this area. The staff think that evaluating decisions in terms of their effect on the potential cash flows that can be derived from the right-of-use would provide a solid anchor that could be interpreted consistently across different types of transactions and different entities.

(b) Make the definition of a lease guidance more focused on the right-of-use asset rather than the underlying asset. The emphasis in the lease assessment would be on the potential cash flows to be derived from *use* of an asset over the period of use, rather than the benefits that could be derived from the underlying asset more generally (that might be interpreted more widely).

(c) Increase consistency with the control guidance in the forthcoming revenue recognition standard.

Determining which party has the ability to direct the use of an asset when both the customer and supplier have decision-making rights

40. This section, including each of the examples within, is written on the basis that there is an identified asset—ie the contract can be fulfilled only by using a particular identified asset or assets—and the customer has the right to obtain substantially all of the potential economic benefits (cash flows) to be derived from use of the asset during the period of use. In the absence of either of these factors, the contract would *not* contain a lease and an entity would *not* be required to assess who has the ability to direct the use of the asset.

41. The 2013 ED stated that a customer has the ability to direct the use of an asset when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset.

42. The 2013 ED provided the examples of decisions that could most significantly affect the economic benefits to be derived from use of an asset, which include, but are not limited to, determining or being able to change any of the following:

    (a) How and for what purpose the asset is employed during the term of the contract;

    (b) How the asset is operated during the term of the contract; and

    (c) The operator of the asset.

    The 2013 ED did not, however, provide additional guidance on how to weight decisions if both the supplier and the customer could make decisions about the use of the asset that affect the economic benefits derived from use.

43. The staff agree with the principle in the 2013 ED that the party with the ability to make decisions that *most* significantly affect the economic benefits (ie the potential cash flows) to be derived from use of the asset is the party that controls the use of the underlying asset. Accordingly, the staff recommend that it should be retained in the final leases standard. The determination as to which party controls the use of the underlying asset is a qualitative one that must take into account the facts and

circumstances specific to the arrangement. The staff note that IFRS 10 and Topic 810 include a similar concept when determining who has power over an investee. The consolidations guidance does not provide extensive guidance on how to weight decision-making rights in scenarios in which multiple parties have these rights—instead, the consolidations guidance includes some application examples that indicate the types of factors that investors might consider, which largely suggest that the determination is based on the facts and circumstances specific to the situation.

44. Although the staff do not think that it is possible to write guidance that would provide answers to every scenario, the staff think that it may be possible (and helpful) to have additional guidance in this area that would provide more of a framework that preparers can use to assess whether a contract contains a lease. The feedback received would suggest that, without any additional guidance, there is a risk of inconsistent application.

45. The staff think that the final leases standard could include guidance on:

    (a) Whether and when some decision-making rights are likely to affect the potential cash flows derived from use more significantly than other decision-making rights.

    (b) Whether the timing of decisions should affect the assessment of whether those decisions affect the potential cash flows that can be derived from use of the asset.

Which decisions most significantly affect the potential cash flows to be derived from use?

46. The staff think it would be useful to clarify that, in most cases, the decisions about 'how and for what purpose the asset is employed' during the period of use will be the decisions that most significantly affect the potential cash flows to be derived from the right-of-use. The staff think this would generally be the case for most assets (eg determining where and when a truck will drive and what it transports; determining what products are sold from a retail unit; determining for which construction project construction equipment is used). The premise of the right-of-use model is that, under a lease, a lessee enters into a lease to obtain economic benefits (cash flows) from using

an asset. Accordingly, the decisions made about the purpose for which the asset is used generally should be the decisions that most significantly affect the potential cash flows that can be derived from use of the asset. If the customer has the right to decide the purpose for which an asset is used and how the asset is used throughout the applicable period of use, in most cases there is a lease.

47. Although the decisions about how to operate an asset would often be important and affect the cash flows that will be derived from use, in most cases those decisions would *not* affect those cash flows more significantly than the decisions about how and for what purpose an asset is used. In most cases, decisions about the operation of an asset would *depend upon* the decisions made about how and for what purpose an asset is used—ie the decisions about for what purpose the asset is used set the parameters within which the operating decisions are made. The parameters set in determining the purpose for which the asset is used would often limit the amount of discretion that is retained within the operating decisions. Consequently, the decisions about the operation of an asset would be expected to have less effect on the potential cash flows to be derived from use of an asset than the decision about how and for what purpose the asset is used.

48. For example, the decisions about the operation of a ship are dependent upon the decisions regarding for what purpose the ship is used, where the ship sails, and when the ship needs to be at its specified destination. There is some discretion involved in operating the ship. Nonetheless, the staff think that the decision-making that has the most significant effect on the cash flows derived from using the ship would reside with the party making decisions about where and when the ship travels, and what goods are transported on that ship (and typically, at what price those goods are transported for).

Example 1 – Shipping contract (time charter)

- Customer enters into a contract with Supplier for the charter of an identified ship for a five-year period.

- Customer determines whether and what cargo will be transported and the timing and location of delivery, and makes these decisions throughout the contract (ie Customer determines when and to which ports the ship sails).
- Supplier operates and maintains the ship and is responsible for the cargo on board the ship. Customer is prohibited from hiring another operator for the ship.

The contract contains a lease. Customer has the ability to direct the use of the ship by making the decisions that most significantly affect the cash flows to be derived from use. This is because, for each day during the five-year term, Customer determines, and can change, how and for what purpose the ship is used (ie where and when it travels and the goods it will transport). Supplier has discretion in operating the ship and those operating decisions can affect the cash flows to be derived from use. However, the operational decisions are dependent on the instructions Customer gives regarding the ship's voyage. For example, Supplier may make decisions about the exact route the ships travels and the exact speed at which it travels on each day. However, the discretion within those decisions is likely to be more limited (and thus have less effect on the overall cash flows to be derived from use) because the captain must ensure that the ship arrives at its destination in accordance with Customer's instructions. Indirectly, Customer is likely to have had considerable influence on the route and the speed at which the ship must travel by specifying when the ship must be at the stated destination(s). Customer would account for the lease component in the contract separately from the nonlease components.

49. Although the staff think that, in most cases, the identification of the party that makes decisions regarding how and for what purpose an asset is used would be the determinative factor in the lease assessment, this would not always be the case. The staff think that it would be helpful to clarify that other decisions, such as decisions about the operations of the asset, or if the customer is involved in designing the asset would most significantly affect the potential cash flows to be derived from the right-of-use in some limited scenarios.

50. One of these scenarios in which the entity that controls the 'how and for what purpose' decisions would not be the determinative factor in the lease assessment is

when the customer determines how and for what purpose the asset is used as part of determining the contract (and the customer cannot change those decisions subsequently). In this case, the customer's decision-making rights about how and for what purpose the asset is used give it the ability only to specify the output of an asset. The ability to specify the output of an asset, without any other decision-making rights relating to use of the asset, gives a customer the same rights as any customer purchasing services. Accordingly, specifying the output of an asset (eg the quantity and description of goods or services produced by the asset) would not, in isolation, mean that a customer has the ability to direct the use of that asset. This is consistent with the proposals in the 2013 ED. However, merely determining how and for what purpose the asset is used as part of determining the contract does not automatically mean there is no lease. If the customer retains the other decision-making rights that most significantly affect the potential cash flows to be derived from use of the asset, the contract would still contain a lease (see Example 3 below).

Example 2 – Shipping contract (voyage charter)

- Customer enters into a contract with Supplier for the transportation of cargo from London to Sydney on an identified ship—the cargo will occupy all of the capacity of the ship.
- Within the contract, Customer determines the cargo to be transported, and the timing and location of delivery in Sydney. Customer has no further decision-making rights about the use of the asset, ie Customer cannot change its instructions without changing the terms and conditions of the contract.
- Supplier operates and maintains the ship and is responsible for the cargo on board the ship.

The contract does not contain a lease. Customer has, in effect, determined how and for what purpose the ship will be used during the period of transportation when negotiating the terms of the contract. However, because Customer does not have any decision-making rights after the contract commences about the use of the ship, Supplier is the only party that, via its decision-making about the operations, can significantly affect the cash flows to be derived from use of the ship. In this example, *Customer's decision-making rights are limited to specifying the output from use of the ship. Customer has no more ability to direct the use of the ship than if it were only one of 10 customers whose goods occupied 1/10th of the capacity of the ship.*

Example 3 – Truck rental contract

- Customer enters into a contract with Supplier for the transportation of cargo from New York to San Francisco on an identified truck—only the Customer's cargo will be transported.
- Within the contract, Customer determines the cargo to be transported and the timing and location of pick-up in New York and delivery in San Francisco.
- Customer is responsible for driving the truck from New York to San Francisco.

The contract contains a lease. Customer has, in effect, determined how and for what purpose the truck will be used during the period of transportation when negotiating the terms of the contract. These decision-making rights, in isolation, only give Customer the ability to specify the output from the use of the truck. However, because Customer also has the sole ability to make decisions about operating the truck during the period of use, it is the only party that can significantly affect the potential cash flows derived from use of the truck during the period of use.

51. Even when the decisions about how and for what purpose the asset is employed are made during the contract, there may still be some infrequent cases when these would not be the decisions that most significantly affect the potential cash flows derived from use of an asset. The following would be indicators of such scenarios:

(a) How the asset is operated has a significant effect on the amount of potential cash flows that are to be derived from use of the asset.

(b) If there is a significant amount of discretion in operating the asset, and those decisions could significantly affect the potential cash flows to be derived from use of the asset.

(c) If the decisions regarding how and for what purpose the asset is used are made, and changed, very infrequently during the period of use.

Example 4 – Contract for drilling services

- Customer enters into a contract with Supplier for the drilling of offshore oil wells to extract oil for a three-year period.
- The contract specifies the drilling equipment to be used. Customer is responsible for the location of drilling and directs where and when the rig is relocated; however, Customer does not expect to move the rig over the course of the contract because moving the rig would be very costly. Customer would change the location of the rig only if there was an unforeseen problem with the original location.
- Supplier is responsible for maintaining and operating the drilling rig, and determining the drilling programme. Operation of the drilling rig is highly specialised and requires specially-trained employees. Customer is prohibited from hiring another operator for the drilling rig and is not involved in the operation of the rig.

The contract does not contain a lease. Supplier's decision-making rights over the operations of the rig are expected to most significantly affect the cash flows to be derived from use of the rig. Because the operation of the rig is highly specialised and involves a significant amount of discretion, how the rig is operated is expected to have the most significant effect on the cash flows to be derived from use of the rig (in this case, how much oil is procured and then sold or used). Although Customer has the ability to determine how and for what purpose the rig is used during the period of use by changing the location of the rig, if necessary, those decisions are not expected to change frequently, if ever. Accordingly, these decision-making rights are not expected to have as significant an effect on the potential cash flows to be derived from use of the rig as the operating decisions of Supplier.

Example 4A

- Assume that the contract with Supplier is for the drilling of wells for exploratory purposes in a particular oilfield for a three-year period.
- The contract specifies the drilling equipment to be used to drill the wells. Customer is responsible for the location of drilling and directs where and when the

rig is relocated. As the wells will be used for exploratory purposes, Customer expects to change the location of the rig multiple times over the period of use.

- Supplier is responsible for maintaining and operating the drilling rig, although the nature of the exploration and the rig being used means that there is less discretion involved in the operations than in Example 4 because the particular rigs to be used in the contract are not as complex to operate as Example 4. Customer is prohibited from hiring another operator for the drilling rig.

The contract contains a lease. Customer has the ability to direct the use of the rig by making the decisions that most significantly affect the economic benefits to be derived from use of the rig. This is because Customer determines the location of the rig. Although Supplier is responsible for operations of the rig, the operational decisions are not as impactful to the economic benefits that can be derived from their use as the decisions with respect to location in this exploratory scenario and in consideration of the less complex nature of these rigs (as compared to Example 4). Therefore, Customer's decision-making rights about the location of the rig (how and for what purpose the rig is used) results in Customer's decision-making having the most significant effect on the cash flows to be derived from use. Customer would account for the lease component in the contract separately from the nonlease components.

52. The staff think these clarifications would be useful because they would provide more specific guidance, and thus a clearer framework, regarding how to assess the decisions affecting the potential cash flows derived from use of an asset.

Decisions made before the lease commences

53. The staff think it might be helpful to clarify that, generally, the decisions that should be considered in the lease assessment are those decisions that are made *during* the period of use, not *before* (with the exception of the decisions about the design of the underlying asset, discussed below). Consequently, the ability to make decisions would be relevant when assessing whether a contract contains a lease generally only if those decisions give an entity the ability to change how the asset is used or operated during the period of use. The staff note that this would be consistent with the notion in IFRS 10 and Topic 810 that an investor generally must have the current ability to direct

relevant activities to have control. The staff think that this clarification would be useful for a number of reasons. It would:

(a) Confirm and be consistent with the proposal in the 2013 ED that specifying the output of an asset would not, in isolation, mean that a customer has the ability to direct the use of an asset, as discussed earlier in the paper.

(b) Address constituent feedback that it would be difficult to evaluate who has the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use when decisions are made jointly between the supplier and customer and written into the contract.

54. The clarification will narrow the number of decisions that need to be considered by focusing on those decisions that take place over the period of use. The 2013 ED proposed that, for contracts in which there are few, if any, substantive decisions to be made after the commencement date, a customer could have the ability to direct the use of an asset by, for example, being involved in designing the asset for its use or determining the terms and conditions of a contract. This guidance could be viewed as conflicting with the staff's proposal to limit the decisions to be considered generally to only those made during the period of use. However, in cases in which there are few, if any, substantive decisions to be made after the commencement date, the staff think it is appropriate to conclude that a lease exists if the customer designed the underlying asset (or caused the underlying asset to be designed) for its use in a way that significantly affects the potential cash flows to be derived from use. For example, assume that decisions A, B, and C would most significantly affect the potential cash flows to be derived from use of the underlying asset during the period of use because there are no, or few, other substantive decisions to be made by either the customer or supplier that could as significantly affect the potential cash flows derived from use. If the customer has the right to make, and change, those decisions during the period of use, it would be clear that there is a lease. The staff think that if the customer designs the asset (or causes the asset to be designed) to effectively predetermine those decisions, the same conclusion should be reached with respect to whether there is, or is not, a lease.

55. In addition, the staff suggest clarifying that decisions made by the customer relating to the design of the underlying asset for its use (in a way that significantly affects the potential cash flows to be derived from use of the underlying asset) should be considered in a lease assessment, even when there are substantive decisions to be made during the period of use.

56. The staff think this is appropriate in the context of determining whether the supplier or customer controls the use of the underlying asset. This is because the staff think that one of those two parties—either the supplier or the customer—must control the use of the underlying asset during the period of use. Consequently, when there are no, or few, substantive decisions to be made about the use of an asset during the period of use, an entity should look to the decisions made about the use of the asset at or before contract commencement. In this situation, if the customer has been involved in designing the asset for its use, the customer would appear to have been able to determine how and for what purpose the asset is employed during the period of use as a consequence of designing the asset for use.

Example 5 – Solar farm producing electricity

- Customer enters into a 15-year contract with Supplier to purchase electricity from an identified solar farm not yet constructed. The contract requires Customer to take all electricity produced by the solar farm.
- Customer is responsible for designing the solar farm—Customer has hired experts in solar energy to assist in determining the location of the farm and the equipment to be used.
- Supplier is responsible for operating and maintaining the solar farm, although there is little, if any, decision-making involved in the operation or maintenance of the solar farm after it is constructed that would affect the cash flows that can be derived from its use.

The contract contains a lease. Customer has the ability to direct the use of the solar farm by making the decisions that most significantly affect the potential cash flows to be derived from use. By making the decisions about the design of the farm, Customer has determined how and for what purpose the solar farm will be used, as well as how *the farm will operate, throughout the period of use. Because there are no substantive decisions to be made about the use or operation of the farm after the commencement date, Supplier's operation and maintenance of the farm does not significantly affect the cash flows to be derived from use of the solar farm, and Customer's decisions in designing the solar farm most significantly affect the potential cash flows to be derived from its use.*

Restrictions on the use of an asset

57. The 2013 ED included guidance stating that restrictions on a customer's use of an asset are protective rights and would not, in isolation, prevent the customer from having the ability to direct the use of the asset. Some have questioned what level of restrictions, if any, would be enough to prevent a customer from having the ability to direct the use of an asset.

58. The staff think it would be useful to include some additional wording about protective rights in line with the guidance in IFRS 10 and Topic 810. That guidance could explain that, in most leases, the lessor would want to protect its interest in the residual asset. Accordingly, there are likely to be at least some restrictions on how an underlying asset could be used during the lease term (eg restrictions on how much an asset could be used or when an asset can be operated). These restrictions are meant to protect the lessor's interest without removing the ability for a lessee to direct the use of an underlying asset during the lease term, in a similar way to restrictions that might be placed on owned assets that are pledged as security against borrowings. These restrictions would essentially narrow the scope of the rights a lessee would have to use an asset without removing a lessee's ability to direct the use of an asset. Accordingly, those restrictions may affect the price paid for the lease (ie a lessee may pay less for the use of an asset if it is more restricted in its use of that asset), and thus the restrictions could affect the measurement of the right-of-use. However, those restrictions would not affect the *existence* of the right-of-use.

59. The staff, however, think that it may be helpful to clarify that, if the restrictions are so restrictive that, in effect, the customer does not have:

(a) Any ability to make decisions that significantly affect the potential cash flows derived from use; or

(b) The rights to those cash flows, then in those cases restrictions over the use of an asset could prevent the customer from having the ability to direct the use of that asset.

Assets incidental to the delivery of services

60. The 2013 ED proposed that a customer would not have the ability to derive the benefits from use of an asset if both of the following occur:

(a) The customer can obtain the benefits from use of the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers; and

(b) The asset is incidental to the delivery of services because the asset has been designed to function only with the additional goods or services provided by the supplier.

61. The feedback received on this aspect of the definition of a lease was largely negative and indicated that the guidance:

(a) Was not clear (for example, constituents requested that the boards clarify the meaning of ‘incidental’);

(b) May be difficult to apply (for example, constituents noted that a customer may not always know if goods or services are sold separately by other suppliers, or that this assessment may change over time);

(c) May not capture the types of contracts the boards intended to capture (for example, constituents noted that cable set-top boxes (discussed below) may be sold separately in some jurisdictions and, thus, would not qualify as an asset incidental to the delivery of services because it would not meet criterion (a)); and

(d) May not capture the types of contracts that constituents thought should be captured by this concept (for example, contracts in which the service component is the primary component of the contract or in which the supplier still had to perform throughout the contract by providing services, but the contract still gave the customer the right to control the use of an underlying asset).

62. Given the feedback received in this area, the staff would not recommend retaining the guidance regarding assets incidental to services.

63. The staff think that in most (if not all) cases, the guidance regarding assets incidental to services would not be needed because applying the general guidance on control would result in the same answer. For example, consider a contract for television services that requires a set-top box to be placed in the customer's premises in order for the customer to access the services (a fact pattern that was frequently mentioned in the discussions about assets incidental to services). The set-top box has no use to the customer other than to receive the requested television services. In this case, the staff think that the customer does not control the use of the set-top box because it cannot make any decisions that affect the potential cash flows derived from use of the set-top box. The supplier has already programmed the set-top box to function to deliver the specified services and controls what content is delivered to (and viewable on) the set-top box. In addition, the customer generally cannot use the set-top box to receive any other services (eg from another service provider). The customer has no more control over the set-top box than it would over equipment located outside of its premises that is used to deliver services to the customer. The customer in this case is essentially only determining the output from the set-top box (eg in requesting a specified television viewing package from the service provider) and, therefore, does not direct the use of the set-top box.

64. In addition, the staff think that it would be difficult to clarify and operationalise the guidance in a way that addresses constituent concerns and captures the contracts the board originally envisaged without broadening the guidance in such a way that would:

    (a) Encourage structuring;

    (b) Be inconsistent with the revenue recognition requirements; and

(c) Most importantly, potentially conflict with the basic control principle (ie lead to contracts being accounted for entirely as services even though the customer controls the use of an identified asset).

65. The feedback on the proposals in the 2013 ED in this respect suggest that any guidance on incidental assets would raise more questions than answers and, in any event, would apply to relatively few scenarios. In addition, the staff think that the control principle and guidance proposed in the 2013 ED (if clarified as proposed earlier in this paper to address constituent feedback) would capture the appropriate population of leases without the need for additional guidance regarding assets that are incidental to the delivery of services. For these reasons, the staff think that it would be preferable to rely only on the core definition of a lease.

Staff recommendation and question for the boards

66. The staff recommend the following regarding the definition of a lease:

(a) Retain the principles in the 2013 ED supporting the definition of a lease that require an entity to determine whether a contract contains a lease by assessing whether:

(i) Fulfilment of the contract depends on the use of an identified asset; and

(ii) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

(b) Clarify the following regarding whether fulfilment of the contract depends on the use of an identified asset:

(i) Fulfilment depends on the use of an identified asset when the supplier has no *practical ability* to substitute an alternative asset or the supplier would not *benefit* from substituting an alternative asset (discussed in paragraphs 29-32).

(ii) A customer would presume that fulfilment of the contract depends on the use of an identified asset if it is impractical for the customer to determine either: (1) whether the supplier has the practical ability to substitute an alternative asset, or (2) whether the supplier would benefit from the substitution (discussed in paragraphs 33-34).

(c) Clarify the following regarding the right to control the use of an identified asset:

(i) Focus the assessment on the ability to affect the *potential cash flows* to be derived from use of the asset during the period of use (discussed in paragraphs 37-39).

(ii) Add guidance regarding which decisions most significantly affect the potential cash flows to be derived from use (discussed in paragraphs 40-59).

(iii) Remove the guidance in the 2013 ED regarding assets that are incidental to the delivery of services (discussed in paragraphs 60-65).

Question for the boards:

Do the boards agree with the staff recommendations regarding the definition of a lease? If not, what do the boards prefer?

Appendix A – The proposals in the 2013 ED

A1. The proposed definition of lease term and accompanying application guidance in the 2013 ED is as follows:

> 6 A lease is a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
>
> 7 At inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing both of the following:
>
> (a) whether fulfilment of the contract depends on the use of an identified asset (as described in paragraphs 8–11); and
>
> (b) whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration (as described in paragraphs 12–19).

Fulfilment of the contract depends on the use of an identified asset

> 8 An asset would typically be identified by being explicitly specified in a contract. However, even if an asset is explicitly specified, fulfilment of a contract does not depend on the use of an identified asset if the supplier (ie the entity that provides the good or service under the contract) has the substantive right to substitute the asset throughout the term of the contract. In contrast, even if an asset is not explicitly specified in a contract, fulfilment of the contract can depend on the use of an identified asset if the supplier does not have a substantive right to substitute the asset.
>
> 9 A supplier's right to substitute an asset is substantive if both of the following conditions are met:
>
> (a) the supplier can substitute alternative assets in place of the asset without requiring the consent of the customer (ie the entity that receives the good or service under the contract); and
>
> (b) there are no barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets in place of the asset during the term of the contract. Examples of such barriers include, but are not limited to, the following:
>
> (i) costs associated with substituting the asset that are so high that they create an economic disincentive to substituting alternative assets during the term of the contract; and
>
> (ii) operational barriers that would prevent or deter the supplier from substituting the asset (for example, alternative assets are neither readily available to the supplier nor could they be sourced by the

supplier within a reasonable time period or without incurring significant costs).

10 Fulfilment of a contract can depend on the use of an identified asset even if a supplier has the right or obligation to substitute other assets in place of the underlying asset if the asset is not operating properly or a technical upgrade becomes available. In addition, fulfilment of a contract can depend on the use of an identified asset even if a supplier has the right or obligation to substitute other assets for any reason only on or after a particular date. In this case, fulfilment of the contract can depend on the use of an identified asset until the date that the right or obligation to substitute becomes effective.

11 A physically distinct portion of an asset (for example, a floor of a building) can be an identified asset. However, a capacity portion of an asset (for example, a capacity portion of a fibre-optic cable that is less than substantially all of the capacity of the cable) cannot be an identified asset because it is not physically distinct from the remaining capacity of the asset.

Contract conveys the right to control the use of an identified asset

12 A contract conveys the right to control the use of an identified asset if, throughout the term of the contract, the customer has the ability to do both of the following:

(a) direct the use of the identified asset (as described in paragraphs 13–17); and

(b) derive the benefits from use of the identified asset (as described in paragraphs 18–19).

Ability to direct the use

13 A customer has the ability to direct the use of an asset when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract.

14 Examples of decisions that could most significantly affect the economic benefits to be derived from use of an asset include, but are not limited to, determining or being able to change any of the following:

(a) how and for what purpose the asset is employed during the term of the contract;

(b) how the asset is operated during the term of the contract; and

(c) the operator of the asset.

15 In some contracts for which there are few, if any, substantive decisions to be made about the use of an asset after the commencement date, a customer's

ability to direct the use of the asset may be obtained at or before that date. For example, a customer may be involved in designing the asset for its use or in determining the terms and conditions of the contract, so that the decisions about the use of the asset that most significantly affect the economic benefits to be derived from use are predetermined. In those cases, the customer has the ability to direct the use of the asset throughout the term of the contract as a result of the decisions that it made at or before the commencement of the contract.

16 A contract may include clauses that restrict a customer's use of an asset; for example, a contract may specify the maximum amount of use of an asset to protect the supplier's interest in the asset. Such protective rights that restrict a customer's use of an asset would not, in isolation, prevent the customer from having the ability to direct the use of the asset.

17 Rights that give a customer the ability to specify the output of an asset (for example, the quantity and description of goods or services produced by the asset) would not, in isolation, mean that a customer has the ability to direct the use of that asset. The ability to specify the output, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases services.

Ability to derive the benefits from use

18 A customer's ability to derive the benefits from use of an asset refers to its right to obtain substantially all of the potential economic benefits from use of the asset throughout the term of the contract. A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, consuming, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products in the form of products and services. Those economic benefits also include other economic benefits from use of the asset that could be realised from a commercial transaction with a third party.

19 A customer does not have the ability to derive the benefits from use of an asset if both of the following occur:

(a) the customer can obtain the benefits from use of the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers; and

(b) the asset is incidental to the delivery of services because the asset has been designed to function only with the additional goods or services provided by the supplier. In such cases, the customer receives a bundle of goods or services that combine to deliver an overall service for which the customer has contracted.