

## 2013 ED Leases: Definition of a Lease

### What makes a difference between a service and a lease?

A personal note developed by staff of the EFRAG Secretariat

#### Disclaimer

EFRAG has, on the basis of its current organisation and due process, supported the lessee accounting model throughout the development of the IASB Lease project since 2008. At all times, EFRAG has noted that its support is subject to the boundary between leases and services being set in a manner that is consistent with the objective to account for leases which are akin to financing arrangements in the same manner as other borrowings of the entity.

Even though EFRAG has noted that progress had been made, EFRAG observed in its comment letter to the IASB on the 2013 ED that the boundary between leases and services needed further improvement.

EFRAG staff has developed the analysis below to support further discussion at the September 2014 ASAF meeting. This paper has neither been reviewed nor endorsed by EFRAG. It therefore cannot and should not be referred to, or reported on, as an EFRAG paper or position.

#### Purpose of this paper

- 1 In May 2013, the IASB issued Exposure Draft ED/2013/6 *Leases* ('the 2013 ED'). During the comment period the IASB and the FASB (the Boards) received more than 600 comment letters. The Boards started their redeliberation process in January 2014 and till now have discussed the majority of the raised issues.
- 2 Concerns have been raised by European constituents that the current definition and criteria to identify a lease would include arrangements that are services, most recently in reply to the additional public consultation launched in July by EFRAG and the NSS of France, Germany, Italy and the United Kingdom. For instance, a user organisation that supported the IASB approach for lessees noted that:

if the supplier retains all the risk of asset availability then there is probably not an asset lease, even if the customer has the other characteristics present. Generally it will be unlikely that a customer would have unfettered right to direct the use of the asset and the supplier would retain an obligation to ensure that it is available but if that is the case then the contract is probably a service.

- 3 This paper, therefore, suggests changes to the requirements, proposed in the 2013 ED and re-deliberated by the Boards in 2014, to enable the development of guidance that assists in distinguishing when a contract between a Customer and a Supplier that involves use of an asset constitutes a lease and when it does not. This is intended to assist the IASB in achieving its purpose of recognising assets and liabilities arising from lease contracts (except when the entity can apply a simplification introduced by the IASB).

## Summary of the issues

### *Issue 1 – financing arrangements*

- 4 The Boards have a long-running project to improve the accounting for leases under IFRS and US GAAP with the objective of improving the quality and comparability of financial reporting by providing greater transparency about leverage of entities. The Project Update *Leases* published in August 2014 by the IASB confirms previous messages from the IASB that:

Leases provide a source of financing. A lessee obtains an asset and incurs a liability when it enters into a lease. This view is held not only by the IASB but also by the majority of investors and analysts, many regulators, standard setters and accounting firms, and some preparers.

- 5 The key issue is to identify when a contract that involves the use of an asset is a financing arrangement and should be accounted for as a lease. The 2013 ED proposed 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.

- 6 This definition requires an entity to identify a specific asset and then assess 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 this identified asset for a period of time in exchange for consideration. (the 2013 ED, paragraph 7)

This latter condition is satisfied if the Customer has the ability to both:

- (a) direct the use of the identified asset; and
  - (b) derive the benefits from use of the identified asset. (the 2013 ED, paragraph 12)
- 7 We think that the above criteria for identifying a lease are not sufficient to identify when the transferred right to use an asset is a financing arrangement (i.e. a lease) and when the transferred right to use an asset is not a financing arrangement. For example, the definition would capture the hiring of a car for an afternoon because the alternative mode of transport is a very expensive taxi. Most would consider that this transaction is undertaken to achieve an operational objective in the most effective way, rather than to gain access to financing. Further, we think that these criteria are likely to include contracts where the use of a Supplier's asset is a necessary part of the provision of services to the Customer.

- 8 We therefore propose that the definition of a lease in the 2013 ED be extended to recognise that the definition should only capture financing arrangements. One possible amendment to the definition of a lease is that a lease is:

a financing arrangement in the form of a contract that conveys the right to use an identified asset (the underlying asset) for a period of time ~~in exchange for consideration.~~

- 9 Once it is accepted that a contract is a lease only if it contains a financing arrangement, guidance to identify financing arrangements is required. This first issue is discussed in more depth later in this paper.

### *Issue 2 Unbundling*

- 10 Paragraph 18 of the 2013 ED explains that the ability to derive the benefits from use of the identified asset refers to the Customer's right to obtain substantially all of the potential economic benefits from use of the asset throughout the term of the contract. Paragraphs 19 then clarifies that a Customer does not have this ability if the benefits may be obtained 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 the asset has been designed to function only with the additional goods or services provided by the Supplier.
- 11 To the extent that a contract is for the provision of a service, the Customer's liabilities arising under the contract represent the Customer's future commitments to compensate the Supplier for the provision of future services. Assets involved in the contract represent the Customer's right to use an ancillary asset because it is only a medium used to provide the services rather than finance provided by the Supplier to the Customer.
- 12 It follows that some contracts that appear to contain a lease may also contain elements that represent services provided by the Supplier. The question arises as to whether these contracts should be:
- (a) unbundled into their lease and service components;
  - (b) accounted for entirely as lease contracts; or
  - (c) accounted for entirely as contracts to deliver services.
- 13 The second issue is discussed in more depth later in this paper.

### **Issue 1 – Financing arrangements**

- 14 As we mentioned above, one important principle not addressed in the definition of a lease is whether the contract is a financing arrangement that provides finance to the Customer. In this section we focus on the characteristics of a financing arrangement, being unconditionality of payments, payment structure and the business model of the Supplier.
- 15 In the case of a lease, the lessor performs at the start of the lease term by passing control over the leased asset's right of use to the lessee. The lessor's performance

during the lease contract is passive rather than active. During the lease term, the lessor cannot recover control over the right of use of the asset unless the lessee fails to perform under the contract. This gives the lessee control of the right-of-use asset during the lease term and the lessee's obligation to pay is not conditional on future performance by the lessor.

- 16 If the asset fails to perform as specified in the lease contract, we would expect that the lessee has a right to redress such as would apply if a purchased asset failed to perform as specified in the purchase contract. This may include some form of compensation and rectification where the contracted quality is not met. A lease differs from a purchase in that the warranty for a purchased asset generally has a limited term whereas the 'warranty' for a leased asset generally lasts for the term of the lease.
- 17 In the case of a financing arrangement, we anticipate that the payments under the lease contract would include components similar to a loan. This means that the contract would require repayments of the principal amount 'lent' to the lessee together with the interest compensating the lessor for the risks inherent in a loan contract and the time value of money. That is, the lease payments would:
- (a) not be variable depending on the usage of the leased asset;
  - (b) not depend on the delivery of other goods or services to perform at a guaranteed service quality level; and
  - (c) late payment may be penalised with additional interest being charged to the lessee.
- 18 Finally, we would expect that a Supplier displays certain characteristics that indicate its business model. Possible indicators that the Supplier's business model is to provide financing rather than to own assets to support services provided to its Customers are:
- (a) the Supplier is a financial institution or a subsidiary of an entity that acts as a financial institution;
  - (b) the Supplier is a manufacturer that both sells and leases assets without providing complex solutions based on delivery of services supported by the assets; or
  - (c) the Supplier's risks are limited to financial market interest risks, the Customer's credit risk and (depending on the conditions of the lease contract) the market risk of the asset's residual value.
- 19 In contrast, indicators that the business model of a lessor is not limited to providing financing include:
- (a) performance by the Supplier is not completed by delivery of the asset under the contract – that is, the Supplier has ongoing obligations to perform actively under the contract;

- (b) the payments under the contract are structured to recover costs of performance as well as capital recovery of the capital tied up in the contract and associated interest;
  - (c) the business model of the Supplier is to provide services that include the use of assets, not to provide financing to enable its Customers to acquire assets.
- 20 Where it is considered that a contract may contain both a financing and a non-financing component, it is necessary to determine if these components should be unbundled.

## Issue 2 – Unbundling

- 21 In the case of a contract that appears to include a financing arrangement, the second question is whether this contract delivers complex solution based on provision of combined assets and services which should be unbundled into lease and service components.
- 22 We raise an example of time charter-parties contracts for a useful life of a vessel. After a number of cargo ship-crashes in 1990's, a typical time charter requires the ship owner (i.e. the Supplier) to provide the services to the merchant (i.e. Customer) to ensure proper loading, unloading, efficient and secure navigation etc. Those services require the involvement of highly skilled crew using dedicated equipment owned by the Supplier. This example may also indicate that the provision of the additional services combined with the delivery of an asset constrains (or prevents) control over the use of the asset by the Customer because it prevents separability of the control of the delivered asset's right of use from the provision of the operating services.
- 23 Similar concerns were raised by EFRAG constituents in the recently conducted Additional Consultation for Preparers in Europe in relation to contracts where the control over the way the asset provides benefits to the Customer depends on resources owned and controlled by the Supplier and managed in accordance with decisions made by the Customer. In other words, the implementation of the Customer's decisions depends on performance by the Supplier. The examples we have been given include drilling rigs, wet leases of planes, specialised manufacturing robots and outsourced IT solutions.
- 24 In our opinion, some of the contracts include both the use of an asset and the provision of services and should be seen for economic purposes as a single unit of account. For these contracts, the use of the asset and the services provided by the Supplier form an inseparable bundle and should not be separated. The Customer is in a different position during the contract term from an owner of a purchased asset who can outsource some of the services related to the asset.
- 25 The following provides indications that the transaction forms an inseparable bundle and is in substance a service:
- (a) the benefits from use of the asset cannot be delivered to the Customer on a continuous basis separately from the services and other goods delivered by the Supplier;

- (b) the Supplier continues to be significantly and actively involved in the operation of the asset after the contract commencement date, such as through having an obligation to operate and maintain the asset throughout the period of the contract;
  - (c) operating risks remain with the Supplier and are not transferred to the Customer;
  - (d) the risk of availability of the asset remains with the Supplier.
- 26 The following provides indications that the contract is intended to deliver an asset to the Customer together with some incidental services:
- (a) the Supplier also sells separately the services; and
  - (b) there is no necessary significant continuing involvement by the Supplier after the date of commencement of the contract, except for credit risk in relation to the collection of contract payments or maintenance not exceeding warranty obligations resulting from typical purchase agreements.
- 27 If the indicators concerning financing characteristics of the contract and the indicators of inseparability of the contract components do not clearly lead to a conclusion that a contract should be within the scope of the proposed guidance for leases, it leads to the conclusion that the contract represents another type of agreement (i.e. it is not a lease). In these cases, it is likely that IFRS 15 *Revenue from Contracts with Customers* will contain the relevant requirements.
- 28 Where indications lead to the conclusion that a contract contains a lease but it cannot be concluded that the contract is solely a lease, then it is likely that the contract contains both a lease and a service. In this case, we propose to rely on the most recent literature available and to align the process of identification of components of the contract with the process of identifying distinct goods or services under IFRS 15.
- 29 We note that both IFRS 15 and the 2013 ED are based on a notion of transfer of control and therefore we believe that the guidance for the recognition of revenue (on the Supplier side) and guidance for the recognition of an asset and a liability (on the Customer side) should be consistent. We note, however, the differences between the criteria for identifying distinct goods and services under IFRS 15 and the 2013 ED right-of-use asset separability criteria when assessing the ability to derive benefits from use.
- 30 Paragraph 27 of IFRS 15 requires any component of the contract to be accounted for as a separate performance obligation only if very narrow criteria are satisfied. Specifically, for goods or services to be distinct, both of the following conditions should be met:
- (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the Customer (i.e. the good or service is capable of being distinct); and

- (b) the entity's promise to transfer the good or service to the Customer is separately identifiable from other promises in the contract (i.e. the good or service is distinct within the context of the contract).

These conditions are further articulated in paragraphs 28 and 29 of IFRS 15.

- 31 In the 2013 ED, entities are required to assess whether the identified asset may be used separately from other components of the contract and, consequently, its right-of-use may be unbundled. In particular, paragraph 18 of the 2013 ED specifies that 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. Paragraph 19 then clarifies that the customer does not have the ability to derive the benefits from the use of the identified asset when the asset is designed in such a way that it may be used only in conjunction with the services (or goods) delivered only by the Supplier.
- 32 We think that the combination of paragraphs 18 and 19 of the 2013 ED addresses similar issues to the conditions in paragraph 27(a) of IFRS 15. However the process of identification of a lease ends with this assessment whereas IFRS 15 requires that, to be distinct, goods and services should also satisfy the condition in paragraph 27(b). That is, the constraints on unbundling in IFRS 15 are more stringent than the proposed constraints in the 2013 ED.

### **Conclusion**

- 33 We consider that two changes should be made to the proposals in the 2013 ED before a new leasing standard is issued.
- 34 First, in order to implement the stated objective of the leasing project, the definition of a lease should be amended to clarify that a lease must be a financing arrangement and, when bundled with services, the financing component must be clearly identifiable. As it stands, the definition of a lease is likely to bring contracts that involve the use of an asset into the scope of the leasing standard even if they do not represent financing arrangements.
- 35 Second, requirements to unbundle contracts that contain both a lease and a service, when unbundling is appropriate, should be aligned with the IASB's most recent thinking on unbundling that is codified in IFRS 15. We expect that this will ensure that contracts where the use of an asset is ancillary to the provision of a service will appropriately result in these contracts being accounted for without unbundling as a service.