

STAFF PAPER

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REG IASB Meeting

Project	Leases		
Paper topic	Transition – Definition of a Lease		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Objective

1. The purpose of this paper is to discuss the transition requirements for lessees and lessors with respect to the definition of a lease.
2. This paper does not address IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. This is because the staff think that the recommendations in this paper are directly related to an entity transitioning from *existing* IFRS requirements and, therefore, should not be applicable upon first-time adoption.
3. This paper is structured as follows:
 - (a) Summary of staff recommendations
 - (b) Background
 - (c) Feedback
 - (d) Staff analysis
 - (e) Staff recommendations
 - (f) Questions for the IASB
4. Throughout this paper, the ‘date of initial application’ is used to describe the first day of the annual reporting period in which an entity first applies the requirements of the final leases standard.

Summary of Staff Recommendations

5. The staff recommend that the new leases standard should permit (but not require) an entity to grandfather the definition of a lease for all contracts that are ongoing at the date of initial application (ie those contracts that were previously assessed under the existing requirements of IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease* and that continue to be in place at the date of initial application). Consequently:
 - (a) an entity could continue to account for contracts that contain a lease under the existing requirements of IAS 17 and IFRIC 4 as containing a lease when applying the new leases standard;
 - (b) an entity would not need to account for contracts that do not contain a lease under the existing requirements of IAS 17 and IFRIC 4 as a lease when applying the new leases standard.
6. The staff also recommend that if an entity chooses to grandfather the definition of a lease:
 - (a) this should apply to *all* contracts that are ongoing at the date of initial application, ie an entity would not apply this option on a lease-by-lease basis; and
 - (b) that fact should be disclosed.

Background

7. IAS 17 defines a lease as an agreement whereby the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments.
8. IFRIC 4 provides guidance relating to contracts that do not take the legal form of a lease but that convey the right to use an asset in return for a payment or series of payments. IFRIC 4 requires an entity to determine whether an arrangement is, or contains, a lease based on an assessment of whether:
 - (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets; and

- (b) the arrangement conveys a right to use the asset. This would be the case if any one of the following conditions is met:
- (i) the purchaser (lessee) has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of its output;
 - (ii) the purchaser (lessee) has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of its output;
or
 - (iii) it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output from the asset and the price that the purchaser (lessee) will pay for the output is neither contractually fixed nor equal to the current market price at the time of delivery.

9. The IASB has tentatively decided that, under the new leases standard, 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.
- (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.

Feedback

10. Preparers have provided feedback that it would be costly for them to reassess all of their existing contracts using the new definition of a lease. Costs would be incurred even if outcomes do not change under the new leases standard. This is

because of the costs associated with assessing each lease under the new guidance and demonstrating that:

- (a) existing leases satisfy the definition of a lease under the new leases standard; and
- (b) existing service contracts (ie those contracts that do not contain a lease) do not meet the definition of a lease under the new leases standard.

Staff Analysis

11. Grandfathering the definition of a lease for contracts that were in place before the date of initial application would remove the costs for preparers of reassessing their existing contracts on transition to the new leases standard.
12. The staff envisage only very narrow differences in outcomes between the application of IFRIC 4 and the boards' tentative decisions on the definition of a lease. These differences would arise when a lessee takes all (or substantially all) of the output of the underlying asset during the lease term (and the contract is priced in a particular way) but does not have any decision-making rights over the use of that asset. Such a contract would be a lease under IFRIC 4 but a service under the new leases standard. We have identified only a few cases where this difference would arise in practice. These cases could arise in the manufacturing industry when, for example, a customer is purchasing all of the output of a factory.
13. On this basis, the staff think that grandfathering the definition of a lease for contracts that were in place before the date of initial application would result in cost savings for preparers with little difference in reporting outcomes.
14. We have identified one concern associated with grandfathering the definition of a lease. Under the existing requirements of IAS 17, operating leases and services are accounted for in the same way. Under the new leases standard, the correct application of the definition of a lease is more critical because a lessee will would recognise all leases on its balance sheet (with limited exemptions). The staff think it is possible that entities may perform a more rigorous assessment of the definition of a lease guidance under the new leases standard and that this *could*

lead to different conclusions in some cases. One consequence of grandfathering the definition of a lease is that such cases might not be identified on transition to the new leases standard. Nonetheless, whilst we acknowledge that this risk exists, we also think that cases of incorrect application of existing guidance should be relatively rare.

Staff Recommendations

15. On balance, the staff think that the cost relief provided by permitting an entity to grandfather the definition of a lease for contracts in place before the date of initial application on transition to the new leases standard outweighs the concerns. We therefore recommend permitting this choice at the date of initial application of the new leases standard.
16. The staff think that a consistent definition of a lease should be used across an entity's lease/contract portfolio on transition to the new leases standard. We think that permitting a choice of grandfathering the definition of a lease on a contract by contract basis would introduce uncertainty to investors and analysts as to what definition of a lease has been applied and possible inconsistency within an entity's financial statements. We therefore recommend that if an entity chooses to grandfather the definition of a lease:
 - (a) this should apply to *all* contracts that are ongoing at the date of initial application and were entered into before that date; and
 - (b) that fact should be disclosed.

Questions for the IASB

Questions: Transition – Definition of a Lease

1. Does the IASB agree with the staff recommendation that the new leases standard should permit (but not require) an entity to grandfather the definition of a lease for all contracts that are ongoing at the date of initial application and were entered into before that date?
2. Does the IASB agree with the staff recommendation that if an entity chooses to grandfather the definition of a lease, this should apply to all contracts that are ongoing at the date of initial application and that were entered into before that date, and that fact should be disclosed?