IFRS Accounting

Staff paper

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IFRS® Interpretations Committee meeting

Date	**November 2022**
Project	**Definition of a lease—Substitution rights (IFRS 16)**
Topic	**Initial consideration**
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about how to assess whether a contract contains a lease applying IFRS 16 *Leases* when the supplier has particular substitution rights.

2. This paper:

    (a) provides the Committee with a summary of the matter;

    (b) presents our research and analysis; and

    (c) asks the Committee whether it agrees with our analysis and recommendation not to add a standard-setting project to the work plan.

Structure of the paper

3. This paper includes:

    (a) background information (paragraphs 5–9);

    (b) summary of outreach (paragraphs 10–19);

    (c) staff analysis—supplier substitution rights (paragraphs 20–40);

    (d) staff analysis—the level at which to evaluate whether substitution rights are substantive (paragraphs 41–45); and

    (e) analysis of whether to add a standard-setting project to the work plan (paragraphs 46–49).

4. The paper includes three appendices:

    (a) Appendix A—proposed wording of the tentative agenda decision;

    (b) Appendix B—submission; and

    (c) Appendix C—excerpts from IFRS 16.

Background information

5. IFRS 16 defines a lease as ‘a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration’ (Appendix A to IFRS 16). Paragraph B14 of IFRS 16 states that ‘a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use’.

6. The submitter asks two questions about how to assess whether a contract contains a lease when the supplier has particular substitution rights:

   (a) **Question 1**: what are the implications if the supplier (i) has the practical ability to substitute alternative assets throughout the period of use but (ii) is expected to benefit economically from the exercise of its right to substitute the asset only on the occurrence of events or circumstances that are not considered likely to occur until some time into the contract term?

   (b) **Question 2**: if a contract is for the use of multiple similar assets, at what level does an entity evaluate whether the supplier’s substitution right is substantive—by considering each asset separately or all assets together?

7. We have reproduced the main facts we considered in our analysis based on the fact pattern described in the submission and responses from the submitter to questions we asked about the fact pattern:

   (a) a customer enters into a 10-year contract with a supplier for the use of 100 similar assets—for example, batteries used in electric buses. The customer uses each battery together with other resources readily available to the customer (each battery is used in a bus that the customer owns or leases from an unrelated supplier).

   (b) the contract specifies a minimum capacity at which the assets must operate (for example, 70% capacity). The supplier is required to replace an asset as soon as its capacity is below the minimum amount specified in the contract. At inception of the contract (and considering the customer’s expected use of the assets), the assets are expected to operate above the specified minimum capacity—without replacement—for eight years. The assets have other use (for example, to store energy) and have an estimated economic life of 15 years.

   (c) the assets are located at the customer’s premises—they are used within buses that return to bus depots at the end of each day. The supplier has the practical ability to substitute alternative assets (as described in paragraph B14(a) of IFRS 16) throughout the 10-year contract term. If an asset were to be substituted, the supplier would be required to indemnify the customer for any revenue lost or costs incurred while the substitution takes place. For this reason, it is expected that the supplier could benefit economically from substituting an asset only when the buses are in the workshop for other reasons (for example, for regular maintenance and inspection). At inception of the contract, that event is not considered likely to occur in the first three years of the contract.

8. The submission asks only about the supplier's substitution right and whether there is an identified asset. This paper does not discuss the other criteria required to conclude that the contract contains a lease.

9. Appendix B to this paper reproduces the submission, which provides further details about the fact pattern. The submitter has identified differing views on the application of IFRS 16 to the fact pattern—the submission explains those views.

Summary of outreach

10. We sent information requests to members of the International Forum of Accounting Standard-Setters (IFASS), securities regulators, and large accounting firms. The submission was also made available on our website.

11. Regarding **Question 1**, the request asked those participating to provide information about whether, in their jurisdictions, fact patterns such as one described in the submission are (or are expected to become) common. If they are common, we asked:

    (a) whether they are common across industries or only in particular industries.

    (b) about the types of assets for which they are common.

    (c) whether the accounting for those fact patterns have a material effect on entities' financial statements.

    (d) how the entity (customer) accounts for the contract if the supplier has the practical ability to substitute alternative assets throughout the period of use and would benefit economically from the exercise of its right to substitute the asset only after a period of time (or at particular point in time during the period of use).

12. Regarding **Question 2**, the request asked those participating whether they are aware of differing views regarding the level at which to evaluate whether a supplier's substitution right is substantive. If so, the request asked those participating to describe the view (or views) observed with reference to the requirements in IFRS Accounting Standards.

13. We received 15 responses— eight from national standard-setters, five from large accounting firms and two from organisations representing a group of securities regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

Findings from outreach on question 1

14. Most respondents said the submitted fact pattern is not common in their jurisdiction. Two respondents said they have observed similar fact patterns in some jurisdictions (China, Hong Kong, Germany, UK, US). Two other respondents said supplier substitution rights—different from those described in the submitted fact pattern—are generally common in practice.

15. Many respondents said they expect similar fact patterns to emerge in the future because they anticipate:

    (a) increasing demand for carbon emission reductions and thus greater use of electric vehicles; or

    (b) the inclusion of substitution rights in contracts in an attempt to avoid lease accounting.

16. Some respondents provided examples of industries in which substitution rights are more common—aviation, transportation, logistics, IT infrastructure services, mining, and industries for which a secondary market exists for used assets (such as engines, medical equipment and oilfield equipment). Some also provided examples of the types of assets for which substitution rights are more common—namely, movable assets such as photocopiers, multifunctional office devices, heavy equipment, batteries for electric vehicles, IT hardware, forklift trucks, ships and heavy mobile equipment used in the mining industry (such as earthmovers, haulers and power generators).

17. The two respondents that observed fact patterns similar to the one submitted said they have observed diversity in how customers account for such contracts—some account for them as service contracts; others account for them as leases, including when they cannot readily determine whether the supplier has a substantive substitution right (paragraph B19 of IFRS 16).

18. Some respondents said the accounting for contracts with substitution rights may have a material effect on entities' financial statements.

Findings from outreach on question 2

19. Some respondents said they were aware of differing views regarding the level at which to assess whether supplier substitution rights are substantive:

    (a) some entities apply paragraph B1 of IFRS 16 (portfolio application), because the assets referred to in the contract share similar characteristics. However, some respondents said portfolio application (set out in paragraph B1) is a practical expedient to apply lease accounting to a portfolio of leases with similar characteristics; it is not applied in assessing whether a contract contains a lease.

    (b) some entities apply paragraph B20 of IFRS 16 (portions of assets), because individual assets are physically distinct.

    (c) some entities apply paragraph B32 of IFRS 16 (separate lease components).

Staff analysis—supplier substitution rights

Identifying a lease—the requirements in IFRS 16

20. At inception of a contract, an entity assesses whether the contract contains a lease. Paragraph 9 of IFRS 16 states:

> A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

21. Paragraph B9 states:

> To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:
>
> (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and
>
> (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

22. The 'period of use' is 'the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)' (Appendix A to IFRS 16).

Identified asset—substantive substitution rights

23. As explained in paragraph BC111 of the Basis for Conclusions on IFRS 16, the first requirement for a contract to meet the definition of a lease is that a customer controls the use of an *identified asset*.

24. Paragraph B13 states that 'an asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer'. Paragraph B14 goes on to state that 'even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use'. In that case, the supplier (not the customer) controls the use of the asset throughout the period of use. As a consequence, there is no identified asset; the contract does not contain a lease.

25. For substitution rights to be substantive, both of the following conditions must exist (paragraph B14):

    (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and

(b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

26. Paragraphs B15–B18 specify requirements that mean, in each of the following situations, a supplier's substitution right is *not* substantive (or the customer is *not* precluded from having the right to use an identified asset):

(a) the supplier has the right or obligation to substitute the asset only on or after a particular date or the occurrence of a specified event;

(b) the supplier has the right or obligation to substitute the asset only for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available; or

(c) the supplier would benefit economically from the exercise of its right only on the occurrence of a future event that, at inception of the contract, is not considered likely to occur.

27. Paragraph B17 notes that the costs of substitution are more likely to exceed the associated benefits when the asset is located at the customer's premises. Paragraph B19 requires the customer to presume that any supplier substitution right is *not* substantive if the customer cannot readily determine whether the supplier has a substantive substitution right.

28. Paragraph BC113 explains the IASB's rationale in developing the requirements on substitution rights in paragraphs B14–B19 (Appendix C reproduces paragraphs B9–B19 of IFRS 16). Paragraph BC113 states that 'the IASB's intention in including [these requirements] is to differentiate between:

(a) substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset; and

(b) substitution rights that do not change the substance or character of the contract because it is not likely, or practically or economically feasible, for the supplier to exercise those rights'.

29. Paragraph BC113 goes on to explain that, at the time of developing IFRS 16, the IASB was of the view 'that, in many cases, it will be clear that the supplier would not benefit from the exercise of a substitution right because of the costs associated with substituting an asset'. 'If substitution rights are substantive, then the IASB thinks that this would be relatively clear from the facts and circumstances' (paragraph BC115).

Assessing whether, in the submitted fact pattern, there is an identified asset

30. The requirements in paragraphs B13–B19—supported by the IASB's explanation in the Basis for Conclusions—set a high threshold for a customer to conclude that there is no identified asset when an

asset is explicitly or implicitly specified. Paragraph B14 says that is the case 'if the supplier has the substantive right to substitute the asset throughout the period of use'.

31. Because paragraph B19 requires a customer to presume that any substitution right is *not* substantive if it cannot readily determine whether any such right is substantive, in our view a customer must demonstrate that a supplier's substitution right is substantive to conclude that this is the case—in particular, when the asset is located at the customer's premises.

32. In the submitted fact pattern, the asset (for example, the battery) is specified—even if not explicitly specified in the contract, the asset would be implicitly specified at the time it is made available for use by the customer. The question is then whether the supplier's right to substitute the asset is substantive throughout the period of use—paragraph B14 states that the customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset *throughout the period of use*.

33. It is assumed in the submitted fact pattern that the condition in paragraph B14(a) exists—that the supplier has the practical ability to substitute alternative assets throughout the period of use (which requires the supplier to (a) have the contractual right to substitute the asset throughout the period of use, and (b) have alternative assets (or be able to source them within a reasonable period of time) throughout that period).

34. But does the condition in paragraph B14(b) exist *throughout the period of use*? No. The facts are such that the supplier would not benefit economically from exercising its right to substitute the asset in the first three years of the contract. Those first three years are part of the period of use—they form part of the 'total period of time that [the] asset is used to fulfil [the] contract with [the] customer'. Applying paragraph B16, the customer ignores future events that, at inception of the contract, are not considered likely to occur. This means that, regardless of whether the supplier would benefit economically from substitution later in the contract term, the supplier's substitution right is not substantive *throughout the period of use*.

35. For this reason, we conclude that in the submitted fact pattern there is an identified asset. The customer would then apply the requirements in paragraphs B21–B30 to determine whether, throughout the period of use, it has the right to obtain substantially all the economic benefits from use, and direct the use, of the identified asset. If that is the case, the contract would contain a lease.

Is there an alternative reading of the requirements in paragraphs B13–B19?

36. Some hold an alternative view. They note that, for a substitution right to be substantive, paragraph B14(b) requires only that a supplier would benefit economically from exercising its right to substitute the asset; paragraph B14(b) does not require that a supplier benefit economically *throughout the period of use* (paragraph B14(a)–(b) is reproduced in paragraph 25). In their view, the condition that needs to exist is not whether the supplier would benefit economically throughout the period of use. Instead, the

supplier must have the practical ability to substitute alternative assets throughout the period of use (as required in paragraph B14(a)) and, if that is the case, the supplier then needs only to be able to benefit economically from exercising its substitution right at some point during the period of use.

37. Therefore, in the submitted fact pattern (one in which paragraph B14(a) is met and the supplier potentially could benefit economically from substitution after the first three years of the contract), some would conclude that the supplier's substitution right is substantive. For that reason, they would conclude that there is no identified asset and, as a consequence, the contract does not contain a lease.

38. We disagree with the conclusion that there is no identified asset. We acknowledge that paragraph B14(b) does not state that the supplier must benefit economically from substituting the asset throughout the period of use. However, we note the following:

(a) paragraph B13 states that an asset is identified by being either explicitly specified in a contract or implicitly specified at the time the asset is made available for the customer's use. Paragraph B14 then goes on to state the circumstance in which the customer does not have the right to use an identified asset even if an asset is specified—that circumstance is when 'the supplier has the substantive right to substitute the asset throughout the period of use'. This alternative reading would mean that, in the submitted fact pattern, the supplier has the substantive right to substitute the asset. However, that right is *not* substantive throughout the period of use because the supplier would not benefit economically from exercising its right in the first three years of the contract. Therefore, the circumstance stated in paragraph B14—in which the customer does not have the right to use an identified asset—does not exist in the submitted fact pattern.

(b) paragraph BC112 reiterates, and explains the rationale for, the requirements in paragraph B14. Paragraph BC112 explains that 'if a supplier has a substantive right to substitute the asset throughout the period of use, then there is no identified asset and the contract does not contain a lease. This is because the supplier (and not the customer) controls the use of an asset if it can substitute the asset throughout the period of use'. In our view, it would be inappropriate to read the wording in paragraph B14 (as explained in paragraph BC112) to imply that there is no lease if the supplier has the substantive right to substitute the asset for *any* part of the contract term. This could result in a conclusion that there is no lease when a customer has the right to use an asset for, say, 15 years but the supplier could benefit economically from substitution only in the last six months of the 15-year contract term. Such a reading of the requirements would, in our view, go beyond what paragraph B14 says.

Staff conclusion

39. In the submitted fact pattern, we conclude that there is an identified asset. This is because the asset is specified and the supplier's substitution right is *not* substantive throughout the period of use (as required by paragraph B14 to conclude that the customer does not have the right to use an identified asset). The facts are such that the supplier would not benefit economically from the exercise of its right

to substitute the asset in the first three years in which the asset is used to fulfil the contract with the customer.

40. If—applying the requirements in paragraphs B21–B30—the customer concludes that the contract contains a lease, the customer (lessee) would then apply the requirements in paragraphs 18–21 (and B34–B40) of IFRS 16 to determine the lease term.

Question 1 for the Committee
1. Does the Committee agree with our analysis of the application of the requirements in IFRS 16 included in paragraphs 20–40?

Staff analysis—the level at which to evaluate whether substitution rights are substantive

41. Paragraph B12 of IFRS 16 states:

> An entity assesses whether a contract contains a lease for each potential separate lease component. Refer to paragraph B32 for guidance on separate lease components.

42. Paragraph B32 states:

> The right to use an underlying asset is a separate lease component if both:
>
> (a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and
>
> (b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets.

43. Therefore, an entity is required to assess whether a contact contains a lease for each asset assuming that:

    (a) the customer can benefit from use of the asset on its own or together with other resources readily available to it; and

    (b) the asset is neither highly dependent on, nor highly interrelated with, other assets in the contract.

44. In the submitted fact pattern, the contract is for the use of 100 similar assets (for example, batteries used in electric buses). The customer is able to benefit from use of each asset (a battery) together with other resources (a bus) available to it and each battery is neither highly dependent on, nor highly interrelated with, the other batteries in the contract.

45. We therefore conclude that, in the submitted fact pattern, the customer assesses whether the contract contains a lease—including evaluating whether the supplier's substitution right is substantive—for each asset. The customer does not consider all 100 similar assets as a single unit of account.

Question 2 for the Committee
2. Does the Committee agree with our analysis of the application of the requirements in IFRS 16 included in paragraphs 41–45?

Whether to add a standard-setting project to the work plan

Staff analysis and conclusions

46. Paragraph 5.16 of the IFRS Foundation *Due Process Handbook* states that the Committee decides to add a standard-setting project to the work plan only if, among other things, the principles and requirements in Accounting Standards do not provide an adequate basis for an entity to determine the required accounting.

47. Based on our analysis in paragraphs 20–45 of this paper, we conclude that this criterion is not met—the principles and requirements in IFRS 16 provide an adequate basis for an entity to evaluate whether, in the submitted fact pattern, there is an identified asset and the level at which to make that evaluation.

Staff recommendations

48. For the reasons described in paragraph 47, we recommend that the Committee not add a standard-setting project to the work plan. We recommend that the Committee instead publish a tentative agenda decision that outlines the applicable requirements in IFRS 16 and how a customer applies those requirements in the submitted fact pattern.

49. Appendix A to this paper sets out the proposed wording of the tentative agenda decision. In our view, the proposed tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Accounting Standards.

Questions 3 and 4 for the Committee
3. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan? 4. Does the Committee have any comments on the proposed wording of the tentative agenda decision in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Definition of a Lease—Substitution rights (IFRS *16 Leases*)

The Committee received a request about how to assess whether a contract contains a lease applying IFRS 16 when the supplier has particular substitution rights. In the fact pattern described in the request:

a. a customer enters into a 10-year contract with a supplier for the use of 100 similar assets—batteries used in electric buses. The customer uses each battery together with other resources readily available to it (each battery is used in a bus that the customer owns or leases from an unrelated party).

b. the supplier has the practical ability to substitute alternative assets (as described in paragraph B14(a) of IFRS 16) throughout the 10-year contract term. If a battery were to be substituted, the supplier would be required to indemnify the customer for any revenue lost or costs incurred while the substitution takes place. For this reason, it is expected that the supplier could benefit economically from substituting a battery only when the bus—within which the battery is used—is in the workshop for other reasons (for example, for regular maintenance and inspection). At inception of the contract, that event is not considered likely to occur in the first three years of the contract.

The request asked:

a. at what level to evaluate whether a contract contains a lease—by considering each asset separately or all assets together—when the contract is for the use of more than one similar asset.

b. whether there is an identified asset if the supplier (i) has the practical ability to substitute alternative assets throughout the period of use but (ii) would not benefit economically from the exercise of its right to substitute the asset throughout that period.

The definition of a lease

Paragraph 9 of IFRS 16 states that ‘a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration’. Applying paragraph B9 of IFRS 16, to meet the definition of a lease the customer must have both:

a. the right to obtain substantially all the economic benefits from use of an identified asset throughout the period of use; and

b. the right to direct the use of the identified asset throughout the period of use.

The period of use is ‘the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)’. (Appendix A to IFRS 16)

The level at which to evaluate whether a contract contains a lease

Paragraph B12 states that 'an entity shall assess whether a contract contains a lease for each potential separate lease component' and directs an entity to paragraph B32 for application guidance on separate lease components. Paragraph B32 specifies that the right to use an underlying asset is a separate lease component if both (a) the lessee can benefit from use of the underlying asset either on its own or together with other resources readily available to it; and (b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

In the fact pattern described in the request, the customer is able to benefit from use of each asset (a battery) together with other resources (a bus) available to it and each battery is neither highly dependent on, nor highly interrelated with, the other batteries in the contract.

Therefore, the Committee concluded that, in the fact pattern described in the request, the customer assesses whether the contract contains a lease—including evaluating whether the supplier's substitution right is substantive—for each battery.

Identified asset

Paragraphs B13–B20 of IFRS 16 provide application guidance on an identified asset. Paragraph B13 states that 'an asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer'. But 'even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use' (paragraph B14). In that case, the supplier—rather than the customer—controls the use of the asset.

Paragraph B14 specifies that a supplier's right to substitute an asset is substantive only if the supplier both (a) 'has the practical ability to substitute alternative assets throughout the period of use…'; and (b) 'would benefit economically from the exercise of its right to substitute the asset…'. An entity's evaluation of whether a supplier's substitution right is substantive excludes consideration of future events that, at inception of the contract, are not considered likely to occur' (paragraph B16).

In the fact pattern described in the request, each battery is specified. Even if not explicitly specified in the contract, a battery would be implicitly specified at the time it is made available for the customer's use. Therefore, the Committee observed that, unless the supplier has the substantive right to substitute the battery throughout the period of use, each battery is an identified asset.

In the fact pattern described in the request, the condition in paragraph B14(a) exists—the supplier has the practical ability to substitute alternative assets throughout the period of use. The Committee observed, however, that the condition in paragraph B14(b) does not exist throughout the period of use because the supplier would not benefit economically from exercising its right to substitute a battery in the first three years of the contract. Those first three years are part of the period of use. Consequently, the supplier's substitution right is not substantive throughout the period of use.

Therefore, the Committee concluded that, in the fact pattern described in the request, there is an identified asset—each battery. To assess whether the contract contains a lease, the customer would then apply the requirements in paragraphs B21–B30 to determine whether, throughout the period of use, it has the right to obtain substantially all the economic benefits from use, and direct the use, of the battery.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to evaluate the level at which to assess whether a contract contains a lease and whether, in the fact pattern described in the request, there is an identified asset. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

B1. We have reproduced the submission below and in doing so deleted details that would identify the submitter.

IFRS IC – POTENTIAL AGENDA ITEM REQUEST
IFRS 16 – Substantive substitution rights

Background

In assessing whether a contract contains a lease within the scope of IFRS 16, a key factor is whether a contract conveys the right to control the use of an identified asset (for a period of time in exchange for consideration). If the supplier has a right to substitute the asset that is substantive in accordance with IFRS 16.B14, there is no identified asset. Consequently, the contract does not meet the definition of a lease and, as such, no right-of-use asset or lease liability is recognised. Instead, the expense is recognised as incurred.

We are noticing a tendency for lessors to increasingly call for substitution rights. The assessment of whether these substitution rights are substantive must therefore be made with increasing frequency. We observe that the assessment is made differently by preparers, as, in our view, the rules of IFRS 16 leave room for interpretation.

This paper solely focuses on substitution rights—that is, it is assumed that all other criteria of the definition of a lease are met.

Fact pattern

The customer enters into a contract with the supplier for the right to use 100 similar assets—for example, batteries used in electric buses. The contract specifies a minimum capacity at which the assets must operate (for example, 70%). The supplier is contractually required to replace an asset as soon as its capacity falls below the minimum amount.

The term of the contract is 10 years. At inception of the contract, the customer expects the asset to operate above the minimum capacity specified in the contract (without replacement) for 8 years. The supplier has the practical ability to substitute alternative assets (as described in paragraph B14(a) of IFRS 16) throughout the term of the contract.

Assets are new when they are used by the customer for the first time. The customer is a heavy user, and the assets are heavily worn after a certain period of time. Although the assets could at that point still be in a condition to be used by the customer, it may be economically beneficial for the supplier at a given point in time to put the assets to a second life application, where the assets are used with a lower deterioration rate (for example, to store energy). The economic life of the asset is 15 years (including 2^{nd} life application).

The assets are used at the premises of the customer. If the assets are substituted, the supplier is required to indemnify any shortfall incurred by the customer. Therefore, it is economically beneficial for the supplier to substitute assets only at a point of time when the buses are in the workshop (for example, for regular maintenance and inspection). The assets themselves are not subject to mechanical wear and tear; there is therefore no need to maintain them separately from the buses and they are monitored remotely. When the bus is inspected, the asset is also checked (for example, plug connection).

At the inception of the contract, the customer expects that the supplier will substitute the asset every 3 years. It is only then economically beneficial for the supplier, because:

- market curves indicate that a substitution is economically beneficial at that time.
- this corresponds with the maintenance cycle of the bus. The substitution is economically beneficial only at that point in time, as the supplier would otherwise be required to indemnify any shortfall incurred by the customer. If the maintenance is carried out, the asset is not in operation.

Question 1: Are there any implications on accounting when the supplier benefits from a substitution only

- **after a period of time?**
- **at certain points in time during the period of use (for example, when the assets are in the workshop anyway)?**

View 1: If the supplier is likely to make at least one substitution during the period of use, this indicates that the substitution right is substantive

According to IFRS 16.B14, the supplier must have a right to substitute the asset time throughout the period of use. Furthermore, the supplier must have the practical ability to substitute and benefit economically from it. This makes the substitution likely during the period of use (IFRS 16.BC113) and a substitution right is substantive only if these conditions are met (IFRS 16.B14). A right of substitution "only on or after either a particular date or the occurrence of a specified event" is not sufficient (IFRS 16.B15). The standard does not stipulate any requirements as to the frequency of an economically beneficial substitution for the supplier. Consequently, an estimate of when and how often an exchange will occur also does not need to be made. According to this reasoning, it is sufficient for a substantive substitution right that a substitution is likely to occur during the period of use. As this is the case in this fact pattern (i.e. after 3 years), no right-of-use asset or lease liability is recognised.

Assume, as a variation from the fact pattern above, that the contract period now is only 2 years. In this case there is no substitution likely to occur. Consequently, the substitution right would not be substantive. Hence, a right-of-use asset and a lease liability are recognised for the contract period of 2 years. As a result, only the contract of 2 years, which has a lower contractual payment obligation than the contract of 10 years, has a balance sheet impact.

View 2: If a substitution is only likely after a (vague) period, then there is an identified asset for this (vague) period

If the supplier only has a right to substitute the asset at a particular date during the period of use, the substitution right is not substantive (IFRS 16.B15). In the example contemplated here, the supplier has the right to substitute the asset throughout the period of use and he has the practical ability to do so, but he would only benefit from it under certain circumstances that are considered to be likely to occur at some point during the period of use,

a. after a period of time, when market curves indicate that a substitution is economically beneficial
b. if the asset is in the workshop for maintenance.

This means that the customer controls an identified asset for a period of time, e.g. to the date when he expects to maintain the asset. According to IFRS 16.24 "the cost of the right-of-use asset shall comprise the amount of the initial measurement of the lease liability". According to IFRS 16.27, the lease liability comprises "payments for the right to use the underlying asset". The underlying asset is expected to be used for three years. Consequently, the customer would account for a right-of-use asset and lease liability for the period until the expected date of substitution (3 years). After the substitution takes place, the customer would account in the same way for the substituting asset.

In our view, this best reflects the right of use granted to the customer.

View 3: If a substitution is only likely after a (vague) period, then there is no substantive substitution right and an identified asset exists for the whole contract period
The IASB's intention to including guidance regarding substitution rights was to differentiate between assets not controlled by the customer as a result of such substitution rights and substitution rights that do not change the substance of a contract (IFRS 16.BC113). To the extent that a substitution is only economically beneficial at a given point in time (e.g. only after a certain number of years or when the asset is in the workshop for maintenance) it could be argued that whilst the supplier does have the practical ability to substitute the asset, he does not have control over the asset throughout the contract term. Such scenarios would thus be comparable to the one stipulated in IFRS 16.B15 and accounted for in the same way as a substitution which contractually may only take place at a particular date or upon a specified event. In such cases there is no substantive right to substitute the asset and a right of use asset is recognised for the contract period. In the example discussed here, the customer would thus account for a right of use asset and a corresponding lease liability for the contract period of 10 years.

In our view, this best reflects the liability arising from the lease contract.

<u>Question 2: Which is the unit of account if a portfolio of similar assets is leased within one contract?</u>
Assume the circumstances from the fact pattern (the customer enters into a contract with the supplier for the right to use 100 similar assets for a period of 10 years). At inception of the contract, the customer expects that the supplier will likely substitute 20 assets (excluding substitutions for repair and maintenance) during the term of the contract. At inception of the contract, the customer cannot estimate which specific assets will be substituted and the substitution of each asset is equally likely (20 per cent).

View 1: Unit of account = each leased asset
According to IFRS 16.B16 "an entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur." It can therefore be concluded that a substitution right is not substantive if it is not likely to be exercised.

As the probability of a substitution is only 20 percent when considering each individual asset, a substitution is not likely in relation to the individual asset. Therefore, the substitution right is assessed as non-substantive. Consequently, right-of-use assets and lease liabilities for all 100 assets are recognised at the inception of the lease.

View 2: Unit of account = portfolio

IFRS 16.B1 allows an entity to apply IFRS 16 "to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio." Some companies might argue that, when considered as a whole, 20 assets out of the 100 assets in total will be substituted during the period of use. For these 20 assets, the substitution is thus likely to occur. Consequently, right-of-use-assets and lease liabilities for only 80 assets are recognised at the inception of the contract.

Reasons for the Interpretations Committee to address the issue

Is the issue widespread and has a material effect on those affected?

These questions affect all companies that enter into leases where the lessor reserves a right to substitute the lease asset across various industries.

The diversity in the accounting practice has a significant impact on the balance sheet. While some lessees gross up lease liabilities and right-of-use assets, other lessees do not recognise them. The different practices lead to limited comparability of the financial statements of entities entering into such arrangements.

Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

In our view there is substantial diversity in practice that could be reduced by actions taken by IFRS Interpretation Committee. This would significantly improve financial reporting.

Is it necessary to add or change requirements in IFRS Accounting Standards to improve financial reporting? Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

We have raised two major questions:

- **Question 1** relates to the circumstances, where the substitution is economically beneficial for the supplier only after a period of time or only sometimes.
- **Question 2** raises the question regarding the unit of account: a single leased asset or a portfolio of similar assets.

In our opinion the questions could be answered efficiently within the existing IFRSs.

Is the issue sufficiently narrow in scope?

We think that we have outlined two issues that are sufficiently narrow in scope. We are convinced that the IFRS IC can undertake the due process in an effective and efficient way.

Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

To our knowledge, no changes to the relevant provisions of IFRS 16 are planned. A solution developed by the Interpretations Committee would therefore be effective for a reasonable time period.

Appendix C—excerpts from IFRS 16

C1. Paragraphs 9–11 of IFRS 16 state:

9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

10 A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

11 An entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.

C2. Paragraphs B9–B19 of IFRS 16 state:

Identifying a lease (paragraphs 9–11)

B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and

(b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

B10 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

B11 A contract to receive goods or services may be entered into by a joint arrangement, or on behalf of a joint arrangement, as defined in IFRS 11 *Joint Arrangements*. In this case, the joint arrangement is considered to be the customer in the contract. Accordingly, in assessing whether such a contract contains a lease, an entity shall assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use.

B12 An entity shall assess whether a contract contains a lease for each potential separate lease component. Refer to paragraph B32 for guidance on separate lease components.

Identified asset

B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Substantive substitution rights

B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

(a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and

(b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

B15 If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

B16 An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include:

(a) an agreement by a future customer to pay an above market rate for use of the asset;

(b) the introduction of new technology that is not substantially developed at inception of the contract;

(c) a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and

(d) a substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract.

B17 If the asset is located at the customer's premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier's premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

B18 The supplier's right or obligation to substitute the asset for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available does not preclude the customer from having the right to use an identified asset.

B19 If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.