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Project Update

Leases: Definition of a Lease

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Leases: distinguishing a lease from a service

What is the purpose of this document?

This document explains how a lease would be defined in the new *Leases* Standard.

Project background

Leases is an important project that the International Accounting Standards Board (IASB) is undertaking jointly with the US Financial Accounting Standards Board (FASB). The IASB and the FASB (the boards) are working together to improve the accounting for leases. To meet this objective, the boards think that a customer leasing assets should recognise assets and liabilities arising from those leases (including leases that are off balance sheet today).

The boards jointly published a revised Exposure Draft *Leases* (the 2013 ED) in May 2013. The boards received extensive feedback on their proposals, and have heard a broad range of views. Since March 2014 the boards have redeliberated most aspects of the project. The boards will finalise their redeliberations shortly. They will decide upon the effective date of the new *Leases* Standard in the next few months.

The IASB plans to issue a new *Leases* Standard before the end of 2015.

What is a lease?

Overview

The new *Leases* Standard will contain a definition of a lease and accompanying guidance to help entities assess whether a contract is (or contains) a lease. The definition and accompanying guidance will apply to both parties to a contract, ie the customer (lessee) and the supplier (lessor). The boards have jointly agreed the definition and guidance.

The definition of a lease is important because, when a contract is (or contains) a lease, the customer (lessee) will recognise assets and liabilities arising from the lease on its balance sheet.

> The customer acquires the right to use an item for a period of time when entering into a lease.

Leases are different from services because, at the start of a lease, the customer obtains control of a resource (the right to use an item). So the definition and accompanying guidance focus on whether a customer *controls* the use of an item.

A *customer* controls the use of an item when the customer has exclusive use of the item for a period of time and can decide how to use it.

In contrast, in a service contract, the *supplier* retains control of the use of any items needed to deliver the service, even if those items are located at the customer's premises. In such contracts, the customer does not obtain control of a resource at the start of the contract but, instead, commits to purchasing a particular service that it will receive in the future.

Lease	**Service**
Customer controls the use of an item	***Supplier*** controls the use of an item

Guidance on the definition of a lease

The definition of a lease in the new *Leases* Standard will be substantially similar to the existing definition in IFRIC 4 *Determining Whether an Arrangement Contains a Lease*. The guidance accompanying the definition, however, has been changed to:

(a) align the concept of control more closely with the control principle in other Standards; and

(b) address practice issues raised about the existing lease definition guidance.

A lease is defined as a contract that conveys to the customer the right to use an asset for a period of time in exchange for consideration.

A lease exists when a customer controls the right to use an identified item, which is when the customer:

1. has exclusive use of the item for a period of time; and
2. can decide how to use it.

In the vast majority of cases, the assessment of whether a contract is a lease or a service is straightforward. However, in some scenarios—for example, when both the customer and the supplier make decisions about the use of the item—the distinction may require judgement. The additional guidance on the definition of a lease has been provided in particular to assist those applying the definition to such scenarios.

Services are not brought on balance sheet

There is no change to the accounting for services as a result of the new *Leases* Standard. Service contracts are not required to be capitalised on the balance sheet.

Contracts often contain both a lease and services.

It is common for contracts to contain both lease and service components.

Examples of contracts containing both a lease and services are:

(a) a lease of a car with maintenance services; and

(b) a lease of a building with security and cleaning services.

Because leases and services are often combined in a contract and the accounting for these components will be different, the new *Leases* Standard will address the separation of lease and service components of contracts. This is because the boards are not changing the accounting for services—the new requirements apply only to leases or lease components of contracts.

When accounting for contracts with lease and service components, a lessee would separate the amounts for the lease and the services using available information (including estimates). A lessee would then recognise on the balance sheet only the amounts that relate to the lease.

Although it is not the boards' intention to require service components of contracts to be recognised on the balance sheet, in response to requests for simplicity, a lessee can *choose* not to separate services from a lease and, instead, account for the entire contract as a lease. Given the accounting consequences of this choice (that services would also be recognised on the balance sheet), entities are expected to make this election only when the service components of contracts are small.

Although leases and services are often combined in a single contract, amounts related to services are not required to be recognised on the balance sheet.

Redeliberations of the 2013 ED definition proposals

Feedback received

The definition of a lease and accompanying guidance were exposed for comment in the 2013 ED, and the feedback on that guidance was generally positive.

In particular, respondents supported using the concept of control to distinguish a lease from a service, and supported the proposal to make the guidance on control more consistent with the guidance in the consolidation and revenue recognition standards. Respondents also thought that the guidance resolved issues that have arisen in practice relating to the guidance in IFRIC 4.

Nonetheless, some respondents had concerns about the potential for inconsistent application—in particular, some thought that parts of the proposed guidance were unclear and could lead to different conclusions about whether similar contracts contain leases. Respondents asked that the guidance be clarified to make it easier to understand the boards' intentions, which would facilitate consistent application of the guidance.

Alternative approaches suggested

Although a substantial majority of respondents agreed with the proposed approach to defining a lease, some did suggest alternative approaches. For example, some suggested changing the definition so that, when a substantial proportion of the amounts in a contract relate to services, the entire contract would be treated as a service. Others suggested changing the definition so that a lease would exist only when the customer operates the leased asset.

Respondents also provided feedback on the proposed approach to separating lease and service components. Respondents generally supported the proposal to separate those components, but asked for simplifications to the way in which a lessee would be required to perform the separation and the information needed to do so. A few respondents suggested including separation guidance in the leases standard similar to the guidance on identifying performance obligations in the revenue recognition standard (IFRS 15 *Revenue from Contracts with Customers*).

Boards' response to this feedback

The boards have taken a number of steps to address the feedback on the proposed definition of a lease in the 2013 ED, and have reached converged decisions on the definition and the separation of lease and service components of a contract.

The boards have confirmed the general approach to defining a lease that was proposed in the 2013 ED (ie a definition based on control of the use of an identified asset). However, the boards have also made a number of clarifications to the accompanying guidance to make their intentions clear and to reduce the risk of inconsistent application.

The specific clarifications made by the boards, and the reasons for those clarifications, are summarised in the table on pages 8-10 of this document.

The boards also considered the alternative approaches proposed by some respondents, but decided not to adopt those approaches.

The boards concluded that those alternative approaches generally would have made the guidance on the definition more complicated and, more importantly, could have resulted in an entity that has control over substantive rights to use assets not recognising those rights of use (and corresponding liabilities) on the balance sheet. For example, the alternative approaches would have the potential to exclude rights to use substantial capital assets, such as oil rigs and ships, from an entity's balance sheet, impairing the usefulness of the financial information. This could be the case even for contracts for which preparers (that are customers in such contracts) have told the boards that they agree that they control rights to use those assets.

The boards were also concerned that some of the alternative approaches would:

(a) encourage entities to change their contracts to avoid meeting the lease definition (for example, inserting services into a contract so that a substantial proportion of the amounts in the contract relate to services);

(b) add unnecessary complexity to the guidance without significantly changing the lease versus service outcomes (for example, including separation guidance similar to that included in IFRS 15 was expected to result in little difference in outcomes and yet would have added an additional step that could be complicated to apply); or

(c) result in other unintended consequences.

The definition and guidance agreed by the boards have benefited from being exposed for comment and refined based on feedback received.

Summary of decisions made about the definition of a lease during redeliberations

Tentative decisions of the boards during 2014 redeliberations	Clarification from the 2013 ED and reasons for change
A lease involves the use of an identified asset. An asset can be identified either implicitly or explicitly in the contract. However, there is no identified asset if a supplier has a substantive right to substitute the asset.	No change in this concept from the 2013 ED. However, the accompanying application guidance is clarified as described below.
A supplier's right to substitute an asset is substantive if both: (a) the supplier has the practical ability to substitute the asset, and (b) the supplier can benefit from substituting the asset.	The 2013 ED proposed that a right to substitute an asset was substantive if there were no economic barriers to substitution. Some were concerned that there was insufficient guidance about what constitutes an economic barrier, and that the proposed guidance would be subjective to apply. Changing the focus to whether a supplier can benefit from substituting the asset makes the assessment more objective.
If it is impractical for the customer to determine whether the supplier's substitution right is substantive, the customer assumes that the right is not substantive.	The presumption regarding substitution rights was introduced to simplify the assessment. Feedback received on the 2013 ED indicated that, in some cases, it can be difficult for a customer to determine whether a right is substantive from the *supplier's* perspective.

Tentative decisions of the boards during 2014 redeliberations	Clarification from the 2013 ED and reasons for change
A lease exists when the customer *controls* the use of an identified asset for a period of time. To control the use of an asset, a customer both 1 has exclusive use of the asset; and 2 directs the use of the asset.	No change in this concept from the 2013 ED. However, the accompanying application guidance is clarified as described below.
1 A customer has exclusive use of an asset if it has the right to obtain substantially all of the economic benefits that result from using the asset during the contractual term.	This concept was proposed in the 2013 ED, and respondents generally agreed with it. The boards removed additional guidance outlining limited circumstances in which a customer would not have the ability to obtain benefits from using an asset. Feedback received indicated that: (a) the additional guidance was complicated to understand and apply, and (b) its inclusion was unlikely to change the lease versus service conclusions reached in applying the remainder of the definition guidance.
2 A customer directs the use of an asset if it has the ability to change *how and for what purpose* the asset is used during the contractual term (for example, the ability to decide what the space in a leased retail unit is used for, or to decide where and when a leased ship sails). A customer also directs the use of an asset if it determines how the asset is operated or designed.	The 2013 ED proposed that a customer directs the use of an asset when it has decision-making rights that give it most influence over the economic benefits that are derived from use of the asset. The 2013 ED also provided accompanying guidance. Respondents were concerned that this proposal was not sufficiently clear in identifying *which* decisions would have most influence over the economic benefits, particularly when both the supplier and the customer could influence the use of an asset in different ways. To address these concerns, the boards have clarified: (a) *which* decisions give the customer the right to direct the use of an asset (ie typically decisions about how and for what purpose an asset is used); and (a) that an entity would generally consider only decision-making rights about use *during* the contractual term (and not decisions made in negotiating the contract).

Tentative decisions of the boards during 2014 redeliberations	Clarification from the 2013 ED and reasons for change
A lessee shall separate lease and service components of a contract and apply the lease accounting requirements only to the lease components. A lessee allocates payments to separate lease and service components on a relative standalone price basis. In doing so, a lessee maximises the use of observable information available to it, and otherwise uses estimates of the standalone prices. However, a lessee may choose, by class of leased asset, to account for the entire contract as a lease.	This guidance is consistent in principle with the 2013 ED. However, in response to comments received, the boards have changed the guidance to allow the use of estimates to simplify the separation of lease and service components. This aligns the separation guidance more closely with the requirements on allocating the transaction price in revenue contracts in IFRS 15. The boards introduced the *option* to account for the entire contract as a lease, instead of separating lease and service components, to simplify application. Some lessees responding to the 2013 ED requested this. For some contracts, in particular those with small service components, those lessees indicated that they would prefer to apply the lease accounting requirements to the entire contract for cost/benefit reasons.

Examples

The examples illustrated in this document have been prepared by the staff of the IFRS Foundation and portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all facts and circumstances of a particular fact pattern would need to be evaluated when determining whether a lease exists.

This section of the document illustrates the application of the definition of a lease and accompanying guidance to the following examples:

Description of the contract	Who controls the use of the item?	Conclusion
1 **Retail rental contract** A retailer enters into a contract with a real estate company to use shop no. 143 in a commercial centre for a five-year period. The retailer uses the premises only for the purpose of operating its well-known store brand and sells its goods during the hours that the commercial centre is open. The retailer decides on the mix of brand goods sold from the shop, the pricing of the goods sold, the fixtures and fittings within the shop, the qualities of inventory held and the space used for storage. The real estate company provides cleaning and security services, as well as advertising services, as part of the contract.	**The customer.** The retailer has exclusive use of the shop (no other party can use the space during the five-year period of the contract) and decides how to use it. For example, the retailer decides: (a) for what purpose the shop is used (ie whether the space within the shop will be used for sales, storage, or both); (b) what mix of products will be sold in the shop; and (c) when the shop is open (during the opening hours of the commercial centre).	**The contract contains a lease and services.** Under the new *Leases* Standard, the retailer would account for the lease of the shop separately from the services (ie the cleaning, security and advertising services provided by the real estate company). The retailer would recognise lease assets and liabilities reflecting only the payments that relate to the lease component.[1]

1 The lessee could choose to account for the lease and service components as a single lease contract.

Description of the contract	Who controls the use of the item?	Conclusion
2 **Airport concession** A coffee company enters into a contract with an airport operator to use a space in the airport to sell its goods for a three-year period. The contract states the exact amount of space and that the space must be located at any one of several boarding areas within the airport. However, the airport operator can change the location of the space allocated to the coffee company at any time during the contractual term, and there are minimal costs to the airport operator associated with doing so.	**The supplier.** The customer does not have exclusive use of a particular piece of airport space, ie there is no identified asset. Although the contract specifies the size of the concession space, the airport operator can change the space allocated to the coffee company at any time.	**The contract is a service.** The contract would not be within the scope of the new *Leases* Standard.

Description of the contract	Who controls the use of the item?	Conclusion
3 **Truck rental contract**	**The customer.**	**The contract contains a lease and services.**
A food company enters into a four-year contract with a truck manufacturer for the use of ten refrigerated trucks. At the start of the contract, the truck manufacturer delivers the trucks to the food company's premises. The food company can decide where, when and how it uses the trucks over the four-year term. The contract specifies that the trucks must have an annual maintenance check, including the replacement of tyres, carried out by the truck manufacturer.	The food company has exclusive use of the trucks throughout the four-year contractual term and decides how to use them – ie the food company decides which goods are to be transported using the trucks, where they are to be transported and when. Although the contract contains conditions regarding the maintenance of the trucks (including that the truck manufacturer carries out that maintenance), those conditions do not prevent the food company from controlling the right to use the trucks during the four-year term.	Under the new *Leases* Standard, the food company would account for the lease of the trucks separately from the services (ie maintenance of the trucks). The food company would recognise lease assets and liabilities reflecting only the payments that relate to the lease component.[2]

2 The lessee could choose to account for the lease and service components as a single lease contract.

Description of the contract	Who controls the use of the item?	Conclusion
4 Oil tanker contract An oil company enters into a contract with a shipowner for the charter of a particular oil tanker for a 20-year period. The oil company decides when and to which ports the oil tanker sails, and the oil to be transported, throughout the 20-year period. The shipowner's crew operate and maintain the tanker throughout the contractual term. The oil company is prohibited from hiring another operator for the ship.	**The customer.** The oil company has exclusive use of the oil tanker throughout the 20-year period and is the only party that decides how the tanker will be used—ie the oil company decides where, when and if the tanker sails and what oil is transported on the tanker throughout the contractual term. The shipowner's expertise in operating and maintaining the tanker is essential to the efficient use of the tanker. However, the shipowner does not have the right to decide how the tanker is used—the oil company has that right. The shipowner's decisions in operating and maintaining the tanker are dependent upon the oil company's decisions about how to use the tanker—they are merely operational rather than directing how and for what purpose the tanker is used. This is similar to the operating decisions taken by the employees of a company that are often dependent upon the strategic decisions taken by the board of directors of that company.[3]	**The contract contains a lease and services.** Under the new *Leases* Standard, the oil company would account for the lease of the oil tanker separately from the services (ie the operating and maintenance services). The oil company would recognise lease assets and liabilities reflecting only the payments that relate to the lease component.[4]

3 It is the strategic decision-making that determines control of an entity.
4 The lessee could choose to account for the lease and service components as a single lease contract.

Description of the contract	Who controls the use of the item?	Conclusion
5 **Outsourcing agreement**	**The supplier.**	**The contract is a service.**
A toy company enters into a contract with a manufacturer to purchase a particular type and quantity of dolls for a three-year period. The manufacturer operates the factory used to produce the dolls. The manufacturer has only one factory that is capable of meeting the needs of the toy company. The contract would result in the toy company taking all of the output from that factory (if running at normal capacity).	The manufacturer controls the use of the factory because it decides how the factory is used. For example, the manufacturer could decide to use the factory to fulfil other contracts by increasing the hours that the factory operates. The toy company's rights are limited to specifying the output it requires at the beginning of the contract—it has no greater right to decide how to use the factory than if it were one of 10 customers whose orders occupied one tenth of the capacity of the factory. The only difference is the volume ordered.	The contract would not be within the scope of the new *Leases* Standard.

Description of the contract	Who controls the use of the item?	Conclusion
6 **Telecommunications contract** A trading company enters into a contract for network services for two years. A telecommunications company installs servers at the trading company's premises in order to supply the services. The contract requires the telecommunications company to supply network services that meet a specified quality level. To do so, the telecommunications company can carry out maintenance to, reconfigure or replace the servers when needed. The trading company does not operate the servers or make any other decisions about their use.	**The supplier.** Although the provision of the network services involves the installation of servers at the trading company's premises, the trading company cannot decide how to use the servers. This is because the telecommunications company determines how and for what purpose the servers are used by being able to reconfigure or replace the servers during the contractual term. In contrast, the trading company cannot change the purpose for which the servers are used, nor does it operate the servers or have any other decision-making rights about their use during the contractual term.	**The contract is a service.** The contract would not be within the scope of the new *Leases* Standard.

Further information

The IASB is close to finalising a new *Leases* Standard that it plans to issue before the end of 2015.

The boards' redeliberations of the proposals in the 2013 ED have taken place in public meetings. Information about these meetings is available on the IASB's website.

Exposure documents and the comment letters are also available on the IASB's website.

To stay up to date with the latest developments of this project and to sign up for email alerts, please visit the project homepage on http://go.ifrs.org/Leases

This Project Update has been compiled by the staff of the IFRS Foundation as guidance for interested parties. The views within this document are those of the staff who prepared this document and are not the views or the opinions of the IASB and should not be considered authoritative in any way. The content of this Project Update does not constitute any form of advice or opinion.

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