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Introduction

1. This paper provides an overview of the lease definition guidance the staff are proposing for the final leases standard in response to the following matters raised by Board members at the May 2014 Board meeting:
 - (a) Requests for a summary of the entire lease definition guidance, including a clear description of the evaluations that an entity must make in order to determine whether a contract contains a lease; and
 - (b) Concerns that were raised that the proposed lease definition guidance was too subjective and too judgmental.
2. To address the concerns raised above and in response to Board member requests, this paper:
 - (a) Provides additional detail regarding the guidance about a customer's right to direct the use of an identified asset, and suggests further clarifications to the guidance in the 2013 ED;

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- (b) Asks the Boards whether a customer must have the ability to derive the economic benefits from directing the use of the identified asset on its own or together with other readily available resources in order to control the use of the identified asset; and
 - (c) Provides a summary of alternative approaches considered and rejected by the staff.
3. This paper is structured as follows:
- (a) Background
 - (b) Staff Analysis: Overview of the definition of a lease
 - (i) General definition
 - (ii) Identified asset
 - (iii) Control of the use of an identified asset
 - 1. Right to direct the use of the identified asset
 - 2. Right to obtain the economic benefits from directing the use of the identified asset
 - 3. Ability to derive the economic benefits from directing the use of the identified asset
 - (c) Alternatives considered and not recommended
 - (d) Staff recommendations
 - (e) Questions for the Boards
 - (f) Appendix A - Examples illustrating how to apply the lease definition guidance
 - (g) Appendix B – Initial staff thoughts on drafting the lease definition guidance

Background

Right-of-use model

4. Entities use assets and resources to operate their business in generating revenue and returns. Entities typically obtain access to, or the use of, the assets needed to operate their business in two ways—by either buying or leasing those assets. In both cases, the Boards are of the view that an entity obtains an asset. In the case of a purchase, an entity obtains the asset that it then uses in its business. In the case of a lease, the lessee obtains a *right-of-use* (ROU) asset that it then uses in its business, and has an obligation to make payments for that ROU asset that is typically (but not always) settled over the lease term. The rights of use that a lessee obtains under a lease are *not* the same as the rights that an entity obtains when it purchases an underlying asset (that is, ownership provides an entity with additional rights, such as the right to sell or pledge the asset). Nonetheless, those rights of use meet the definition of an asset because the lessee obtains control of an economic resource or benefit resulting from the past event of the lessor's performance at lease commencement (that is, the lessor making the underlying asset available for the lessee's use) and future economic benefits are expected to flow to the lessee. Correspondingly, the obligation to make lease payments meets the definition of a liability. As a result, lease assets and lease liabilities should be recognized by the lessee at commencement of a lease.
5. In contrast, service contracts do not transfer the right to use an asset to the customer. Accordingly, an entity should not apply the proposed lease accounting requirements to service contracts or the service component of contracts that also contain leases. In a contract that contains lease and nonlease (service) components, an entity would separate the amounts paid for the lease from the amounts paid for nonlease components, and is required to recognize lease assets and lease liabilities *only* for the amounts paid for the lease (subject to the practical expedient agreed by the Boards at the May 2014 meeting that would allow lessees the option of *not* separating lease from nonlease components, and instead, accounting for those components as a single lease component).

6. Consistent with existing lease accounting requirements, the final leases standard would define a lease—it would not define service or nonlease components. Accordingly, in determining whether to apply the requirements in the leases standard, an entity would determine whether a contract contains a lease by applying the lease definition guidance. If a contract does *not* contain a lease, the contract is outside the scope of the proposed requirements.
7. This paper discusses that first step—how to determine whether a contract contains a lease.

The definition of a lease

8. The 2010 ED had retained the requirements included in IFRIC 4 *Determining whether an Arrangement contains a Lease* and Topic 840 *Leases* with only minor changes to the wording of those requirements.
9. The 2013 ED defined a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” An entity would determine whether a contract contains a lease by assessing whether:
 - (a) Fulfillment of the contract depends on the use of an identified asset; and
 - (b) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.
10. The 2013 ED’s definition of a lease and its emphasis on whether a customer obtains the right to control the use of an underlying asset are consistent with existing guidance in IFRIC 4 and Topic 840. However, the 2013 ED proposed to change the existing application guidance on the definition of a lease to:
 - (a) Align the concept of control more closely with the control principle in the recently-issued revenue recognition standard and in existing consolidation requirements; and
 - (b) Address practice issues that were raised about the definition of a lease in IFRIC 4 and Topic 840 (specifically, EITF Issue 01-8 *Determining Whether an Arrangement is a Lease*).

11. Most constituents that commented on the lease definition proposals stated that the proposed definition of a lease in the 2013 ED was an improvement compared to the 2010 ED and to existing guidance. Many constituents found the additional guidance in the 2013 ED to be helpful and supported the proposal to more closely align the control concept in identifying a lease with the control concept in the Boards' recently-issued revenue recognition standard and existing consolidation guidance.
12. However, in providing feedback on the proposed definition of a lease, many constituents stressed the increased importance of, and pressure on, that definition. Although most constituents that commented supported the overall direction of the proposed definition of a lease, the majority of constituents did not think the Boards had provided adequate guidance in the 2013 ED to support consistent application of that definition.
13. A full summary of the feedback received on the proposed definition of a lease in the 2013 ED can be found in the May 2014 agenda paper 3A/FASB Memo No. 282 ('May 2014 definition paper').
14. At the May 2014 Board meeting, the Boards discussed various clarifications to address feedback received on the 2013 ED. At that meeting, the Boards also asked the staff to provide additional analysis to explain better how an entity would apply the lease definition guidance.

Staff Analysis: Overview of the definition of a lease

15. The following paragraphs provide an overview of the lease definition guidance the staff are proposing to include in the final leases standard, which is largely consistent with the 2013 ED proposals and incorporates:
 - (a) The recommendations for clarifications to the 2013 ED proposals made in the May 2014 definition paper, and
 - (b) Further recommended clarifications to the "direct the use" guidance to address Board members' requests at the May 2014 meeting for guidance that is straightforward, clear, and minimizes subjective judgments.

16. The staff analysis also asks the Boards whether the definition of a lease should include a requirement that the customer have the ability to derive the economic benefits from directing the use of an identified asset on its own, or together with other readily available resources.
17. Appendix A to this paper includes examples that illustrate how the staff think the definition of a lease would apply if the Boards agree with the staff proposals discussed in this paper (when combined with the tentative decisions reached at the May 2014 joint meeting).
18. Appendix B to this paper includes initial staff thoughts on drafting the lease definition guidance.

General definition

19. The staff recommend that a lease 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,” which is consistent with the definition in the 2013 ED. An entity would determine whether a contract contains a lease by assessing whether:
 - (a) Fulfillment of the contract depends on the use of an identified asset (the “identified asset” concept discussed below); and
 - (b) The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration (the “control” concept discussed below). 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
 - (ii) Obtain substantially all of the economic benefits from directing the use of the identified asset.
20. The identified asset concept is discussed first in this paper. The control concept is discussed in its component sections:

- (a) First, the staff's proposal for guidance regarding whether a customer has the right to direct the use of the identified asset.
- (b) Second, confirmation of the notion that, in order to control the use of the identified asset, the customer must have the right to obtain substantially all the economic benefits from directing the use of the identified asset.
- (c) Lastly, the staff analysis asks the Boards whether the lease definition guidance should include a requirement that the customer be able to derive the economic benefits from directing the use of the identified asset on its own or together with resources that are readily available to the customer.

Identified asset

21. Consistent with the 2013 ED proposals and the staff recommendations in the May 2014 definition paper, the definition of a lease would require that a lease involves the use of an *identified asset* that is either explicitly or implicitly specified. A contract would not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfill the contract. A supplier would have the substantive right to substitute an asset if:
- (a) It has the practical ability to substitute the asset; and
 - (b) It can benefit from exercising that right of substitution (that is, the economic benefits associated with substituting the asset are expected to exceed the associated costs).
22. The staff think that the concept of having an identified asset is important to the definition of a lease and that in most cases it should be clear whether the contract involves the use of an identified asset. If the customer is not using an identified asset and is, instead, contracting for the use of one of any number of assets that can be substituted at any time by the supplier, the supplier controls the use of those assets. The supplier can decide how and for what purpose each individual asset capable of fulfilling the contract is used (that is, whether to use the asset to fulfill the contract with the customer or use it for another purpose). The customer cannot control the use

of an asset because there is no specific asset to control. Therefore, the contract does not contain a lease.

Control of the use of an identified asset

23. The staff think that a customer needs to have both of the following to control the use of an identified asset:

- (a) The right to direct the use of the identified asset, and
- (b) The right to obtain substantially all of the economic benefits from directing the use of the identified asset.

These requirements were also part of the lease definition guidance in the 2013 ED and proposed in the May 2014 definition paper.

24. In addition, the Boards are asked in this paper to decide whether a customer must have the ability to derive the economic benefits from directing the use of the identified asset on its own or together with resources that are readily available to the customer in order to control the use of an identified asset. The 2013 ED contained a notion that was, in some ways, similar to this guidance (that is, the “asset incidental to a service” concept).

25. The staff note that the 2013 ED referred to a customer’s *ability* to direct the use and derive benefits from use of an identified asset. However, the 2013 ED also included guidance about a customer’s *rights* in its description of how to assess the customer’s ability to direct the use and derive the benefits from use of an identified asset. The staff think alternating between use of the two terms “ability” and “right” in the guidance is confusing and thinks that use of the term “right” explains best the intention of the proposed guidance. Therefore, this paper, including the draft wording for the lease definition guidance in Appendix B, uses the term “right” rather than “ability.”

Right to direct the use of the identified asset

26. The 2013 ED proposed that a customer would have the ability to direct the use of an identified asset when it has the ability to make decisions about the use of the asset that

most significantly affect the economic benefits to be derived from use. The 2013 ED also stated, and the staff continue to think, that the ability to specify output from an asset, without any other decision-making rights relating to use of the asset, gives a customer the same rights as any customer that purchases services and, thus, does not convey the right to direct the use of that asset.

27. The staff are proposing further clarifications to the 2013 ED guidance to more directly link these two concepts that were proposed in the 2013 ED so that the lease definition guidance is more coherent. The staff proposals, in effect, would mean that when a customer directs the use of the identified asset, it has rights of use that extend beyond solely having the right to specify output from the asset.
28. The staff propose clarifying that a customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the applicable period of use. In contrast, if the supplier has that right, *it* directs the use of the underlying asset (and therefore, no lease would exist).
29. The staff think that decisions about how and for what purpose an asset is used are the decisions that are the most important in directing the use of that asset. This is because those decisions determine how, and what, economic benefits are derived from use. Those decisions could include:
- (a) The purpose for which the identified asset is used, including what type of output the asset will produce; and/or
 - (b) When and where the identified asset is used or deployed.
30. The staff's proposed guidance in this area is generally consistent with the 2013 ED, which proposed that the party that had the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use would be the party with the ability to direct the use of the asset. The staff's proposals would also be generally consistent with the May 2014 definition paper, which proposed to clarify that in *most* cases the decisions about how and for what purpose the asset is used would be the decisions that most significantly affect the economic benefits to be derived from use.

31. However, the staff's proposed guidance would represent a change from both the 2013 ED and the May 2014 definition paper in that the proposal would clarify that *whenever* a customer has the ability to decide how and for what purpose an asset is used throughout the period of use, the customer would direct the use of the asset. The staff think this is appropriate for the reasons described above. In addition, the staff think that this would simplify the definition of a lease assessment by removing the need for a customer to weight all decisions relating to the use of the asset when the customer decides how and for what purpose an asset is used.
32. The staff think that the decisions about how and for what purpose an asset is used are more important than other decisions to be made about use, including decisions about operations and maintenance. This is because decisions about how and for what purpose an asset is used generally have the most influence on the economic benefits that can be derived from use. Decisions regarding operations are generally about *implementing* the decisions about how and for what purpose an asset is used and are dependent upon (and subordinate to) those decisions. For example, a supplier's operational decisions would have no effect on the economic benefits derived from use of the asset if the customer decides not to operate the asset, and would always have proportionally less effect than the decisions about how and for what purpose the asset is used. The staff view the decisions about how and for what purpose an asset is used as similar to the decisions made by a Board of directors when assessing control of an entity. Decisions made by the Board of directors are generally the decisions that matter in the control assessment, rather than the actions of individuals in implementing those decisions.
33. The staff think that when a customer controls how and for what purpose an asset is used, it directs the use of that asset. However, in some cases, these decisions are predetermined by the contract (that is, the contract specifies how and for what purpose the asset will be used throughout the applicable term and this specification cannot be changed other than through a contract modification) or otherwise *mutually* agreed between the customer and the supplier. In these cases, neither the customer nor the supplier would control how and for what purpose the asset is used. Therefore, further

guidance would be necessary to determine whether the customer directs the use of the asset.

34. If neither the customer, nor the supplier, controls how and for what purpose the asset is used throughout the period of use, the customer is considered to have the right to direct the use of the identified asset in *either* of the following circumstances:
- (a) The customer has the right to operate the asset or to direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions); *or*
 - (b) The customer designed the asset, or caused the asset to be designed, in a way that predetermines:
 - (i) How and for what purpose the asset will be used; *or*
 - (ii) How the asset will be operated.
35. In addition, consistent with the proposals in the 2013 ED and the May 2014 definition paper, the staff propose including guidance about a supplier’s “protective” rights. This guidance would help distinguish between protective rights (that do not affect the assessment of who directs the use of the asset) and other decision-making rights (that should be considered when assessing whether a customer directs the use of the asset).
36. A contract may include clauses designed to protect the supplier, which are intended to protect the supplier’s interest in the asset or related assets, to protect its personnel, or ensure the supplier’s compliance with laws or regulations. For example, a contract may:
- (a) Specify the maximum amount of use of the asset or when the customer can use the asset;
 - (b) Give a supplier the right to approve a change in how or for what purpose the asset is used; *or*
 - (c) Require a customer to follow prudent operating practices.
37. The staff think that such protective rights, in essence, define the scope of the rights that a customer has to use an asset without removing a customer’s right to direct the use of that asset. Accordingly, those restrictions may affect the price paid for the lease

(that is, a lessee may pay less for the use of the asset if it is more restricted in its use of that asset). Nonetheless, those restrictions would not affect the *existence* of the right unless they are so restrictive that the customer has no ability to direct the use of the identified asset.

Right to obtain the economic benefits from directing the use of the identified asset

38. The staff continue to think that it is appropriate to require that a customer have the right to obtain substantially all of the potential economic benefits that can be obtained from directing the use of the asset throughout the period of use. If another party has the right to more than an insignificant portion of those potential economic benefits, the customer does not control the use of the asset. For example, it would not be appropriate to conclude that a customer controls the use of a factory when it has the right to only 50 or 60 percent of the output from that factory. Accordingly, such a contract would not contain a lease.
39. The May 2014 definition paper outlined that a customer may be able to obtain economic benefits from a lease by (not all-inclusive):
- (a) Using the asset to produce goods or provide services;
 - (b) Using the asset to enhance the value of other assets;
 - (c) Holding the asset (for example, locking up the capacity of a scarce resource); or
 - (d) Subleasing the asset.

Ability to derive the economic benefits from directing the use of the identified asset

40. In this section, the staff ask the Boards whether the definition of a lease should include the requirement that the customer be able to derive the economic benefits from directing the use of the identified asset on its own or together with other resources that are readily available to the customer:
- (a) *Alternative A* – Would include such guidance in the final leases standard.

- (b) *Alternative B* – Would *not* include such guidance in the final leases standard.

Alternative A

41. Alternative A proposes that the customer must have the *ability* (that is, possession of the means or skill) to derive the economic benefits from directing the use of the identified asset on its own or together with other resources that are readily available to the customer. Alternative A suggests this must be the case for the supplier's performance *at lease commencement* to result in probable future economic benefits to the customer (that is, separate from the supplier's continued or ongoing performance).
42. A readily available resource would be defined as a good or service that is sold separately (by the supplier or any other entity) or a resource that could be sourced by the customer in a reasonable period of time. By way of example, readily available resources would generally include, but not be limited to, all of the following:
- (a) Services sold separately by the supplier or a third party that could operate the identified asset (for example, an entity could employ the services of a company that provides flight crew services to make use of an aircraft).
 - (b) Services sold separately by the supplier or a third party to operate a complementary asset (for example, an entity is able to obtain property management and other related services from other parties to make use of rented space in a larger building).
 - (c) Trained personnel that are available directly for hire by the supplier or a third party or that are readily available in the market (for example, an unemployed operator). The staff think that it would generally be inconceivable that an entity could not obtain, within a reasonable period of time, a truck driver or forklift operator.
 - (d) Consumables or other supplies sold separately by the supplier or a third party (for example, if the supplier sells its consumables separately through refill orders to its customers or those consumables are sold by a third-party).

43. In contrast, resources would not be “readily available” just because an entity might be able to assemble the required expertise to derive economic benefits from directing the use of the asset from the marketplace over an *extended period* of time
44. Under Alternative A, if the customer is unable to derive the benefits from directing the use of the asset on its own or together with other readily available resources, a lease would not exist and the customer would not recognize lease assets and lease liabilities at commencement of the contract. In this scenario, Alternative A would conclude that the customer does not obtain or control probable future economic benefits from the supplier’s initial performance at contract commencement (for example, that of conveying to the customer the right to direct the use of the asset). The customer obtains economic benefits from the supplier’s initial performance at contract commencement only together with the supplier’s *continued* performance (for example, of operating the asset). If the supplier does not continue to perform, the customer would not be able to derive any (or only minor) economic benefits from directing the use of the asset.
45. For example, assume that a customer contracts for the use of a highly-specialized asset as well as specialized operating services. The customer does not have the expertise to operate the asset and such expertise is not readily available to the customer. In this example, without the services of the supplier, the asset would remain idle and the customer would be unable to implement any decisions about how and for what purpose the asset is used (and therefore derive economic benefits from those decisions) until those services are delivered.
46. Under Alternative A, the customer would be required to consider its ability to derive all types of economic benefits from directing the use of the asset (including, for example, benefits from subleasing the asset). However, under this approach, the staff do not think it would be appropriate for the customer to conclude that it can derive the benefits from directing the use of the asset on its own or together with other readily available resources if it can derive only an incidental or otherwise minor amount of the benefits it can derive from the contract. This is because the staff think that the customer would almost always be able to derive at least *some* economic benefit from its rights to use an asset. For example, the customer may be able to derive *some minor*

economic benefit from use of a piece of equipment solely by using it for storage (for example, using a specialized rail car or the bed of a construction vehicle for storage). In contrast, if the customer can derive a substantial portion, but not all or substantially all, of the economic benefits from use together with its own goods or services (or those otherwise readily available), Alternative A would conclude that the customer can derive the benefits from directing the use of the identified asset.

47. Under Alternative A, an entity would take into account the following when assessing whether the customer has the ability to derive the economic benefits from directing the use of the asset on its own or together with other readily available resources:
- (a) The entity would ignore any specific terms or conditions in the contract. For example, contractual prohibitions against subleasing or using another party to obtain services that the supplier is providing to the customer should be ignored in the assessment. Such contractual prohibitions do not, in the staff's view, call into question whether an asset is conveyed to the customer at contract commencement and could invite structuring.
 - (b) The entity would consider the specific resources of the individual customer in the contract. For example, an equipment lease could be classified as a lease by one customer that owned similar assets (and therefore, is capable of operating the asset on its own) and not a lease by a customer that has no similarly trained employees, assuming there are no readily available third-party resources.

Alternative B

48. Alternative B would not include a requirement in the final leases standard that the customer must be able to derive the economic benefits from directing the use of an identified asset on its own or together with other resources that are readily available to the customer in order for the contract to contain a lease. Alternative B would therefore conclude that a customer controls the use of an asset if it directs the use of the asset and has the *right* to obtain substantially all the economic benefits from directing the use of the asset during the period of use.

49. Alternative B would conclude that the “ability to derive benefits” test described in Alternative A is not needed. This is because the test of whether a customer directs the use, and has the right to obtain substantially all of the economic benefits from directing the use, of the asset is sufficient to identify when the customer controls the use of an identified asset.
50. The staff note that they expect the outcomes under Alternative A and Alternative B in terms of the identification of a lease to be the same in most cases. The types of contracts for which the staff would expect different outcomes under Alternative A and Alternative B would be, for example, contracts for the use of specialized equipment, in which:
- (a) The supplier also provides specialized operations services that the customer is not capable of performing on its own or purchasing separately from other parties and
 - (b) For which the customer would be unable to sublease the asset on its own (that is, there is no market for subleasing the asset on its own, separate from the supplier’s services).

For this relatively narrow population of contracts, applying Alternative A might result in the conclusion that these contracts are not leases, while applying Alternative B might result in the conclusion that these contracts contain leases.

Advantages of Alternative A

51. The principal advantage some see in Alternative A is that it would result in a customer *not* recognizing lease assets and lease liabilities for contracts for which some think that the supplier’s performance at lease commencement does not create an asset for the customer. When the customer cannot derive benefits from its right to direct the use of the identified asset on its own or together with other readily available resources, the customer’s ability to realize future economic benefits may be entirely dependent on the supplier’s *continuing* performance. Consequently, in those cases, Alternative A would conclude that any separate accounting for the asset component of the contract is artificial (that is, because the customer’s rights of use lack substance independent of the ongoing performance of the supplier).

52. The staff think that the concepts and much of the terminology underlying this alternative are similar (though not the same as, or intended to be directly correlative) to proposals in the 2013 ED and included in the recently-issued revenue recognition standard as follows:

- (a) This guidance would be similar in many respects to what was previously exposed in the 2013 ED in paragraphs 842-10-15-16 (FASB ED) and 19 (IASB ED):

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

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

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

- (b) Some of the concepts underlying this guidance already exist in issued guidance (that is, within the recently-issued revenue recognition standard).

53. Alternative A may be more responsive to concerns raised by some constituents that the proposed definition of a lease in the 2013 ED would capture contracts that, in their view, are service contracts.

Advantages of Alternative B

54. Including the additional guidance required by Alternative A would require entities to apply more judgment and would create additional complexity in determining whether a contract contains a lease than *not* including this guidance. Although some particular types of contracts may be affected by including this additional guidance, if applied as intended, the staff do not think that it would substantially change the overall

population of contracts that would be determined to contain leases. Therefore, those supporting Alternative B would argue that the additional complexity introduced by Alternative A that would apply to *all* leases is not warranted given the small change in outcomes as compared to Alternative B.

55. Further, some think there is a valid argument that a lease exists even when the criteria proposed in Alternative A are not met. Those supporting Alternative B think that it is appropriate to assess control in the context of a lease by assessing *only* whether a customer has the right to direct the use, and obtain substantially all of the economic benefits from directing the use, of an asset. This control assessment is also consistent with the control concepts in other standards. If a customer controls the use of an asset by having the right to direct the use of, and obtain substantially all the economic benefits from, that asset, the customer controls a resource or benefit—the right to use an asset—from which future economic benefits are expected to flow to the customer.
56. That right to use an asset embodies economic benefits on its own—that is, if *any* party can derive economic benefits from the rights of use separately from other services, then those supporting Alternative B think an asset exists that is separate from those services. Therefore, even if the customer in a contract is unable to use or otherwise benefit from the asset on its own or together with other readily available resources, a ROU asset exists because another entity would be able to do so (for example, an entity that leases the same type of asset on its own).
57. Those supportive of Alternative B also note that control of an asset includes the ability to prevent others from directing the use of and obtaining the benefits from an asset. If the customer has obtained the right to direct the use, and obtain substantially all of the economic benefits from directing the use, of an asset, no other entity can benefit from use of the asset (for example, the supplier cannot use the asset or re-direct it to another customer during the term of the contract).
58. Alternative A would be expected to *reduce* the number of contracts that would meet the definition of a lease as compared to Alternative B, the proposals in the 2013 ED, and existing leases guidance. Consequently, Alternative A may result in some contracts that investors and analysts and others currently consider to be leases being accounted for as service contracts. For those constituents, Alternative A would result

in assets and liabilities not being recognized for some contracts that, in their view, create assets and liabilities. If those contracts are currently accounted for as leases, but would not be considered leases under Alternative A, adopting Alternative A would mean that investors would receive *less* information on those contracts than they get today through existing lease disclosure requirements.

59. Because the guidance in Alternative A is similar to that proposed in the 2013 ED (often referred to by constituents as the “assets incidental to a service” guidance), the staff think a review of the concerns expressed about that guidance is useful to the discussion of whether to adopt Alternative A or Alternative B. This is because the staff think that those concerns raised about the guidance in the 2013 ED would also be relevant under Alternative A. The following represent the key concerns expressed about the guidance proposed in the 2013 ED:

- (a) Constituents raised concerns about the judgment inherent in determining whether an entity can “obtain the benefits from use of the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers.” The staff assume those concerns would remain in the context of Alternative A, which would retain similar guidance.
- (b) Constituents raised concerns about the lack of clarity as to the meaning of the term “incidental” in the 2013 ED guidance. The guidance envisioned by the staff under Alternative A would require entities to interpret similar qualitative terms such as “substantial portion”, “a reasonable period of time” and “readily available.”
- (c) Constituents raised concerns about reaching different answers for similar contracts. Under Alternative A, this is also possible because the assessment of the ability to derive the benefits from use of the identified asset is based on whether the customer in the contract is capable of doing so on its own or together with other readily available resources. This has the potential to result in the same contract being classified in two different ways (that is, as a lease for one customer and as a service for another), depending on the resources of the customer in the contract (and also, still, based on the sales

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practices of the supplier). Some staff are concerned about the potential lack of comparability across entities from a customer’s perspective. Those staff also question the consequences of such an approach for lessors—if a lessor were to apply the lease definition guidance in this way, a lessor could classify two identical contracts in different ways depending on the resources available to its respective customers. Other staff members, however, are not concerned with this outcome from the customer’s perspective. This is because the economics of the contract may be very different to a customer that effectively has a lease versus buy decision (because it can derive benefits from directing the use of the asset on its own) than to a customer that does not (by virtue of its inability to derive benefits from directing the use of the asset without the supplier).

60. Alternative A could have unintended consequences. The “asset incidental to a service” proposal included in the 2013 ED was narrowly defined, whereas the proposals within Alternative A are more broadly defined (principally because Alternative A would not contain the guidance in the 2013 ED requiring that the asset itself be “incidental” because the asset has been designed to function only with the additional goods or services provided by the supplier). The concept in Alternative A is likely to be rigorously tested (and pushed) because the outcome of concluding that the customer cannot derive the benefits from directing the use of the identified asset is that a lease does not exist.

Alternatives considered and not recommended

61. In recent meetings, in particular the September 2014 Accounting Standards Advisory Forum (ASAF) meeting, alternatives to the definition of a lease proposed in the 2013 ED have been suggested as a means of arriving at what some regard as a more appropriate population of leases. The following paragraphs outline various alternatives, beyond those outlined above in the staff analysis section. These alternatives have been considered by the staff following requests from Board members or external parties but not recommended for the reasons noted in the following paragraphs.

Financing component approach

62. One of the suggestions made at the September 2014 ASAF meeting was to define a lease by requiring that a lease is a *financing arrangement* for the right to use an asset. If the financing component in an arrangement is not clearly identifiable, an entity would conclude that the contract does not contain a lease. The rationale for this proposal is that the 2013 ED definition of a lease inappropriately captured too many contracts, including those that are not entered into for the purpose of financing the purchase of an asset. This proposal was partly in response to the observation that the IASB has referred to leases as a source of financing.
63. The proposal discussed at the ASAF meeting described multiple indicators to help determine whether it is clearly identifiable that a contract contains a financing component. Those indicators included, among others:
- (a) Whether there was any conditionality in payments (for example, in a contract for the use of an asset and services, would the customer be obliged to pay for the right of use if the supplier did not provide the services as promised in the contract, or are the payments for the right of use and the services conditional upon the delivery of both components?);
 - (b) Whether the contractual payments are variable based on use;
 - (c) Whether the asset involved in the contract depends on the delivery of other goods or services to perform at a guaranteed service quality level; and
 - (d) Whether the supplier's business model is to provide financing to enable its customers to acquire assets.
64. The staff do not recommend limiting the definition of a lease to only those contracts that qualify as a financing arrangement. The definition of a lease has always focused on the fact that an asset (a ROU asset) is obtained by the customer as a result of the lessor's performance at lease commencement. The ROU asset gives rise to a corresponding lease liability if payments are made over time, but exists even if there is no lease liability (for example, when lease payments are fully prepaid). The focus on the asset obtained in a lease also distinguishes leases from other contracts, such as service or supply arrangements.

65. If an entity has obtained the right to use an asset, the staff think it is appropriate to conclude that the contract contains a lease, regardless of the timing of payments. Whether or not the contract contains a financing element does not affect whether a lease creates an asset and a liability for the lessee.
66. The staff note that “financing,” in the context of the leases standard, is used simply to refer to the receipt of an asset at lease commencement that is paid for over time. This is the same as how the concept of financing is used in the revenue recognition standard. The revenue recognition standard refers to contracts that contain a “significant financing component” to mean contracts for which the timing of the delivery of goods or services is different from the timing of payments for those goods or services—in that standard, the presence of a significant financing component affects the measurement of revenue; it does not affect the identification of the goods or services in a contract nor when the related revenue is recognized.
67. The staff are also concerned about the consequences of defining a lease on the basis of the proposed characteristics and indicators of financing:
- (a) The guidance would introduce new and subjective terms that, in the staff’s view, would be complex to apply.
 - (b) Many of the indicators of financing focused on the form of the payments, and those payments being similar to payments within a loan agreement. The staff fear that this focus on form could result in the following:
 - (i) Many existing leases, including many existing finance leases and many (if not most) existing real estate leases, no longer being considered to be leases, even when it is clear that the customer has obtained an asset at contract commencement.
 - (ii) It being relatively easy to structure a contract to fail to meet the definition of a lease by changing the payment structure, or including particular services together with the right to use an asset, while not changing the substance of the right of use.

IFRS 15/Topic 606 approach

68. Another suggestion made at the September 2014 ASAF meeting was to more closely link the lease definition guidance to the guidance in IFRS 15 *Revenue from Contracts with Customers* and Topic 606, *Revenue from Contracts with Customers* on unbundling, and in particular the guidance on whether a good or service is “distinct.” ASAF members are generally supportive of consistency in concepts between the leases standard and the recently-issued revenue recognition standard.
69. The recently-issued revenue recognition standard states that a good or service is distinct if both of the following conditions are met:
- (a) The customer can benefit from the good or service on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct); and
 - (b) The supplier’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct in the context of the contract).
70. An ASAF member suggested that, in the context of leases, the concept of “distinct” in IFRS 15 could be used to help distinguish between contracts that contain distinct lease and service components (that an entity should unbundle and account for separately) and contracts that do not contain distinct lease and service components. If a contract does not contain distinct lease and service components, some would suggest that the entire contract should be accounted for as a service. This is because, in their view, in that scenario the customer does not truly control the right to use an asset without the accompanying services provided by the supplier.
71. The staff considered, but do not recommend, this alternative for the following reasons:
- (a) The distinct guidance in the revenue recognition standard was developed to address a different objective than that of the definition of a lease. According to paragraph BC85 of the revenue recognition standard, the objective of developing the distinct guidance “was to ensure that entities appropriately identify the unit of account for the goods and services

promised in a contract.” In other words, the intent of the distinct guidance is to appropriately identify the nature of the promise to the customer to ensure the most appropriate allocation and recognition of revenue. In contrast, the lease definition guidance has the aim of identifying when a customer has obtained a ROU asset from a supplier. Applying the full distinct notion (including the “distinct in the context of the contract” criterion), developed for a different purpose than identifying asset and liabilities of a customer, would likely result in a customer not recognizing assets and liabilities that meet the conceptual definition thereof. The staff think that control is a more appropriate basis on which to determine when a customer has obtained a ROU asset than the distinct guidance. Using control for the purpose of determining when a customer has obtained a ROU asset would be consistent in some ways with the revenue recognition standard, which uses control to determine when an entity has transferred a good to a customer.

- (b) The staff think that the lease definition guidance proposed in this paper would be less complex to apply than applying the distinct guidance in the context of leases. Some staff also think that the lease definition guidance proposed would result in similar outcomes as applying the distinct guidance, if that distinct guidance is applied as it was intended.

72. In addition, the staff would be concerned about including this guidance. While sellers often have little incentive to conclude that two goods or services are a single performance obligation, in the context of leases, lessees would have an incentive to make the opposite conclusion—that lease and service components are not distinct—because the result would be not having to recognize lease assets and liabilities. It is partly as a result of this consideration, but also in light of the feedback from some stakeholders on the “distinct in the context of the contract” guidance in the new revenue standard, that some staff members are not convinced this IFRS 15/Topic 606 approach would be applied in a manner that would result in similar outcomes as the staff proposals in this paper.

Operations approaches

73. The staff considered two variations of an “operations approach”:
- (a) The first would consider a contract to contain a lease only if the customer has the right to operate (or direct others to operate) the identified asset (for example, by being able to hire or fire the operator and/or designate significant operating policies and procedures with the operator having no right to override those decisions).
 - (b) The second would conclude that, if a customer does not have the right to operate (or direct others to operate) the identified asset, the contract contains a lease only if the customer would be *capable* of operating the asset on its own or together with other readily available resources. “Capable” would be defined as described in Alternative A discussed earlier in this paper.
74. The staff rejected the first iteration of an “operations approach” for the following reasons:
- (a) As outlined in the staff analysis section of this paper, the staff think that, in general, the right to direct how and for what purpose an asset is used (for example, where or when the asset is used, what tasks it performs, etc.) are the most important decisions regarding the use of the asset. Accordingly, that right gives a customer the ability to direct the use of the asset, regardless of whether it has the right to operate the asset, or direct others to operate the asset. The staff think that restricting the definition of a lease to only assets for which a customer has the right to operate (or direct others to operate) an asset creates a definition that is too narrow. The staff think that a customer can control the use of an asset, even if another party controls the operations of that asset. Often, the supplier operates the underlying asset in a lease merely to provide a separate service (for example, because it has a specialized skill-set) or to protect its investment in the asset (including the residual asset). In these cases, even though the supplier operates the asset, if the customer decides how and for what purpose an asset is used, then the

customer has rights of use that extend significantly beyond the rights associated with receiving a service over the contract term. It seems counter-intuitive that a supplier controls the use of an asset by virtue of operating discretion it enjoys only *if* and/or when the customer (i) decides to use the asset and (ii) controls the overriding task that the operations are to fulfill.

- (b) This type of approach would encourage structuring to achieve off-balance sheet accounting. The staff think it would be relatively easy for many lessors to provide “mandatory” operating services to lessees, offering customers the opportunity to continue to enjoy off-balance sheet lease accounting. Equipment lessors would offer operators (for example, a driver with a truck), while even real estate lessors could offer “operations personnel” that might be considered to operate the leased building or space. Not only would this type of structuring defeat the principal goal of the leases project, but it would also *reduce* the amount of information investors and analysts get about those contracts. This is because investors and analysts would no longer get the disclosures they currently receive about these contracts because they are operating leases.

75. The second iteration of an “operations approach” was rejected principally because it was too narrow in orientation. The staff think the core premise underlying this second version of an “operations approach” is encompassed within Alternative A discussed earlier in the paper. This second “operations approach” considered only whether the customer was capable of *operating* the asset on its own or together with other readily available resources. The staff think that, under this approach, some would rightly question why the assessment is limited to whether the customer is capable of operating the underlying asset or did not consider the other forms of benefit a customer can obtain from a lease. Following the general rationale behind this approach, a customer may not be able to benefit from its rights in a contract if the customer is unable to source other goods or services, such as consumables, needed to derive the benefits from directing the use of an asset. Therefore, the staff recommend

that, if the Boards support this concept, they should adopt the concept more generally by adopting Alternative A described earlier in this paper.

Substantial services approach

76. In more recent meetings, some have suggested that an entity should not be required to unbundle the lease and service components of a contract *if* the service components are substantial and the predominant portion of the overall contract. In that case, they propose that an entity should account for the contract entirely as a service. Some respondents to the 2013 ED also suggested a similar approach.
77. Supporters of this approach would view it as similar to (although the opposite of) the Boards' tentative decision to permit an entity *not* to unbundle lease and service components, and to instead account for the entire contract as a lease. They anticipate that an entity would choose the option available under the Boards' tentative decision only when the service components are a relatively small portion of the overall contract. This is because an entity would not wish to recognise significantly larger lease assets and lease liabilities, which would be the outcome if the service components of a contract are substantial. Supporters would argue that including such a requirement or option *not* to unbundle lease and service components when the service components are predominant (together with the option already tentatively decided upon by the Boards) would result in the following:
- (a) An entity accounting for an entire contract as a *lease* when the *lease* component is substantially larger than any service components of a contract (as a result of the Boards' tentative decision on separation mentioned above).
 - (b) An entity accounting for an entire contract as a *service* when the *service* components are substantially larger than any lease components of a contract.
78. In their view, this would provide considerable cost relief because they think that unbundling the lease and service components of many contracts would involve significant costs. It would also provide useful information because it would remove

from the scope of the leases standard contracts that some view as being service contracts (that is, those contracts that are predominantly for services).

79. The staff do not recommend this approach. Similar to analysis for some of the other approaches discussed earlier in this section of the paper, the staff think that if an entity obtains the right to use an asset, the entity should recognize assets and liabilities for the amounts paid for the lease (but not for amounts paid for any services in the contract). The staff think that adding services to a contract does not necessarily change the rights of use that a lessee obtains. Accordingly, if a lessee retains the right to direct the use, and obtain substantially all of the economic benefits from directing the use, of an identified asset, the lessee should recognize a lease (that is, ROU) asset and a lease liability.
80. The staff would also be concerned if similar ROU assets could be accounted for differently simply because services of a more significant value had been bundled together with some ROU assets and not others. For example, it could create incentives to add services to a contract containing a lease in order to account for the contract as a service arrangement.
81. Because of this concern, if the Boards were to consider adopting this alternative, the staff would recommend that an entity be permitted to treat the entire contract as a service *only* if:
- (a) It is impractical to separate the lease and service (nonlease) components; and
 - (b) The service components are substantially more significant than any lease components in the contract.
82. Nonetheless, the staff are not recommending this amended alternative because, in their view:
- (a) It would add complexity. The approach would require entities to interpret terms such as “substantially more significant” or “predominant,” which could create comparability issues if not interpreted consistently.

- (b) It would not be expected to change the scope of the leases standard in any meaningful way. The staff have not identified any contracts that would be considered to contain leases under the proposed definition of a lease that would also meet the two criteria outlined above.
83. Some have mentioned the following contracts as examples of those that they think should be accounted for as services—information technology (IT) and manufacturing outsourcing contracts, contracts for the use of hotel rooms and concession space in a larger retail store, airplane wet leases, ship time charter contracts, and drilling rig charter contracts. The staff do not think that this approach would change the accounting for these contracts for the following reasons:
- (a) The staff think that many of the IT and manufacturing outsourcing contracts, and contracts for the use of hotel rooms and concession space, would *not* contain leases under the proposed definition of a lease recommended by the staff in this paper (refer to Appendix A for some illustrative examples).
- (b) Although the service components can be significant, the staff understand that in the airplane, ship, and drilling rig contract scenarios, the investment in the asset (and thus the amounts charged for the lease component of the contract) would typically substantially outweigh the service components of the contract.
84. In addition, the staff note that the Boards' tentative decision to allow the use of estimates when separating lease and nonlease components should make the exclusion of service components from the leases standard easier to implement than the proposals in the 2013 ED. This should help to address the concerns about complexity that have prompted some to suggest this alternative.

Modified Topic 840/IFRIC 4 approach

85. Given the concerns of some Board members about complexity, the staff considered whether the Boards should retain the existing lease definition guidance in Topic 840/IFRIC 4, perhaps with targeted improvements for existing practice issues. For example, improvements could be made with respect to determining whether the price

that the purchaser will pay under the arrangement is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

86. The staff are not recommending this approach because we think the staff proposal outlined above with respect to when a customer has the ability to direct the use of an identified asset would be less complex to apply over time than the existing definition guidance. The staff also think that it more appropriately determines when the customer has *rights* of use that extend beyond receiving output from the asset than making that determination based solely on the pricing in the contract (as is the case with the existing lease definition guidance).
87. In addition, the majority of constituents that provided feedback on the 2013 ED definition of a lease commented that they viewed the revised definition of a lease as an improvement on the existing definition of a lease in Topic 840/IFRIC 4. Some of that support was inevitably derived from the view that the revised definition would narrow the population of leases compared to existing requirements. Nonetheless, many respondents explained that the revised definition more appropriately links the definition of control used in the revised lease definition and the definition of control in the recently-issued revenue recognition standard and in the consolidations guidance.

Staff Recommendations

Right to direct the use of the identified asset

88. The staff recommend that the Boards adopt the staff proposal outlined earlier in this paper with respect to clarifying the guidance about the right to direct the use of an identified asset.
89. In summary, the staff propose clarifying that:
- (a) A customer has the right to direct the use of an asset whenever it has the right to direct how and for what purpose the asset is used, including the

right to change how and for what purpose the asset is used, throughout the period of use.

- (b) If how and for what purpose the asset is used throughout the period of use is predetermined in the contract or otherwise mutually agreed between the customer and the supplier, the customer still has the right to direct the use of the identified asset if:
 - (i) It has the right to direct how the asset is operated; or
 - (ii) It designed the asset in a way that predetermined how and for what purpose the asset is used or how the asset is operated.
 - (c) A supplier's protective rights typically define the scope of the customer's use of the asset but do not, in isolation, prevent the customer from having the right to direct the use of the identified asset.
90. The staff think this guidance represents a significant part of an overall improved definition of a lease from that in existing leases guidance (that is, Topic 840/IFRIC 4) that more closely aligns the definition of a lease with other control-based guidance (for example, within the revenue recognition and consolidations standards).
91. In addition, the staff think that the staff proposal:
- (a) Will be clearer and less complex to apply than the guidance proposed in the 2013 ED and in the May 2014 definition paper. Consequently, it addresses the concerns in this regard expressed by both constituents and some Board members.
 - (b) Effectively links together what many viewed as incoherent concepts in the 2013 ED (that is, the concept of a customer controlling the use of an identified asset (and thus having a lease) and the concept of a customer solely having rights to specify the output from the asset (and thus not having a lease)).
 - (c) Appropriately captures when an entity directs the use of an asset and receives rights beyond those of a customer with only the right to receive a specified output from an asset.

Ability to derive the benefits from directing the use of the identified asset

92. On balance, the staff recommend that the Boards *not* include a requirement in the final leases standard that the customer have the ability to derive the benefits from directing the use of the identified asset on its own or together with other resources that are readily available to the customer (that is, the staff recommend Alternative B, which is presented above) in order for the contract to contain a lease.
93. Although the staff think there are some advantages to the guidance proposed in Alternative A, the staff do not think the potential benefits outweigh the costs of including this guidance in the definition of a lease. The following factors influenced this recommendation:
- (a) The additional judgment and complexity inherent in the guidance proposed in Alternative A would apply to all lease evaluations, even though it is likely to result in different conclusions in only a relatively small sub-set of contracts. As a result, the guidance is likely to increase the costs of application for all preparers that enter into a lease, while affecting the accounting result for only a small proportion thereof.
 - (b) There is at least the *potential* for unintended consequences under Alternative A. Some constituents might inappropriately apply the additional guidance and conclude that some contracts the Boards think should be accounted for as leases are not leases.
 - (c) Alternative A would likely reduce the amount of information available to investors and analysts. This would be likely to result in entities accounting for some types of transactions not as leases that investors consider to be leases (irrespective of the point raised in (b) above). For those contracts, investors would no longer receive even the limited amount of information they receive today in the lease disclosures under existing guidance (such as, information currently provided in the lease maturity table).
 - (d) Lastly, some staff think that the most appropriate way to assess control in the context of a lease is to assess *only* whether a customer has the right to direct the use, and obtain substantially all of the potential economic benefits

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from directing the use, of an asset (that is, the guidance proposed in Alternative B). These staff think that, if a customer controls the use of an identified asset in this way, then the customer obtains rights of use that meet the definition of an asset and provide economic benefits to the customer separate from any services provided by the supplier.

Accordingly, these staff do not think that the additional guidance proposed in Alternative A is needed to assess whether a contract contains a lease.

94. The staff think that including the additional guidance proposed in Alternative A would be counter to one of the principal goals for the redeliberations process in this area (that is, to address constituent concerns with respect to the complexity of the guidance on the definition of a lease). It also has the potential to counter some of the effect of other simplifications the Boards have enacted to reduce costs and complexity. In addition, it may potentially reduce, rather than enhance, the benefits investors and analysts would obtain from a final leases standard.

Questions for the Boards

- 1) Do the Boards agree with the staff's proposed clarifications/simplifications to the guidance about a customer's right to direct the use of an identified asset?
- 2) Do the Boards want to include guidance in the final leases standard that would stipulate that a contract contains a lease only when the customer has the ability to derive the benefits from directing the use of an identified asset on its own or together with other readily available resources?

Appendix A: Examples illustrating how to apply the lease definition guidance

- A1. The following examples illustrate the analysis that would need to be made to assess whether a contract contains a lease.

Example 1 – Retail Unit

Customer enters into a contract with Supplier to use Retail Unit A for a five-year period.

Customer is guaranteed to have the right to use Retail Unit A; Supplier cannot force Customer to move to another retail unit.

The contract requires that Customer may use the premises only for the purpose of operating its well-known store brand and may sell its goods only during the hours that the larger retail space is open. Customer decides on the mix of brand goods sold from the unit, the pricing of the goods sold (including when goods are on sale), the fixtures and fittings within the store, the qualities of inventory held and space used for storage. Customer also controls physical access to the unit at all times throughout the period of use.

Supplier provides janitorial and security services, as well as advertising services, as part of the contract.

The contract contains a lease.

The contract involves an identified asset. Retail Unit A is explicitly identified in the contract and Supplier has no right to substitute the asset.

Customer has the right to direct the use of the asset. Within the scope of its right of use, Customer makes the decisions about how and for what purpose the retail unit is used. Customer decides:

- a) For what purpose the retail unit is used (that is, whether the space within the unit will be used for sales, storage, or both)*
- b) What mix of products will be sold in the retail unit*
- c) When the retail unit is open (during the opening hours of the larger retail space).*

Although Customer's decision-making rights about how and for what purpose the retail unit is used would be sufficient, in isolation, to conclude that Customer has the right to direct the use of the asset, Customer also has the right to direct how the retail unit is operated. Customer makes decisions about inventory control, employment, management, and the design and décor within the retail unit.

Customer has the right to obtain substantially all of the economic benefits from directing the use of the identified asset. Customer has the right to the proceeds from sales from the retail unit during the period of use. No other party can use the space during the period.

Customer would account for the lease component in the contract separately from the non-lease components (that is, the janitorial, security and advertising services provided by Supplier), recognizing lease assets and liabilities only for the payments made for the lease.

Additional Analysis – Ability to Derive Economic Benefits (Alternative A)

The contract contains a lease.

Customer can derive benefits from directing the use of the leased space on its own (it has access to the retail unit and operates the store on its own) and together with readily available other resources (for example, third-party janitorial, security, and advertising services).

Example 2—Department store concession

Customer enters into a contract with Supplier for a specified amount of space within a larger department store. Customer will then use that space to sell its branded goods. The contract states the exact amount of space and that the space must be located on the 2nd floor of the department store. However, Supplier has the right to change the location of the space allocated to Customer at any time during the contractual term, and there are no costs associated with doing so. Supplier also provides other services to Customer.

The contract does not contain a lease because it does not involve the use of an identified asset. Although the contract specifies the size of the concession space, the actual space is not explicitly or implicitly specified. Supplier can change the space allocated to Customer at any time, and it is assumed that Supplier could benefit from that substitution of space because there are no costs to the Supplier in the case of substitution. Consequently, Customer does not control the use of an identified asset.

Example 3—Hotel Rooms

Airline enters into a contract with Hotelier to reserve 50 rooms in a given hotel for 2 years for its staff to use between flights.

Contract does not specify the rooms that need to be used to fulfill the contract but specifies that rooms need to be of a particular size and have a particular number and type of beds.

Hotelier has multiple rooms in the hotel that could meet these specifications.

The contract does not contain a lease because it does not involve the use of an identified asset. Although the contract requires hotel rooms of a particular specification, the contract does not explicitly or implicitly specify particular hotel rooms that must be used to fulfill the contract and could be used only by Airline.

Hotelier has multiple hotel rooms that could be used to fulfill the contract.

Accordingly, Airline does not direct the use, nor have the right to obtain substantially all of the economic benefits from directing the use, of any particular hotel room. For any given hotel room on any given night, the occupant (who may or may not be the Airline's personnel) will direct the use of the room and have the right to obtain the economic benefits from directing the use of that room for the evening.

Example 4: Specialized Equipment

Customer enters into a five-year contract with Supplier for the use of Equipment B.

Equipment B is explicitly specified in the contract. Supplier cannot substitute another piece of equipment for Equipment B unless Equipment B is not working.

Equipment B is a specialized piece of equipment that is operated by Supplier.

Nonetheless, the contract gives Customer the right to decide whether, when, and where Equipment B is used, as well as what tasks it performs (for example, what it produces or what it transports), throughout the five-year contract term.

The contract contains a lease.

The contract involves an identified asset. Equipment B is explicitly identified in the contract and Supplier has no right to substitute the asset unless it is not working.

Customer has the right to direct the use of the asset. This is because Customer makes the decisions about how and for what purpose Equipment B is used. Customer decides whether, when, and where Equipment B is used, as well as what tasks it performs, throughout the period of use. These decision-making rights give Customer the right to direct the use of the identified asset, regardless of the fact that Supplier operates the asset under the terms of the contract.

Customer also has the right to obtain substantially all of the economic benefits from directing the use of the identified asset. No other party can use the equipment throughout the contract term.

Customer would account for the lease component of the contract separately from the service component (the operating services provided by Supplier), recognizing lease assets and liabilities only for the payments made for the lease.

Additional Analysis – Ability to Derive Economic Benefits (Alternative A)

A lease would not exist if the following conditions were met:

- a) Customer is not capable of operating the specialized asset on its own or together with other readily available resources. Supplier has specialized knowledge with respect to its equipment that is not readily available in the marketplace (that is,*

the operating services are not provided separately by Supplier or another third party, and could not be sourced in a reasonable period of time).

- b) *Customer cannot otherwise derive a substantial portion of the economic benefits from directing the use of the identified asset (for example, there is no market for subleasing the asset separate from the operations services provided by the supplier).*

Example 5 – Truck rental contract

Customer enters into a contract with Supplier for the transportation of cargo from New York to San Francisco on an identified truck—only the Customer’s cargo will be transported.

The cargo to be transported, as well as the timing and location of pick-up in New York and delivery in San Francisco, are specified in the contract.

Customer is responsible for driving the truck from New York to San Francisco.

Assume that it is not practical for Supplier to substitute the truck throughout the period of use.

The contract contains a lease (which in this example may be a short-term lease).

For the period of time between the contractually-agreed pick-up/loading date and the contractually-agreed delivery/return date, the contract depends on an identified truck.

Supplier is not practically able to substitute an alternative truck throughout the period of use.

Customer controls the use of the truck throughout this time period. Although how and for what purpose the truck is used is predetermined in the contract (and thus agreed jointly by Supplier and Customer), Customer directs the use of the truck because it controls how the truck is operated (that is, speed, route, rest stops, etc.) throughout the period of use. Customer also has the right to obtain substantially all of the economic benefits from directing the use of the truck throughout the agreed time period (that is, no other party can use the truck during the designated trip).

Additional Analysis – Ability to Derive Economic Benefits (Alternative A)

The contract contains a lease.

Customer can derive the economic benefits from directing the use of the truck because Customer is able to operate the asset on its own and any supplies it would need to derive those benefits from directing the use of the truck (for example, fuel) are readily available.

Example 6 – Dump Truck

Customer enters into a contract for the use of a specified dump truck for three years. The contract specifies that that a certified operator must operate the truck. The contract specifies that Customer will use the dump truck for transporting coal from a mine in Alberta, Canada to a nearby rail yard. Customer will operate the asset and determine whether and when the dump truck is used. Assume that it is not practical for Supplier to substitute the dump truck.

The contract contains a lease.

The dump truck is explicitly specified and it is not practical for Supplier to substitute the truck.

Customer directs the use of the truck. Even though the purpose for which the dump truck will be used is predetermined in the contract (and thus agreed jointly by Supplier and Customer), Customer still retains decision-making rights relating to how the truck is used (for example, whether and when to use the dump truck), and controls how the asset is operated, throughout the period of use.

Customer has the right to obtain substantially all of the economic benefits from directing the use of the truck throughout the period of use because Customer controls access to the truck at all times such that no other party is able to use the truck.

Additional Analysis – Ability to Derive Economic Benefits (Alternative A)

The contract contains a lease.

Customer can derive the economic benefits from directing the use of the dump truck independent of the supplier (that is, from its own operation of the truck and together with readily available fuel and other supplies).

Example 7—Contract for Shirts

Customer enters into a contract with Supplier to purchase a particular type and quantity of shirts for a three-year period.

Supplier can use only one factory to meet the needs of Customer. The contract would result in Customer taking all of the output from the factory producing this type of shirt (if running at normal capacity).

Supplier makes all decisions about the operations of the factory, including whether to run the factory at an increased capacity (for example, adding a third shift).

The contract does not contain a lease.

Customer does not have the right to direct the use of the factory. Supplier has the ability to direct its use because Supplier is responsible for operating the factory and determining how and for what purpose the factory is used.

Customer also does not have the right to obtain substantially all the economic benefits from use of the factory because Supplier could decide to use the factory to fulfill other contracts during the contract term by increasing the hours that the factory operates.

Customer's rights are limited to specifying output from the factory—Customer has no more rights to direct the use of the factory than if it were one of 10 customers whose orders occupied 1/10th of the capacity of the factory. The only difference is the volume ordered.

Example 8 – Airplane “Wet” Lease

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

Customer determines where the airplane will fly (subject to legal restrictions) and when, who will fly on the airplane, and the prices and other fees that passengers will pay.

Supplier's crew operates the airplane. Customer is prohibited from hiring another operator for the airplane during the term of the contract. However, third party flight crews are available for hire in the marketplace.

It is not practical for Supplier to substitute the airplane during the five-year period.

The contract contains a lease.

Throughout the term of the contract, Supplier fulfills the contract using an identified asset.

Customer directs how and for what purpose the airplane is used throughout the five-year period of use (that is, whether, where, and when it travels; the passengers and cargo it will transport; and the price it charges parties for transport on the airplane). Accordingly, Customer directs the use of the airplane.

Customer has the right to obtain substantially all of the economic benefits to be derived from directing the use of the airplane during the five-year period because no other party can use it.

Additional Analysis – Ability to Derive Economic Benefits (Alternative A)

The contract contains a lease.

If the customer is an airline, it would most likely be able to derive the economic benefits from directing the use of the airplane on its own (for example, with its own flight crews). For any other customer (as well as an airline customer), it would be able to derive the economic benefits from directing the use of the airplane with readily available third-party flight crew services.

Appendix B: Initial staff thoughts on drafting the lease definition guidance

B1. The following represents the staff's initial thoughts on drafting the lease definition guidance, incorporating the Boards' tentative decisions reached at the May 2014 meeting and the staff recommendations in this paper. The proposed drafting also includes the staff's initial thoughts on drafting Alternative A discussed in this paper regarding the ability to derive the economic benefits from directing the use of an identified asset, which is set out in paragraph X15 below.

Identifying a lease

- X1. A lease conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
- X2. At inception of a contract, an entity shall determine whether that contract contains a lease by assessing both of the following:
- (a) whether fulfillment of the contract depends on the use of an identified asset; and
 - (b) whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.
- X3. When assessing whether a contract contains a lease, a joint arrangement can qualify as the customer (ie the entity that receives the good or service under the contract).

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

- X4. An asset would typically be identified by being explicitly specified in a contract. However, even if an asset is explicitly specified, fulfillment of a contract does not depend on the use of an identified asset if the supplier (ie the entity that provides the good or service under the contract) has the substantive right to substitute the asset throughout the period of use. In contrast, even if an asset is not explicitly specified in a contract, fulfillment of the contract can depend on the use of an identified asset if the

supplier does not have a substantive right to substitute the asset.

- X5 A supplier's right to substitute an asset is substantive if both of the following conditions are met:
- (a) the supplier has the practical ability to substitute alternative assets (ie the customer cannot prevent the supplier from substituting an 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 can benefit from the exercise of its right to substitute an asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).
- X6 If it is impractical for the customer to determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.
- X7 Fulfillment of a contract can depend on the use of an identified asset even if a supplier has the right or obligation to substitute other assets in place of the underlying asset if the asset is not operating properly or a technical upgrade becomes available. In addition, fulfillment of a contract can depend on the use of an identified asset even if a supplier has the right or obligation to substitute other assets for any reason only on or after a particular date.
- X8 A physically distinct portion of an asset (for example, a floor of a building) can be an identified asset. However, a capacity portion of an asset (for example, a capacity portion of a fibre-optic cable that is less than substantially all of the capacity of the cable) cannot be an identified asset because it is not physically distinct from the remaining capacity of the asset.

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

X9 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 do both of the following:

- (a) direct the use of the identified asset; and
- (b) obtain substantially all of the economic benefits from directing the use of the identified asset.

Right to direct the use of the identified asset

X10 A customer has the right to direct the use of an identified asset when it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

X11 A contract may include clauses designed to protect the supplier's interest in the asset or related assets, to protect its personnel, or ensure the supplier's compliance with laws or regulations. For example, a contract may:

- a) specify the maximum amount of use of an asset or when the customer can use the asset;
- b) give a supplier the right to approve a change in how or for what purpose the asset is used; or
- c) require a customer to follow prudent operating practices.

Such protective rights typically define the scope of the customer's use of the asset but do not, in isolation, prevent the customer from having the ability to direct the use of the asset.

X12 If neither the customer, nor the supplier, has the right to direct how and for what purpose the asset is used throughout the period of use, the customer still has the right to direct the use of the asset in the following circumstances:

- a) the customer has the right to operate the asset or to direct others to operate the asset in a manner that it determines,

with the supplier having no right to change those operating instructions.

- b) the customer designed the asset, or caused the asset to be designed, in a way that predetermines, during the period of use:
 - i) how and for what purpose the asset will be used; or
 - ii) how the asset will be operated.

X13 If the customer does not meet the criteria in either paragraph X10 or paragraph X12, the contract only conveys a right to the output from the asset. A customer's ability to specify the output of an asset at the beginning of the contract (for example, the quantity and description of goods or services produced by the asset) would not, in isolation, mean that a customer has the ability to direct the use of that asset. The ability to specify the output, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases services.

Right to obtain [Ability to derive¹] substantially all of the economic benefits from directing the use of the identified asset

X14 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the potential economic benefits from directing the use of the asset throughout the period of use. A customer can obtain economic benefits from directing the use of an asset directly or indirectly in many ways, such as by using, holding, or sub-leasing the asset. The economic benefits from directing the use of an asset include its primary output and by-products in the form of products and services, including cash flows derived from these items. Those economic benefits also include other economic benefits from directing the use of the asset that could be realized from a commercial transaction with a third party.

¹ Text in brackets and italics “[Xxxx]” denotes initial staff thoughts on drafting of Alternative A discussed in the main body of the paper if the Boards decide on that alternative.

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[X15 *The ability to derive the economic benefits from directing the use of an asset refers to its ability to derive a substantial portion of the economic benefits from directing the use of that asset either on its own or together with other resources that are readily available to the customer. A readily available resource is a good or service that is sold separately (by the supplier or any other entity) or a resource that can be sourced in a reasonable period of time.*]