Is it a lease? Boards defer decision on definition, make progress on other topics in leases project

What you need to know
- At their May 2014 meeting, the IASB and the FASB continued to seek ways to clarify and simplify their 2013 joint proposal on leases.
- The Boards reached converged decisions on how to separate lease and non-lease components, how to allocate contract consideration and the accounting for initial direct costs.
- The Boards deferred a decision on the definition of a lease. Instead, the Boards’ directed the staffs to draft language and further develop examples that demonstrate how the proposed definition would be applied.

Overview
The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) continued re-deliberating their 2013 proposal to put most leases on lessees’ balance sheets. At their May meeting, they focused on the definition of a lease and the proposed requirements for separating lease and non-lease components and accounting for initial direct costs.

The Boards directed their staffs to further develop the approach they recommended to clarify the definition of a lease, implicitly acknowledging that the definition of a lease is fundamental to the operability of any final standard. However, by reaching converged decisions on the other topics discussed, the Boards signalled that they continue to seek ways to minimise any differences between IFRS and US GAAP, while addressing constituents’ concerns that their 2013 proposal would have been too complex and costly to apply. It remains unclear when or whether the Boards will revisit their fundamental differences that arose earlier in re-deliberations on the proposed lessee and lessor accounting models. The Boards’ latest decisions, like all decisions to date, are tentative.

1 See the Exposure Draft: Leases on the IASB’s website.
2 See our IFRS Developments 75: Boards back away from some key aspects of leases proposal (AU2269).
Definition of a lease
The Boards did not reach a decision on the definition of a lease at the May meeting. Instead, they elected to continue to evaluate the staffs’ recommendations, which attempt to clarify the 2013 proposal. Under that proposal, the definition of a lease would require entities to determine whether a contract contains a lease by assessing whether:

- The fulfilment of the contract depends on the use of an identified asset
- The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration

The staffs recommended that the Boards retain this principle, but clarify how an entity would determine whether a contract depends on an identified asset and how to evaluate whether an entity has the right to control the use of such an identified asset.

Identified asset
Under the 2013 proposal, an asset would not be an identified asset if the supplier has a substantive substitution right (i.e., the supplier can substitute an alternative asset without the customer’s approval, and there are no barriers to such substitution). At the May meeting, the staffs recommended that the Boards clarify that fulfilment of a contract would depend on an identified asset when either of the following criteria is met:

- The supplier does not have the practical ability to substitute an alternative asset (e.g., the customer can prevent substitution, an alternative asset cannot be sourced by the supplier within a reasonable time period)
- The supplier would not benefit from substituting an alternative asset

A customer would presume that fulfilment of a contract depends on an identified asset when it is impractical to evaluate either of these criteria. No presumption for suppliers is necessary because they generally have sufficient information to make such a determination.

While the Boards did not reach a decision, they indicated that suppliers and customers would apply the criteria qualitatively.

Right to control the use of an identified asset
The 2013 proposal stated that an entity would have a right to control the use of an identified asset when the entity has the ability to both direct the use of the asset and obtain substantially all of the potential economic benefits from the asset’s use. Constituents said additional guidance was needed for determining whether a customer has the ability to direct the use of an identified asset in more complex arrangements such as those involving significant services (e.g., power purchase agreements, oil rigs).

To address these concerns, the staffs recommended providing additional guidance on how entities would determine when a customer has the ability to direct the use of the identified asset (e.g., how to identify the decisions that most significantly affect the economic benefits to be derived from the asset’s use and which party has the ability to most significantly affect those economic benefits, including when the supplier and customer both have decision-making rights). This recommendation appears to more closely align the ‘right to control’ concept with existing consolidation principles and the new revenue recognition standard\(^3\) the Boards issued on 28 May 2014. The staffs also recommended that certain guidance from the 2013 proposal for determining whether an asset is incidental to a supplier’s delivery of a service be excluded from any final standard.

How we see it
The Boards appeared to generally support the recommendations of their staffs. However, until a decision on the definition of a lease is reached, it will be unclear how certain concerns about the 2013 proposal are addressed.

\(^3\) IFRS 15 Revenue from Contracts with Customers.

Is it a lease? Boards defer decision on definition, make progress on other topics in leases project
Key decisions

Separating lease and non-lease components

The Boards agreed to retain the guidance proposed in 2013 for:

▶ Identifying separate lease components (i.e., in contracts that contain multiple rights of use) when the lessee can benefit from a right of use (on its own or with other readily available resources) and the underlying asset is not dependent on, or highly interrelated with, other underlying assets in the contract

▶ Separating the lease components and non-lease components of a contract and allocating contract consideration to each component

However, in a change from their 2013 proposal, the Boards agreed on a practical expedient that would permit lessees to make an accounting policy election (by class of underlying asset) to account for lease and non-lease components as a single lease component.

Identifying the components in a contract

The Boards decided that activities (or lessor costs) in a contract that do not provide the lessee with an additional good or service would not be considered lease or non-lease components, and lessees and lessors would not allocate contract consideration to such activities (or lessor costs). Examples might include certain administrative costs.

In their discussions, the Boards agreed that activities and costs, such as a lessor’s promises to provide services (e.g., common area maintenance), operate the underlying asset (e.g., vessel charter, aircraft wet lease), or pay for utilities consumed by the lessee would represent non-lease components.

Allocating contract consideration

The Boards agreed that lessees would allocate, subject to the practical expedient described above, contract consideration to the lease and non-lease components on a relative standalone price basis. Lessees would use observable standalone prices when available. However, the Boards clarified that lessees would be permitted to use estimated standalone prices when observable standalone prices are not available. In estimating standalone prices, lessees would be required to maximise the use of observable information and to apply estimation methods in a consistent manner. This would be similar to how lessees allocate contract consideration under IFRIC 4 Determining whether an Arrangement contains a Lease and ASC 840, Leases.

The Boards confirmed that lessors would be required to apply the new revenue recognition standard to allocate contract consideration between the lease and non-lease components of a contract.

The Boards also reached decisions about the reallocation of consideration in a contract. Lessees would be required to reallocate consideration upon a contract modification that is not accounted for as a separate, new contract, or upon a reassessment of the lease term or a lessee’s purchase option (i.e., whether the lessee is, or is not, reasonably certain to exercise the option). Lessors would be required to reallocate the consideration in a contract upon a modification that is not accounted for as a separate, new contract. Modifications resulting in a separate, new lease for lessors would require consideration to be allocated to the lease and non-lease components (as applicable), as with any new lease.

---

4 See our IFRS Developments 76: Boards make more progress on leases project (AU2323).
Initial direct costs
The Boards agreed to clarify that only incremental costs would qualify as initial direct costs. Costs, such as commissions, would be considered incremental if they would not have been incurred absent the lease being obtained (i.e., executed). From the lessor’s perspective, initial direct costs would be consistent with the concept of incremental costs in the new revenue recognition standard. The Boards also clarified that lessees and lessors would apply the same definition of initial direct costs.

Consistent with the 2013 proposal, lessors would include initial direct costs in the initial measurement of the lease receivable for Type A leases (generally finance leases today). However, the Boards clarified that initial direct costs related to Type A leases that include selling profit would be expensed at lease commencement. Lessors would recognise initial direct costs associated with Type B leases (generally operating leases today) over the lease term on the same basis as lease income, consistent with the 2013 proposal.

The Boards agreed that lessees’ initial measurement of the right-of-use asset would include initial direct costs. Lessees’ costs that are incurred in a lease modification and meet the definition of initial direct costs would be included in the measurement of the new right-of-use asset (i.e., for a modification that results in a separate, new lease) or the adjustment to the right-of-use asset (i.e., for a modification that does not result in a separate, new lease). 4

How we see it
For IFRS, the Boards’ decision to clarify that only incremental costs would qualify as initial direct costs is consistent with the recent IFRS Interpretations Committee discussions on incremental costs under IAS 17 Leases. For US GAAP, the Boards’ decision would result in two key changes in practice —lessors’ initial direct costs would exclude allocated internal costs (e.g., salaries) and costs incurred before the lease is executed (e.g., legal advice, tax advice).

What’s next
In June 2014, the Boards plan to re-deliberate residual value guarantees, subleases and sale-leaseback accounting. A final standard is not expected before 2015.

4 See our IFRS Developments 76: Boards make more progress on leases project (AU2323).