Boards reaffirm the definition of a lease but continue to work on its application

What you need to know

- The Boards reaffirmed that a lease would 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, as they proposed in their 2013 proposal.
- The Boards decided that a customer would have the right to direct the use of an identified asset whenever the customer 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.
- The Boards deferred a decision on another aspect of whether a customer has the right to control the use of an identified asset and asked their staffs to further develop the proposed approaches.

Highlights

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) continued redeliberating their 2013 proposal to put most leases on lessees’ balance sheets. At their October 2014 joint meeting, the Boards reaffirmed their proposed definition of a lease and decided how portions of that definition would be applied. They also discussed an additional clarification, but deferred a decision on it until a future meeting.

The Boards discussed the definition of a lease in May 2014, but deferred decisions on the definition and clarifications at that time. Instead, they directed their staffs to draft language and further develop examples to demonstrate how the definition in the 2013 proposal would be applied to complex arrangements such as those involving significant services (e.g., power purchase agreements, oil rigs). The Boards’ latest decisions, like all decisions to date, are tentative.

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1 See the Exposure Draft: Leases on the IASB’s website.
Key decisions
The Boards reaffirmed that a lease would 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. This definition is consistent with their 2013 proposal. Under this definition, entities would determine whether a contract contains a lease by assessing whether:

- The use of an identified asset is either explicitly or implicitly specified
- The contract conveys to the customer the right to control the use of the identified asset throughout the period of use

The Boards also reaffirmed that 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. The Boards decided that a substitution right would be substantive if the supplier has the practical ability to substitute the asset and can benefit from exercising that right.

Further, the Boards agreed that 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 direct the use of the identified asset and obtain substantially all of the economic benefits from directing the use of the identified asset.

At this meeting, the Boards agreed on how an entity would determine whether the customer has the right to direct the use of the identified asset. The Boards explored but deferred decisions on whether a contract would contain 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.

**Right to direct the use of an identified asset**

The Boards decided 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 period of use. The Boards believe that, in most circumstances, these are the decisions that most significantly affect the economic benefits that can be derived from the use of the underlying asset.

If neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use (e.g., when how and for what purpose the asset can be used are predetermined in the contract), the Boards decided the customer would have the right to direct the use of the identified asset in either of the following circumstances:

- The customer has the right to operate the asset or direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions)
- The customer designed the asset, or caused it to be designed, in a way that predetermines how and for what purpose the asset will be used or how it will be operated

The Boards also decided that a supplier’s protective rights, in isolation, would not prevent the customer from having the right to direct the use of an identified asset. However, the Boards believe that protective rights typically define the scope of the customer’s use of the asset. Protective rights are intended to protect a supplier’s interests (e.g., interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use or a requirement to follow specific operating instructions.
How we see it

- Until the Boards complete their redeliberations on issues related to the definition of a lease, it is not clear how their decisions on a customer’s ‘right to direct the use of an asset’ would be applied.
- In addition, we still have questions related to how the Boards’ definition would be applied to a contractual arrangement when significant services are included and the major terms of those services have been predetermined. That is, does the customer have the right to control the use of the identified asset when virtually all of the operating decisions have been predetermined? It is also unclear to us what decisions come into play in making the assessment.

Other discussion topics

**Derive the benefits from directing the use of an identified asset**

The Boards discussed clarifying how the economic benefits portion of the definition of a lease would be applied, including whether a contract would contain 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. The Boards instructed their staffs to consider feedback from Board members and to bring the issue back to a future Board meeting.

**Next steps**

Before drafting a standard, the Boards need to complete their redeliberations on the definition of a lease and address several remaining issues, including the IASB’s recognition and measurement exemption for leases of small assets, lessee disclosures, transition, effective date and consequential amendments to other standards. The FASB will also separately discuss not-for-profit issues. A standard is not expected before the third quarter of 2015.