



August 14, 2013

Memorandum

To: Members of the Board
M.R. Valentine
From: Monica R. Valentine, Assistant Director
Wendy M. Payne
Through: Wendy M. Payne, Executive Director
Subject: Leases Project – **Tab B¹**

MEETING OBJECTIVES

To review the lease definition and scope issues currently being addressed by GASB in the context of the federal environment.

BRIEFING MATERIAL

- ☐ Staff Memo
 - FASAB Staff Analysis and Board Questions on the Leases Project
- ☐ Attachments –
 - I. GASB Staff Issue Papers on Lease Project
 - II. Excerpts from FASB s Revised ED on Leases

BACKGROUND

The Lease project is being undertaken by the Board primarily because the current lease accounting standards, SFFAS 5 and 6, have been criticized as ineffective because they do not make meaningful distinctions between capital and operating leases regarding the substance of lease transactions. In addition, the lease accounting standards in SFFAS 5 and 6 are based on Financial Accounting Standards Board (FASB) lease accounting standards which are currently being revised. The FASB and International Accounting Standards Board (IASB) have undertaken a joint project on lease accounting that

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

focuses on the conveyance of rights to future economic benefits (such as the right of use).

In May 2013 the FASB released a revised exposure draft (ED) on Leases. Since the release of the FASB ED, the Governmental Accounting Standards Board (GASB) has begun Board discussions to reexamine issues associated with lease accounting and consider improvements to existing guidance. FASAB staff is currently working with the GASB staff to coordinate our efforts where applicable to develop new lease accounting standards.

The primary objective for this meeting's discussion is to consider the lease definition and scope issues currently being addressed by GASB.

Member feedback on the information presented will direct staff on the next steps to take in the project.

**Staff Analysis and Questions for Board Consideration on the
FASAB Leases Project**

Note: Staff suggests reading the attached GASB issue papers (Attachment I) before considering the below FASAB staff analysis and Board questions because the GASB issue papers are the basis for our analysis and questions.

GASB ISSUE 2², PAPER 1:

- ❖ **Scope of the Lease project** – *GASB Question 1: What topics should be considered within the scope of the Leases project? The GASB project staff recommended that the Leases project consider all topics currently in the GASB's lease literature (Category 1) and one other relevant topic about which there currently is not GASB guidance (SCA-like situations from Category 3).*

GASB has tentatively agreed to address the following topics in its leases project:

- Scope and definition of a lease
- Classification of leases
- Fiscal funding or cancellation clauses
- Accounting and reporting by lessees, including disclosures
- Accounting and reporting by lessors, including disclosures
- Leases involving real estate
- Leases between state and local governments and public authorities
- Leases between related parties
- Sale-leaseback transactions
- Sale-leaseback transactions involving real estate
- Accounting and reporting for subleases and similar transactions
- Accounting and reporting for leveraged leases
- Service Concession Agreement (SCA)-like agreements

The current FASAB standards on Leases are outlined in SFFAS 5 & 6.

- **SFFAS 5, Accounting for Liabilities of the Federal Government**

Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or

² Note that GASB numbers issues addressed at each meeting. The FASAB equivalent would be "projects." So, "Issue 2" references "leases" which was the second topic addressed at the August GASB meeting. Also, GASB may provide multiple papers to facilitate discussion of different aspects of a single issue. In this case, "PAPER 1" addresses scope matters and "PAPER 2" addresses definitional matters.

more of the following four criteria, the lease should be classified as a capital lease by the lessee:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains an option to purchase the leased property at a bargain price.
- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property. If a lease does not meet at least one of the above criteria it should be classified as an operating lease. (*paragraph 43*)

The amount to be recorded by the lessee as a liability under a capital lease is the present value of the rental and other minimum lease payments during the lease term, excluding that portion of the payments representing executory cost to be paid by the lessor. [footnote ²⁰: “The cost of general property, plant, and equipment acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease at its inception. [See SFFAS No. 6, Accounting for Property, Plant, and Equipment.] However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the liability should be the fair value. If the portion of the minimum lease payments representing executory cost is not determinable from the lease provisions, the amount should be estimated. (*paragraph 44*)

The discount rate to be used in determining the present value of the minimum lease payments ordinarily would be the lessee’s incremental borrowing rate unless (1) it is practicable for the lessee to learn the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the lessee’s incremental borrowing rate. If both these conditions are met, the lessee shall use the implicit rate. The lessee’s incremental borrowing rate shall be the Treasury borrowing rate for securities of similar maturity to the term of the lease. (*paragraph 45*)

During the lease term, each minimum lease payment should be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability. [footnote ²¹: OMB Circular No. A-11, “Preparation and Submission of Annual Budget Estimates,” explains the measurement of budget authority, outlays, and debt for the budget in the case of lease-

purchases and other capital leases. Circular A-94, “Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs,” provides the requirements under which a lease-purchase or other capital lease has to be justified and the analytical methods that need to be followed.] (paragraph 46)

- **SFFAS 6, Accounting for Property, Plant, and Equipment (PP&E)**

Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria, [footnote ⁷: Note that the criteria for identifying capital leases for financial reporting purposes differ from OMB criteria for budget scoring of leases. OMB Circular No. A-11, *Preparation and Submission of Budget Estimates*, includes criteria for identifying operating leases in Appendix B. OMB provides four additional criteria which relate to the level of private sector risk involved in a lease-purchase agreement. This is necessary because, for budget purposes, there is a distinction between lease-purchases with more or less risk. This distinction is not made in the financial reports and, therefore, FASAB does not include the four criteria related to risk levels.] the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease. [footnote ⁸: “Operating leases” of PP&E are leases in which the Federal entity does not assume the risks of ownership of the PP&E. Multi-year service contracts and multi-year purchase contracts for expendable commodities are not capital leases.]

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains an option to purchase the leased property at a bargain price.
- The lease term is equal to or greater than 75 percent of the estimated economic life [footnote ⁹: “Estimated economic life of leased property” is the estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.] of the leased property.
- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value [footnote ¹⁰: “Fair value” is the price for which an asset could be bought or sold in an arm’s-length transaction between unrelated parties (e.g., between a willing buyer and a willing seller). (adapted from Kohler’s Dictionary for Accountants)] of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property. (paragraph 20)

The cost of general PP&E acquired under a **capital lease** shall be equal to the amount recognized as a liability for the capital lease at its inception (i.e., the net present value of the lease payments calculated as specified in the liability standard [footnote ²¹: See Statement of Recommended Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*.] unless the net present value exceeds the fair value of the asset). (paragraph 29)

➤ **Staff Analysis**

The current FASAB guidance on leases is minimal and is in need of improvement. Revised lease standards are necessary to fully address the various lease transactions/activities currently being used in the federal community.

Question 1: What topics should be considered within the scope of the FASAB leases project?

Staff Recommendation

Staff recommends that all of the topics tentatively agreed to be addressed by GASB (listed above) should also be addressed in the FASAB project, with the following qualifications. GASB has tentatively agreed to address “Leases between state and local governments and public authorities,” since this topic is not applicable to the federal sector staff recommends revising this topic to “Leases between federal entities.” Also, more research is necessary to determine the extent of sale-leaseback, leveraged lease, and SCA-like transactions within the federal community. Staff also recommends adding enhanced use leases³ to the project’s scope.

If the Board agrees with staff, we would continue our research on the tentatively agreed topics and identify any other areas for scope inclusion or exclusion

GASB ISSUE 2, PAPER 2:

- ❖ **Definition of a Lease – “Agreement” vs. “Contract”** – *GASB Question 1: Should the term “contract” be used instead of “agreement” in the definition of a lease? The GASB project staff recommended the term “contract” over “agreement” because “contract” emphasizes the legal enforceability of the lease terms and conditions and “agreement” can be an informal arrangement between parties.*

The **FASB ED** on Leases proposes the following definition for lease – *A contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.*

³ **Enhanced Use Lease** – Typically a long-term agreement with public and private entities for the use of federal property, resulting in cash and/or in-kind consideration for the agency—or to retain the proceeds from the sale of real property. (*Federal Real Property: Authorities and Actions Regarding Enhanced Use Leases and Sale of Unneeded Real Property* -- GAO-09-283R, 02/17/2009)

GASB's current lease definition -- *An agreement conveying the right to use capital assets (land and/or depreciable assets) usually for a stated period of time.* **GASB** has tentatively agreed to modify its lease definition by changing from “agreement” to “contract.”

The current **FASAB** standards do not have a definition of lease; however “capital lease” and “operating lease” are both defined in SFFAS 6. “**Capital leases** are leases that transfer substantially all the benefits and risks of ownership to the lessee. **Operating leases** of PP&E are leases in which the Federal entity does not assume the risks of ownership of the PP&E. Multi-year service contracts and multi-year purchase contracts for expendable commodities are not capital leases.” (SFFAS 6, paragraph 20)

➤ **Staff Analysis**

In the federal environment, the term “contract” could narrow the scope of leasing activities applicable under the standard. There are instances when a federal lease arrangement may not contain all of the elements of a contract (i.e., an offer, acceptance of the offer, consideration, and intent to be legally enforceable/bound). For example, legal enforceability may not always be a clear element with federal lease arrangements.

Question 2: Should the term “contract” or “agreement” be used in the FASAB definition of a lease?

Staff Recommendation

Staff recommends that the FASAB definition of lease use the term “agreement” as opposed to “contract” because using “contract” could narrow the scope of the lease standards and not capture all leasing transactions involving federal entities.

❖ **Definition of a Lease – “Asset” vs. “Capital Asset/Property, Plant & Equipment”** – *GASB Question 2: Should the term “asset (the underlying asset)” be used instead of “capital assets (land and/or depreciable assets)” in the definition of a lease? The GASB project staff recommends replacing the term — “capital assets (land and/or depreciable assets)” with the term — “asset (the underlying asset)” in the definition of a lease in the existing GASB Standards. One reason given is the scope of an asset is broader and more inclusive than capital asset.*

In **GASB** Concepts Statement No. 4, *Elements of Financial Statements*, paragraph 8, assets are defined as — “resources with present service capacity that the government presently controls.” GASB has tentatively agreed to use “asset (the underlying asset)” in its definition of lease.

In **FASAB** SFFAC 5: *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements* defines an asset as – “a resource that embodies economic benefits or services that the federal government controls.”

In **FASAB** SFFAS 6, property, plant, and equipment (PP&E) consists of tangible assets, including land, that meet the following criteria:

- they have estimated useful lives of 2 years or more;
- they are not intended for sale in the ordinary course of operations; and

- they have been acquired or constructed with the intention of being used, or being available for use by the entity.

➤ **Staff Analysis**

Although many federal leasing activities involve PP&E, the scope of the leasing standard should not be limited to only PP&E assets. PP&E assets are limited to tangible assets. Also, the three criteria for PP&E would further narrow the scope of the lease standard.

Question 3: Should the term “asset” or “property, plant, & equipment” be used in the FASAB definition of a lease?

Staff Recommendation

Staff agrees with GASB tentative decision to use the broader term “asset” as opposed to “property, plant, & equipment” which could narrow “leases” in a way that leads to similar activities being excluded from coverage of the standards. Staff believes narrowing should be accomplished through specific exclusions (the approach taken by the FASB and IASB) as they are likely to be clearer to the reader.

- ❖ **Definition of a Lease – Addition of “in Exchange for Consideration” -- GASB**
Question 3: Should the phrase “in exchange for consideration” be added to the definition of a lease? GASB project staff believes that the phrase — “in an exchange or exchange-like transaction” should be added to the definition instead of — “in exchange for consideration.”

GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, defines an **exchange-like transaction** as – “one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transactions. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition.” GASB staff believes that using “in exchange for consideration” alone would exclude both nonexchange and exchange-like transactions from the scope of the lease standards. Additionally, they noted that nonexchange lease transactions will be adequately addressed in GASB Statement no. 33. GASB has tentatively agreed to add the phrase — “in an exchange or exchange-like transaction” to the lease definition.

Current **FASAB** standards define exchange and nonexchange transactions, but do not include a definition of “exchange-like transactions.” The FASAB terms are defined in SFFAS 5, paragraphs 22 & 24 – “an **exchange transaction** arises when each party to the transaction sacrifices value and receives value in return. There is a two-way flow of resources or of promises to provide resources. A **nonexchange transaction** arises when one party to a transaction receives value without directly giving or promising value in return. There is a one-way flow of resources or promises.”

FASAB has also addressed the distinction between exchange and nonexchange transactions in the context of revenue. SFFAS 7, *Accounting for Revenue and Other*

Financing Sources, states that “an exchange transaction occurs when one party sacrifices value and receives a valuable good or service in return.” It further provides that “nonexchange revenues arise primarily from exercise of the Government’s power to demand payments from the public, such as taxes, duties, fines, and penalties.” SFFAS 7 also established disclosure requirements regarding exchange revenue. Federal entities are required to disclose instances when pricing policies for programs with exchange revenue require prices that are not based on either full cost or market value.

The GASB literature specifies that in an exchange each party receives and gives up essentially equal values. In contrast, the FASAB standards do not address whether the exchange is of essentially equal values. In both SFFAS 5 and 7, the standards provide guidance to classify specific transactions. For this reason, staff believes it is reasonable to assume exchange-like transactions as defined by GASB are classified as exchange transactions by federal entities.

➤ **Staff Analysis**

Since current FASAB standards do not use the term “exchange-like transactions” we will not specifically address the question in the same manner as GASB. However, the FASAB needs to address whether “a lease” arises in nonexchange transactions. For example, should an agreement through which a host government (e.g., another nation or a state government) provides use of a facility free of charge for a period of time qualify as a lease? The accounting consequence would be potential recognition of the right of use of the facility as an asset and the gift of the use as a “revenue” (or deferred revenue). Given that an asset is a resource that embodies economic benefits or services that the federal government controls, a key question is whether “control” is established through a nonexchange transaction. Assuming it can be, the Board may wish to consider whether the matter should be addressed in standards for “leases” or through standards tailored to such nonexchange transactions (the GASB approach).

Staff needs to do additional research to determine the extent of nonexchange or “exchange-like” leasing transactions within the federal government. If our research shows that nonexchange and “exchange-like” leasing transactions are prevalent in the federal environment and not addressed in current FASAB guidance, staff would consider the facts and make the appropriate recommendations concerning those leasing transactions.

Question 4: Should staff assess the prevalence of nonexchange and “exchange-like” leasing transactions and whether “control” of a resource is generally conveyed in such transactions in the federal environment?

Staff Recommendation

Staff recommends that we make this assessment. While we believe “exchange-like” transactions are generally included in “exchange transactions” under the current federal standards, we should confirm this. In addition, we are aware that there are agreements allowing use of facilities for nominal (\$1) or even no fees we do not know the extent to which these are used.

- ❖ **Notions Supporting the Definition of a Lease – Explanatory Guidance -- GASB**
Question 4: Should the explanatory guidance be included in the text of the standard? GASB project staff does not believe that the explanatory guidance should be included in the text of the standard.

Immediately following the definition of a lease **FASB's** ED provides further explanatory guidance to assist in determining if an arrangement is a lease.

At inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing both of the following:

- a. Whether fulfillment of the contract depends on the use of an identified asset.
- b. Whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

The GASB project staff believes that this type of explanation is better suited for implementation guidance rather than text of a standard.

➤ **Staff Analysis**

Staff believes that this question should be deferred until the proposed lease standards are further developed. We believe that it is premature to decide whether this explanatory language is appropriate. Two key differences between GASB and FASAB may lead us to a different conclusion – FASAB establishes standards for a single reporting entity so more detailed guidance at the standards level may be cost-effective and FASAB does not publish a comprehensive implementation guide as is GASB's practice so timely guidance (as an illustration or within the standards) may be helpful.

Question 5: Should the question concerning the explanatory guidance to assist in determining if an arrangement is a lease included in the FASB ED be deferred until the FASAB lease standards are further developed?

Staff Recommendation

Staff recommends that this question be deferred until the proposed lease standards are further developed.

- ❖ **Scope of Standards – Inclusions -- GASB Question 5: Should the current inclusion continue for the agreements that are not called lease but are in-substance leases? The GASB project staff believes that contracts that are not identified as leases but meet the definition of a lease should continue to be included in the lease literature. GASB Question 6: Should a heat supply contract continue to be included as an example of a lease that is within the scope of the lease literature? The GASB project staff believes the example of a heat supply contract should be removed from the lease literature.**

FASB Statement 13, paragraph 1, states that a lease: — “includes agreements that, although not nominally identified as leases, meet the above definition, such as a ‘heat supply contract’ for nuclear fuel.” It is also states that — “agreements that do transfer

the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.”

The **GASB** project staff recommended that for the purpose of defining a lease, it is necessary to continue to include agreements that meet the definition of a lease, but are not self-described as leases. The GASB project staff believes that the nature of those agreements reflects the substance of a lease, which is to transfer the right to use the underlying asset. GASB has tentatively decided that the current inclusion continue for the agreements that are not called leases but are in-substance leases.

The **GASB** project staff does not believe it is appropriate to continue to include the example of a heat supply contract, as this specific contract has very limited applicability in the government environment. The example of a heat supply contract was included in GASB Statement 62 because it was written in FASB Statement 13. GASB has tentatively agreed with its staff’s recommendation to remove the specific “heat supply contract” example from the scope section of the lease standard.

➤ **Staff Analysis**

Staff agrees with GASB’s tentative decision that the current inclusion continue for the agreements that may not be called leases but are in-substance leases for the same reasons noted above by the GASB staff – if the nature of the agreements reflect the substance of a lease, they should be included within the scope of the lease standards. For example, GSA intra-governmental leases are referred to as “occupancy agreements.”

Staff is not currently aware of the applicability of “heat supply contracts” in the federal environment. Additional staff research is necessary to determine if federal entities are involved in “heat supply contracts.” Therefore we believe this topic should be deferred until staff determines the applicability of these contracts in the federal environment.

Question 6: Should the scope of FASAB lease standards include agreements that reflect the substance of a lease even if they are not called a lease? Should FASAB defer the decision to include or exclude “heat supply contracts” as an example in the lease standards?

Staff Recommendation

Staff recommends that the scope of FASAB lease standards include agreements that reflect the substance of a lease even if they are not called a lease. Staff also recommends deferring the decision to include or exclude “heat supply contracts” as an example in the FASAB lease standards.

❖ **Scope of Standards – Exclusions** -- *GASB Question 7: Should the current exclusions continue for the scope of leases? The GASB project staff believes that*

scope exclusions, as discussed below, should continue to be consistent with those excluded by the FASB.

The GASB staff recommended that for the purpose of defining a lease, the current exclusions existing in GASB Statement 62 should be continued, for the following reasons:

- Agreements that are contracts for services that do not transfer the right to use capital assets from one contracting party to the other do not meet the definition of leases.
- Leases to explore for or use of minerals, oil, natural gas, and similar nonregenerative resources should be excluded, because of the complexity of this topic. While many governments may be lessors in these types of arrangements, few are lessees. It would be difficult to explore accounting for these situations without a larger research effort into extractive activities. The FASB excluded these arrangements from its proposal for these reasons.
- Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights should be excluded because they are examples of intangible assets. The topic of intangible assets is complex, and was addressed in GASB Statement 51. The FASB's proposal excluded intangible assets from the scope in favor of reviewing all accounting issues related to intangibles in a separate project. The FASB's proposal removes references to these specific types in favor of excluding intangible assets in general.
- Agreements that meet the definition of a service concession arrangement (SCA) should be excluded because the guidance on SCA were provided in GASB Statement 60. The IASB similarly scoped out SCAs because it has separate guidance for those arrangements, though the project staff notes that the IASB's definition of SCA is slightly different from the GASB's definition.
- Additionally, because of the complexity of the topics, the GASB staff recommended that the following exclusions from the FASB's ED be added:
 - Leases of intangible assets.
 - Leases of biological assets, including timber.

GASB has tentatively agreed to continue all existing GASB exclusions (contracts for services, oil/gas/etc., licensing agreements, and service concession arrangements), add an exclusion for biological assets, but not exclude all intangibles (keep the status quo where some are in scope and some are not).

➤ **Staff Analysis**

- Agreements that contract for services that do not transfer the right to use an asset from one contracting party to the other would not meet the basic premise of a lease which transfers/conveys the right to use an asset.
- Federal natural resources is defined in Technical Bulletin (TB) 2011-1: *Accounting for Federal Natural Resources Other than Oil and Gas* as – resources that occur in nature (including nonrenewable and renewable natural resources) and meet all of the following criteria: (a) the federal government may exercise sovereign rights over the resources with respect to exploration and exploitation; (b) the federal government has the authority to derive revenues from the resources for its use; and, (c) the resources are contained on federal lands or the federal government substantially manages and/or controls the resources. Leases involving oil and gas are covered in SFFAS 38: *Accounting for Federal Oil and Gas Resources* and leases involving other federal natural resources is covered in TB 2011-1.
- Intangible assets, other than internal use software (which is considered to be PP&E), are not addressed in the current FASAB standards. Additional staff research is necessary to determine the extent federal entities are involved in leasing activities of intangible assets other than internal use software.
- Service concession arrangements (SCAs) will be addressed in the FASAB Public-Private Partnership project. GASB 60, *Accounting and Financial Reporting for Service Concession Arrangements*, defines SCAs – “a type of public-private or public-public partnership. An SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental entity) in which (1) the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset (a “facility”) in exchange for significant consideration and (2) the operator collects and is compensated by fees from third parties.”

Question 7: Should the scope of FASAB lease standards exclude the above four bulleted topics?

Staff Recommendation

Staff recommends that the scope of FASAB lease standards exclude three of the above four bulleted topics, with the exception being internal use software and other intangible assets that will be further researched?

- ❖ **Draft Standard Language – Scope and Applicability** -- *GASB Question 8: What comments does the GASB Board have about the draft text shown above? The GASB project staff believes the draft text illustrates the recommendations made previously in the [GASB issue] paper.*

GASB project staff proposed the following language:

Draft Standard - Scope and Applicability of This Statement

XX. This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For purposes of applying this Statement, a lease is defined as a contract that conveys the right to use an asset (the underlying assets) for a period of time in an exchange or exchange-like transaction. It includes contracts that, although not nominally identified as leases, meet the above definition. This definition does not include contracts for services that do not transfer the right to use capital assets from one contracting party to the other. However, contracts that do transfer the right to use capital assets meet the definition of a lease for purposes of applying this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

XX. This Statement does not apply to lease contracts concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does this Statement apply to leases of biological assets, including timber. This Statement does not apply to leases of intangible assets, including licensing contracts for items such as motion picture films, plays, manuscripts, patents, and copyrights. This Statement also does not apply to contracts that meet the definition of a service concession arrangement in Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*.

GASB staff will be re-drafting the above proposed language to make the necessary edits based on the Board's tentative decisions and other minor edits.

➤ **Staff Analysis**

Staff believes that there are several scope issues that need to be researched and addressed by the Board before proposed draft standard language related to the scope and applicability of the lease standard can be developed.

Question 8: Should the proposal of draft standard language related to the scope and applicability of the lease standard be deferred until the further staff research can be performed on those scope issues identified earlier in the paper?

Staff Recommendation

Staff recommends that the proposal of draft standard language related to the scope and applicability of the lease standard be deferred until the further staff research can be performed to address the scope issues identified earlier in the paper.

Questions for the Board

1. What topics should be considered within the scope of the FASAB leases project?
2. Should the term “contract” or “agreement” be used in the FASAB definition of a lease?
3. Should the term “asset” or “property, plant, & equipment” be used in the FASAB definition of a lease?
4. Should staff assess the prevalence of nonexchange and “exchange-like” leasing transactions and whether “control” of a resource is generally conveyed in such transactions in the federal environment?
5. Should the question concerning the explanatory guidance to assist in determining if an arrangement is a lease included in the FASB ED be deferred until the FASAB lease standards are further developed?
6. Should the scope of FASAB lease standards include agreements that reflect the substance of a lease even if they are not called a lease? Should FASAB defer the decision to include or exclude “heat supply contracts” as an example in the lease standards?
7. Should the scope of FASAB lease standards exclude service contracts that do not transfer the right to use an asset, leases involving natural resources, leases involving intangible assets, and service concession arrangements?
8. Should the proposal of draft standard language related to the scope and applicability of the lease standard be deferred until the further staff research can be performed on those scope issues identified earlier in the paper?

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MEMORANDUM

Issue 2, Paper 1
August 2013 Meeting

To: Board Members and David Bean
From: Deborah Beams, Randy Finden, Jialan Su,
Ken Schermann, Christopher Teats, Kathryn Walsh
c: GASB Staff, Task Force Members, and Meeting Observers
Date: July 23, 2013
Re: Leases Project: History and Scope of the Project

This paper introduces the Leases project. It begins with a history of the current literature to provide background information. It then discusses options for defining the scope of the project and includes as Appendix A the project plan based on the staff recommendations for the scope of the project. This version includes more detail than the technical plan to show when all of the topics mentioned in the paper are proposed to be considered during the deliberations.

CURRENT LITERATURE

1. Private Sector Lease Pronouncements

The lease literature consists of numerous pronouncements by several standard setters. An early pronouncement that addresses lease accounting is found in Chapter 14, "Disclosure of Long-Term Leases in Financial Statements of Lessees," of Accounting Research Bulletin No. 43, *Restatement and Revisions of Accounting Research Bulletins*, issued June 1953. The focus was on disclosures of amounts payable. The amounts of annual rentals to be paid, with some indication of the periods for which they are payable, and any other "important obligation" assumed or guarantee made should be disclosed. When it is "clearly evident" that a lease is a purchase in substance, the leased property "should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement" (Chapter 14, paragraph 7). No explanation of "clearly evident" is provided.

Accounting Principles Board (APB) Opinion No. 5, *Reporting of Leases in Financial Statements of Lessees*, was issued September 1964. That Opinion stated that leases

that provide a lessee with a material equity in the leased asset represent purchases. That said, only leases that “are clearly in substance installment purchases of property . . . should be recorded as purchases” (paragraph 15). Factors to be considered are whether the initial term is less than the useful life of the property and if the lessee at the end of the lease has the right to acquire the asset at a price that appears to be substantially less than the probable fair value of the property (paragraph 10). On the other hand, a lease that merely gives a right to use property in exchange for future rental payment does not create an equity stake in the property (paragraph 7). The Opinion described these types of leases (operating leases) as being like service contracts, where the lessor has a continuing performance obligation to the lessee in each period, to provide the use of the asset for that period.

APB Opinion No. 7, *Accounting for Leases in Financial Statements of Lessors*, was issued November 1966. Lessor accounting, however, is not symmetrical with lessee accounting. Lessors should capitalize leases when risks and rewards of ownership have been transferred to the lessees (paragraph 8). Operating leases do not transfer risks and rewards of ownership. In contrast to the lessee criteria that capitalized leases must clearly be installment purchases, lessors should pick the lease method that fairly reflects net income (paragraph 10). The choice of method provided in APB Opinion 7 was between an operating lease and a financing lease.

Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, (issued November 1976) was intended to bring symmetrical criteria for classification between lessor and lessee accounting (Basis for Conclusions [BFC], paragraph 67). “A lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the occurrence of an obligation by the lessee and as a sale or financing by the lessor” (BFC, paragraph 60). FASB Statement 13, unamended, is not particularly long, with only 51 paragraphs. On the other hand, current codified text is 186 pages.

Some FASB members (though not a majority) supported the issuance of Statement 13 but believed that regardless of whether substantially all the benefits and risks of ownership are transferred, a lease gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee. They believed that such an asset and obligation should be reflected in the lessee's financial statements (BFC, paragraph 63). This view is consistent in part with the FASB's recently issued revised Exposure Draft, *Leases* (FASB's ED).

The FASB's current project on leases, a joint project with the International Accounting Standards Board (IASB), was undertaken based on a recommendation from the Securities and Exchange Commission in its 2005 publication, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*. That report criticized the existing lease accounting model for the off-balance sheet treatment of certain leases, and particularly the bright-line test used to determine that treatment. The FASB and the IASB issued an Exposure Drafts in August 2010 that proposed a single model for leases that would put all leases on the balance sheet. Based on feedback received since then, the FASB and the IASB issued the previously-mentioned revised Exposure Drafts in May 2013.

2. Public Sector

In March 1979, the National Council on Governmental Accounting (NCGA) issued Statement 1, *Governmental Accounting and Financial Reporting Principles*. In a footnote, the Statement indicates that state and local governments should apply FASB Statement 13 (footnote 6 of NCGA Statement 1). NCGA Statement 1, however, provides no specifics, such as how leases should be reported in governmental funds.

Three years later, in December 1982, the NCGA issued Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*. The Statement indicates that the NCGA observed inconsistent application of FASB

Statement 13. It also specified that amendments to and interpretations of FASB Statement 13 should be followed, in addition to the Statement itself. When following FASB Statement 13, if the lease is a capital lease, the lease agreement should be capitalized. When there is a capital lease reported in a governmental fund, the lessee should report an addition to both the general fixed asset and the long term debt account groups, and a capital expenditure and an other financing source. The lessor should report a lease receivable and deferred revenue. On the other hand, leases reported in business type activities should apply FASB Statement 13 without modification. Fiscal funding or cancellation clauses are also addressed in NCGA Statement 5. If the possibility of cancellation is remote, leases that meet the capitalization criteria should be capitalized (paragraph 21). Accounting for leases between a government and a public authority depends on whether the authority is part of the government's reporting entity. If the authority is part of the government's reporting entity, the authority's debt and assets should be reported as the government's asset or debt. If the authority is not part of the reporting entity, the lease should be reported as any other lease between unrelated parties.

In May 1990, the Governmental Accounting Standards Board (GASB) issued Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*. The Statement provided that governments should account for operating leases with scheduled rent increases by using the terms of the lease contract when the pattern of the payment requirements is systematic and rational. This includes lease agreements that specify scheduled rent increases over the lease term that are intended to cover economic factors relating to the property, such as the anticipated effects of cost increases or property value appreciation. If, however, an operating lease contains payment requirements in a particular year that are artificially low (for example, to ease the lessee's near-term cash flow requirements), governments should measure the operating lease transactions either on a straight-line basis over the lease term or based on the estimated fair value of the rental. This is a difference from the private-sector guidance, which requires straight-line recognition in most cases.

In December 2010, the GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. Leases are addressed in paragraphs 211–271. Those paragraphs are a compilation of the following pronouncements:

- FASB Statement 13
- FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt*
- FASB Statement No. 98, *Accounting for Leases*
- FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*
- FASB Interpretation No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*
- FASB Interpretation No. 24, *Leases Involving Only Part of a Building*
- FASB Interpretation No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease*
- FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*

Specific criteria is provided for lease classifications:

- Lessees should classify leases as either capital or operating leases
- Lessors should classify leases as one of the following: sales-type leases, direct financing leases, leverage leases, or operating leases.

Statement 62 originally included the provisions from FASB Statement 13 for recognizing lease expense (lessee) or revenue (lessor) on a straight-line basis, which could be viewed as being contradictory to the guidance in GASB Statement 13, as previously discussed. GASB Statement No. 66, *Technical Corrections—2012*, clarified the stating of GASB Statement 13 by deleting paragraph 222 from Statement 62.

The public-sector statements described in this section are compiled in section L20 of the GASB codification. The scope of the lease guidance in that section is the focus of this month's lease papers.

SCOPE OF THE PROJECT

Within the broad subject of leases there are many topics for discussion, including what is a lease, accounting treatment by lessees, accounting treatment by lessors, note disclosures, and special topics such as sale-leasebacks and leases between related parties. The project staff has organized these topics into three categories for possible inclusion in the scope of the project. The categories are as follows: Category 1—Current literature, Category 2—Topics addressed in FASB ED, but not in the current literature, and Category 3—Additional topics.

Category 1—Current Literature

This Category involves evaluating each of the topics already covered in the GASB literature in light of the FASB's proposals as well as for consistency with GASB Concepts Statements that have been issued since the lease literature went into effect. It would involve evaluation of each section within L20 of the GASB Codification. This includes:

- Scope and definition of a lease
- Classification of leases
- Fiscal funding or cancellation clauses
- Accounting and reporting by lessees, including disclosures
- Accounting and reporting by lessors, including disclosures
- Leases involving real estate
- Leases between state and local governments and public authorities
- Leases between related parties

- Sale-leaseback transactions
- Sale-leaseback transactions involving real estate
- Accounting and reporting for subleases and similar transactions
- Accounting and reporting for leveraged leases

Disclosures would be addressed as appropriate within each section. The project staff believes that it would be logical for a project on leases to re-evaluate each of those areas. Most of those topics are directly addressed by the proposals in the FASB's ED, and the others should be considered in light of those proposals. Some of those topics will require more consideration than others. The project plan in Appendix A reflects this variation.

Category 2—Topics Addressed in the FASB ED, But Not in the Current Literature

This Category involves evaluating topics that are addressed in the FASB's ED but not in current GASB literature. The project staff has determined that the only topic in this category is presentation matters. That is, the FASB's ED describes how lease-related elements should be presented in the financial statements. For example, lease liabilities are required to be either displayed separately from other liabilities or disclosed separately in the notes. From this requirement, users would know the amount of lease liabilities (whether from the face of the financial statements or the notes). The project staff believes that the FASB's presentation requirements are intended to ensure that relevant financial information related to leases is provided to users. The project staff believes that the questions of what lease information should be provided to users will be considered in the discussions on recognition and measurement and disclosure, which are already included in Category 1.

Category 3—Additional Topics

This Category includes lease topics that are neither covered in the current GASB literature nor in the FASB's ED. This project provides an opportunity to explore those topics in order to achieve a more comprehensive project.

One such topic is certain tax exempt leasing programs, in which a government leases an asset and then subleases it to another entity, with the government assigning the sublease payments to the main lessor. This allows the sublessee to take advantage of the government's tax exempt status and obtain a lower rate on its lease financing. This situation is not specifically covered by existing literature, though the project staff has found examples of authorities treating it similar to conduit debt. However, there have been no technical inquiries on the topic. Due to the fact that there does not appear to be a need for guidance in this area, the project staff recommends this topic not be included in the scope of the project. However, if the Board were to address conduit debt again in the future, this topic could be addressed in that project.

Another lease topic on which current guidance is silent is how to account for early lease terminations. A technical inquiry received in 2006 asked about treatment of a lease termination payment for an operating lease. The topic also could explore how to derecognize any lease assets and liabilities. However, there does not appear to be much need for guidance in this area, as evidenced by only one technical inquiry on the topic of early termination, and the GASB generally does not provide guidance on derecognition of specific assets and liabilities. Therefore, the project staff recommends this topic not be included in the scope of the project.

The project staff solicited feedback from Governmental Accounting Standards Advisory Council (GASAC) and the American Institute of Certified Public Accountants (AICPA) State and Local Government Expert Panel at their respective meetings in June. One concern raised by the Expert Panel was related to situations that are similar to service

concession arrangements (SCA) but do not meet the criteria to be accounted for as such. Because Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, has just recently become effective, the Expert Panel indicated that this is a current practice issue. Likewise, GASAC members also raised a question about these kinds of situations. It was noted that the IASB Exposure Draft, like the GASB's current literature, excludes service concession arrangements from following the lease guidance. However, it was also noted that the IASB's definition of a SCA is slightly different from the GASB's definition. The arrangements that fail to meet all of the SCA criteria would likely fall into the lease guidance, and this project could explore whether different treatment under the lease section should be provided for these SCA-like situations. Based on this input from the AICPA Expert Panel and GASAC, the project staff recommends that a topic of SCA-like arrangements be included in the scope of the project.

Other issues raised by GASAC were more specific in nature and could be addressed within the broader topics already proposed in Category 1. For example, comments were made about treatment of natural resources, assets with a zero historical cost basis that are leased by a government (lessor), and the impact on statutory debt limits and bond ratings of adding a liability to the statement of financial position. The project staff recommends that these issues not be considered separate topics within the scope of the project, but included in the relevant deliberations.

Additionally, the project staff intends to ask members of the project task force for their input on this subject. The initial conference call is tentatively scheduled to occur before the Board's August deliberations and any additional leasing topics raised will be presented at the August Board meeting.

Staff Recommendation

Based on the discussion above, the project staff recommends that all topics of the GASB's existing lease guidance (Category 1) be considered. The project staff also recommends that one of the topics from Category 3, SCA-like situations (not currently addressed but recommended by the GASAC, AICPA Expert Panel, and project task force), be incorporated into the project plan based on the feedback received by those groups.

Board Discussion Question

Question 1

What topics should be considered within the scope of the Leases project?

The project staff believes that the Leases project should consider all topics currently in the GASB's lease literature (Category 1) and one other relevant topic about which there currently is not GASB guidance (SCA-like situations from Category 3).

APPENDIX A – PROJECT PLAN

<u>Board meetings</u>	<u>Topics to be considered</u>
<u>August 2013:</u>	Discuss scope and definition of a lease.
<u>September 2013:</u>	Discuss lease term (including fiscal funding clauses) and classifications of leases, including leases involving real estate.
<u>October 2013:</u>	Discuss lessee recognition and measurement.
<u>December 2013:</u>	Continue discussion of lessee recognition and measurement.
<u>January 2014:</u>	Discuss lessee disclosures.
<u>March 2014:</u>	Discuss lessor—recognition and measurement.
<u>April 2014:</u>	Continue discussion of lessor—recognition and measurement.
<u>May 2014:</u>	Discuss lessor disclosures.
<u>July 2014:</u>	Discuss special topics: sales and leaseback transactions, including those involving real estate; subleases and leveraged leases; situations similar to service concession arrangements; related party leases; and leases between governments and public authorities.
<u>August 2014:</u>	Review draft standard section.
<u>September 2014:</u>	Review preballot draft of proposed Statement.
<u>November 2014:</u>	Review ballot draft and issue Exposure Draft.
<u>December 2014–March 2015:</u>	Due process, including field test.
<u>April–October 2015:</u>	Redeliberations.
<u>November 2015:</u>	Review preballot draft of final Statement.
<u>December 2015(T/C):</u>	Review ballot draft and issue final Statement.



MEMORANDUM

Issue 2, Paper 2
August 2013 Meeting

To: Board Members and David Bean
From: Deborah Beams, Randy Finden, Jialan Su,
Ken Schermann, Christopher Teats, Kathryn Walsh
CC: GASB Staff, Task Force Members, and Meeting Observers
Date: July 23, 2013
Re: Leases Project: Definition of a Lease and Related Scope Issues

I. INTRODUCTION

The objective of this paper is to examine the definition and related scope issues associated with leases in the current authoritative literature of the major standard setters and the recent Exposure Draft (ED) proposed by two major standard setters. This paper discusses what was included and excluded in the existing scope of lease literature, and provides a basis for the Board to consider whether a revision is needed for the definition of a lease and the scope of the lease literature in governmental accounting standards.

II. DEFINITION OF A LEASE

Leases are included in the current literature of the major standard setters.

A. Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB)

The FASB defines a lease in Statement of Financial Accounting Standards FASB Statement No. 13, *Accounting for Leases*, paragraph 1, as:

An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.



The IASB defines a lease in International Accounting Standards (IAS) No. 17, *Leases*, paragraph 4, as:

An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

While the wording is different between the current definitions, the concepts are the same. The FASB issued a revised ED, ASU Topic 842, *Leases* in May 2013. The IASB also issued its revised ED on Leases at the same time. The proposed definition of a lease would be consistent between both boards. The FASB's ED, paragraph 842-10-15-2 and IASB's ED/2013/6, paragraph 6, propose to define 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.

B. GASB

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, incorporates the provisions of FASB Statement 13 as amended and interpreted, into the GASB authoritative literature. GASB Statement 62, paragraph 211 defines a lease as:

An agreement conveying the right to use capital assets (land and/or depreciable assets) usually for a stated period of time.

Although this definition is consistent with the definition of a lease in FASB Statement 13, the FASB's new ED has proposed changes to the definition as discussed in the preceding section. The comparison between the existing GASB literature and the FASB's ED are discussed in Sub-Section D of this section.

C. Other Standard Setters

Federal Accounting Standards Advisory Board (FASAB)

The FASAB does not define the term “lease,” but rather only defines the term “capital leases” in its *2012 FASAB Handbook of Federal Accounting Standards and Other Pronouncements, as Amended*, Statement of Federal Financial Accounting Standards (SFFAS) 5, *Accounting for Liabilities of the Federal Government*, paragraph 43, as follows:

Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee:

- The lease transfers ownership of the property to the lessee by the end of the lease term
- The lease contains an option to purchase the leased property at a bargain price
- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property
- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property. If a lease does not meet at least one of the above criteria it should be classified as an operating lease.

International Public Sector Accounting Standards Board (IPSASB)

The IPSASB has issued International Public Sector Accounting Standards (IPSAS) No. 13, *Leases*. It was issued in 2001 and revised in 2006, and was drawn primarily from current IASB lease guidance. IPSAS 13, paragraph 8, defines a lease as follows:

A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time.

D. Staff Analysis

The project staff notes there is general consistency between the standard setters in the ideas in the definition of a lease, even if the wording is slightly different. There are three distinctive differences between the definition of a lease in GASB Statement 62 and that in the FASB's ED, as summarized below:

1. "Agreement" vs. "Contract"

While existing FASB and GASB standards use the term "agreement" in the definition of a lease, the FASB's ED uses the term "contract." In the FASB's ED, "contract" is defined as "An agreement between two or more parties that creates enforceable rights and obligations." In the Basis for Conclusions (BC) of FASB's ED, paragraphs BC107 through BC111 describe the reasons of the FASB's intention to include the definition of "contract" in the ED.

The difference between an agreement and a contract is the enforceability of the terms outlined. While an agreement can be represented by promises that are informal and loosely agreed upon by both parties, a contract is a legally binding agreement that imposes rights and obligations on both parties and forms strict terms of which the courts have the authority to enforce. The element of legal enforceability implied in the context of a contract makes the term "contract" a more rigid and formal form compared with the term "agreement," and therefore narrows the scope of contracts to only certain agreements that are legally binding and enforceable. As described in its Basis for Conclusions (ED paragraphs BC107–BC111), the FASB wants this concept of enforceability underpinning the definition of a lease because of questions raised by

constituents about certain types of lease terms, such as “cancellable” or “month-to-month.”

In the project staff’s view, the term “contract” is an improvement compared to the term “agreement.” The term “contract” emphasizes the legal enforceability of the lease terms and conditions, whereas “an agreement” can be an informal arrangement between the parties which may or may not contain the necessary elements to be enforceable before a court of law. The project staff recommends replacing the term “agreement” with the term “contract” in the definition of a lease in existing GASB Standards.

Board Discussion Question

Question 1

Should the term “contract” be used instead of “agreement” in the definition of a lease?

The project staff believes the term “agreement” should be replaced with “contract.”

2. “Capital Asset” vs. “Asset”

In GASB Statement 62, the term “capital assets (land and/or depreciable assets)” is used in the definition of a lease. In the FASB’s ED, however, the term “an asset (the underlying asset)” is used. Underlying asset is defined in the ED as “An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset” (FASB ED, paragraph 10).

According to GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, paragraph 19, capital assets are assets that 1) are used in operations and 2) have an initial useful life in excess of one year. The term embraces both tangible assets (land, buildings, building improvements, vehicles, machinery, equipment, works of art, historical treasures, and infrastructure) and intangible assets (easements, software, water rights).

In GASB Concepts Statement No. 4, *Elements of Financial Statements*, paragraph 8, assets are defined as “resources with present service capacity that the government presently controls.” Further, in paragraph 9, “the present service capacity of an asset” is the existing capability of an asset which enables the government to provide services.

The project staff recommends replacing the term “capital assets (land and/or depreciable assets)” with the term “asset (the underlying asset)” in the definition of a lease in the existing GASB Standards because of the following reasons. Comparing the term “capital asset” as defined in Statement 34 and the term “asset” as defined in the Concepts Statement 4, the scope of an asset is broader and more inclusive. While a capital asset only refers to an asset that is used in operations, the nature of an asset does not limit the ways or form of activities by which it can be used by a government, which include not only operations, but also investing and financing activities. For example, a leased building may be held by a government as an income-producing rental property. Additionally, the length of the initial useful life does not matter in the definition of an asset whereas it does factor in the definition of a capital asset. Instead, the substance of an asset is its present service capacity that the government controls. Therefore, by using the term “asset” in the definition of a lease instead of the term “capital asset,” the number of transactions that would be included in the definition of a lease would be broadened. While leased assets typically are capital assets, the broader term allows for leases of other types of assets to be included in the scope of this literature.

In addition, this paper will discuss intangible assets in Section V, Scope of Literature—Exclusions. In the existing literature, intangible assets are one of the two types of capital assets. They are almost universally excluded from the scope of leases among the standard setters. Intangible assets are addressed in GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*.

Board Discussion Question

Question 2

Should the term “asset (the underlying asset)” be used instead of “capital assets (land and/or depreciable assets)” in the definition of a lease?

The project staff recommends the term “capital assets (land and/or depreciable assets)” be replaced with “asset (the underlying asset).”

3. Addition of “in Exchange for Consideration”

In the proposed new definition of a lease in the FASB’s ED, the phrase “in exchange for consideration” was added. This serves to exclude nonexchange leases from the scope of the guidance. The FASB’s ED does not discuss why this phrase was added to the proposed definition. One reason could be that nonexchange leases are uncommon in the FASB’s jurisdiction (other than not-for-profit [NFP] entities). However, the project staff believes that the addition of the phrase “in exchange for consideration” is necessary in relation to the proposed new lessee accounting model. This model requires that the lessee record an asset and a liability that are measured based on the lease term and lease payments (ED “Questions for Respondents” Question 4, *Measurement*). If there is no consideration exchanged for the right to use the underlying asset (no lease payments), then there would not be an obligation on the part

of the lessee that would become a liability. This also would cause a problem for measuring the right of use asset, because its initial measurement is proposed to be based on the liability.

One possible solution to this issue could be to require measurement of the right of use asset based on a market value represented by what the lessee would have paid. This is similar to the FASB's current provision (958-605-55-24) for a NFP entity receiving free or discounted rent to record a contribution in the amount of the fair rental value of the space less the rent payments actually made (if any). Again, the FASB's ED is silent on whether this option was considered. However, because nonexchange transactions are much more common in the government environment, the project staff believes that it would be inconsistent to measure this type of transaction by "what it would have cost" while other types of nonexchange transactions are not.

Nonexchange transactions are addressed in GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. As stated, in paragraph 7, "In a nonexchange transaction, a government (including the federal government, as a provider) either gives value (benefit) to another party without directly receiving equal value in exchange or receives value (benefit) from another party without directly giving equal value in exchange."

Nonexchange transactions of governments are grouped into four classes based on their principal characteristics. Statement 33 identifies the four classes of nonexchange transactions based on shared characteristics that affect the timing of recognition:

1. *Derived tax revenues*, which result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption)
2. *Imposed nonexchange revenues*, which result from assessments imposed on nongovernmental entities, including individuals, other than

assessments on exchange transactions (for example, property taxes and fines)

3. *Government-mandated nonexchange transactions*, which occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform)

4. *Voluntary nonexchange transactions*, which result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations).

The project staff believes that leases classified as nonexchange transactions most likely fall into the fourth class above. A common example is a government that enters into an agreement with another government or a non-government entity (in many cases a NFP) as a lessor, with the lessor government providing the right to use certain office space to the other party for a period of time free of charge or charging de minimis rent. In these nonexchange leases, the lessor government that provides the space for the lessee to use usually imposes purpose restrictions and eligibility requirements on the other party.

For example, a government and a NFP may voluntarily enter into an agreement, by which the government provides space to the NFP for its tax-exempt purposes that will benefit the general public or targeted population in the community. The agreement may specify the eligibility requirements of the NFP that receives the benefit of using the space, such as the requirement that the NFP must have and maintain its tax-exempt status and the purpose of using the space is restricted to the NFP's charitable activities that provide public services which otherwise may not be easily accessible to the general public. The NFP may not pay rent to the government or pays de minimis rent as long as the NFP abides by the agreement. The arrangement enables the NFP to fulfill its charitable mission and helps the government to fulfill its mission of providing public services. The eligibility requirements and purpose restriction, together with the fact

that the government provides space without receiving equal value in exchange, constitute the main aspects of that voluntary nonexchange lease.

The project staff believes that the key feature of nonexchange leases is the “nonexchange” aspect, rather than the fact that they happen to be called “leases.” A lessor that enters into a nonexchange lease arrangement must have a nonfinancial reason for agreeing to those terms, likely the desire to make certain services available. While the agreement may be called a lease, the project staff believes that the substance of the agreement is to provide services, and therefore the economics of a nonexchange lease resembles the economics of a service contract rather than a right to use an asset. Because of this, the project staff believes that the rights for a lessor and the obligations for a lessee in a nonexchange lease arrangement are different from the lessor rights and lessee obligations that arise from a lease as defined in the FASB’s ED.

Based on the discussion above, the project staff believes that nonexchange transactions have been adequately addressed in Statement 33, and that there is no need to address nonexchange leases separately.

In excluding nonexchange leases from the scope of leases, another question may arise. Free rent meets the definition of “nonexchange,” but some may raise the question at what level can the value (benefit) in a transaction be considered as equal value in exchange. For example, what about de minimis rent of \$1 per year? The phrase “in exchange for consideration,” used by the FASB, could mean any amount of consideration, even if it is significantly below market rate. To make the distinction that a lease within the scope of this guidance should be an exchange or exchange-like transaction, the project staff recommends using the phrase “in an exchange or exchange-like transaction” in the definition instead of “in exchange for consideration.” While this would result in a difference between the GASB’s proposed definition and the

FASB's proposed definition, the project staff believes this phrase is more appropriate for the governmental environment.

Based on the analysis above, the project staff recommends to the Board that the phrase "in an exchange or exchange-like transaction" should be added to the definition of a lease.

Board Discussion Question

Question 3

Should the phrase "in exchange for consideration" be added to the definition of a lease?

The project staff believes that the phrase "in an exchange or exchange-like transaction" should be added to the definition instead of "in exchange for consideration."

III. NOTIONS SUPPORTING THE DEFINITION OF A LEASE

Immediately following the definition of a lease in paragraph 842-10-15-2, FASB's ED provides further explanatory guidance to assist in determining if an arrangement is a lease (paragraph 842-10-15-3):

- At inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing both of the following:
- a. Whether fulfillment of the contract depends on the use of an identified asset.
 - b. Whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

The paragraphs following the above guidance describe these notions in further detail in paragraphs 842-10-15-5 through 16 (included as Appendix A to this paper). Although

the explanatory guidance provides clear criteria in great detail that help identify the contracts that meet the definition of a lease, it is not part of the glossary definition. These paragraphs are referred to in the Basis for Conclusions as “application guidance” and are intended to assist in determining if a contract is or contains a lease. The project staff believes that this type of explanation is better suited for implementation guidance rather than text of a standard. For this reason, the project staff does not believe the explanatory guidance should be included in the text of a standard.

Board Discussion Question

Question 4

Should the explanatory guidance be included in the text of a standard?

The project staff does not believe that the explanatory guidance should be included in the text of a standard.

IV. SCOPE OF LITERATURE—INCLUSIONS

A. FASB and IASB

FASB

FASB Statement 13, paragraph 1, states that a lease:

“includes agreements that, although not nominally identified as leases, meet the above definition, such as a ‘heat supply contract’ for nuclear fuel.¹

¹ Heat supply (also called “burn-up”) contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the uncovered cost base. The residual value

usually accrues to the lessee, and the lessor furnishes no service other than the financing.

It is also states that “agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.”

In FASB’s ED on *Leases*, paragraph 842-10-15-1 states that “An entity shall apply this Topic to all leases as defined in the following paragraph, including leases of right-of-use assets in a sublease, except for the following:...” This is a broad inclusion (anything that meets the definition of a lease) that is essentially the same as what is provided in FASB Statement 13. It also eliminates the previously-provided example of a heat supply contract. Leases excluded from the scope according to FASB’s ED are discussed in Section V of this paper.

IASB

In the revised IAS 17, paragraph 3 states that “This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.”

B. GASB

GASB Statement 62, paragraphs 211–271 states those agreements that should be included in the scope, which are identical to the FASB Statement 13, paragraph 1, as discussed above.

C. Other Standard Setters

FASAB

The FASAB is silent on the scope of inclusion in lease guidance in *2012 FASAB Handbook of Federal Accounting Standards and Other Pronouncements, as Amended*.

IPSASB

In IPSAS 13, *Leases*, paragraph 5 states that “This Standard applies to agreements that transfer the right to use assets, even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.”

D. Staff Analysis

The project staff notes the consistency of the scope of leases among the above major standard setters. Their scopes for lease guidance include those agreements that meet the definition of a lease, even if they are not called leases. Therefore, the project staff recommends that for the purpose of defining a lease, it is necessary to continue to include agreements that meet the definition of a lease, but are not self-described as leases. The project staff believes that the nature of those agreements reflects the substance of a lease, which is to transfer the right to use the underlying asset.

On the other hand, the project staff does not believe it is appropriate to continue to include the example of a heat supply contract, as this specific contract has very limited applicability in the government environment. The example of a heat supply contract was included in GASB Statement 62 because it was written in FASB Statement 13. In FASB Statement 13, that example was included as a response to specific comments received where some thought these nuclear leases should not be in scope because they

are more like supply contracts, but FASB disagreed. Therefore, the project staff recommends excluding the example of a heat supply contract when describing the types of agreements within the scope of a lease.

Board Discussion Questions

Question 5

Should the current inclusion continue for the agreements that are not called lease but are in-substance leases?

The project staff believes that contracts that are not identified as leases but meet the definition of a lease should continue to be included in the lease literature.

Question 6

Should a heat supply contract continue to be included as an example of a lease that is within the scope of the lease literature?

The project staff believes the example of a heat supply contract should be removed from the lease literature.

V. SCOPE OF LITERATURE—EXCLUSIONS

A. FASB and IASB

FASB

FASB Statement 13, paragraph 1 states that the definition of a lease “does not include agreements that are contracts for services that do not transfer the right to use property,

plant, or equipment from one contracting party to the other.” It also states that “The Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights.” In the FASB’s ED, paragraph 842-10-15-1 states that the following leases shall be excluded from the scope:

- a. Leases of intangible assets (See Topic 350, *Intangibles-Goodwill and Other*)
- b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (See Topic 930, *Extractive Activities—Mining*, and Topic 932, *Extractive Activities—Oil and Gas*)
- c. Leases of biological assets, including timber (See Topic 905, *Agriculture*.)

IASB

According to IAS 17, *Leases*, paragraph 3, “This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.” Also, paragraph 2 states:

“The Standard shall be applied in accounting for all leases other than:

- a. leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and
- b. licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

However, this Standard shall not be applied as the basis of measurement for:

- a. property held by lessees that is accounted for as investment property (see IAS 40 *Investment Property*);
- b. investment property provided by lessors under operating leases (see IAS 40);
- c. biological assets held by lessees under finance leases (see IAS 41 *Agriculture*); or

- d. biological assets provided by lessors under operating leases (see IAS 41).”

In IASB ED/2013/6, *Leases*, paragraph 4 indicates:

An entity shall apply this [draft] Standard to all leases as defined in paragraph 6, including leases of right-of-use assets in a sublease, except for the following:

- (a) leases of intangible assets for lessors (see [draft] IFRS X Revenue from Contracts with Customers).²
- (b) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see IFRS 6 Exploration for and Evaluation of Mineral Resources).
- (c) leases of biological assets (see IAS 41 Agriculture).
- (d) service concession arrangements within the scope of International Financial Reporting Interpretation Committee (IFRIC) 12, *Service Concession Arrangements*.

² Any references to [draft] IFRS X *Revenue from Contracts with Customers* refer to the Exposure Draft *Revenue from Contracts with Customers* published by the IASB in November 2011.

Paragraph 5 further specifies that “A lessee need not apply this [draft] Standard to leases of intangible assets,” which gives lessees the option, but not a requirement, to apply lease treatment to intangible assets.

B. GASB

In GASB Statement 62, paragraph 211 lists those agreements that should be excluded in the scope. That list is identical to FASB Statement 13, paragraph 1, as discussed above. Additionally, GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, provides that the lease guidance does not apply to arrangements that meet the definition of a service concession arrangement.

C. Other Standards Setters

FASAB

The FASAB literature is silent on the scope of exclusion from lease guidance in *2012 FASAB Handbook of Federal Accounting Standards and Other Pronouncements, as Amended*. However, it is noted that individual FASAB standards may specifically address a topic (such as natural resources), which would take precedence over applying lease guidance.

IPSASB

In IPSAS 13, *Leases*, paragraphs 5-7, it is stated that:

This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. Public sector entities may enter into complex arrangements for the delivery of services, which may or may not include leases of assets. These arrangements are discussed in paragraphs 25–27.¹

This Standard does not apply to (a) lease agreements to explore for or use natural resources such as oil, gas, timber, metals, and other mineral rights, and (b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights. This is because these types of agreements have the potential to raise complex accounting issues that need to be addressed separately.

This Standard does not apply to investment property. Investment properties are measured by lessors and lessees in accordance with the provisions of IPSAS 16.

¹ Staff Note: IPSAS 13, paragraphs 25-27 discussed those arrangements entered into by public sector entities with private sector which meet the conditions for recognition of service concession arrangements in accordance with IPSAS 32, *Service Concession Arrangements: Grantor*.

D. Staff Analysis

The project staff notes the consistency among the above standard setters in the following areas that are excluded from the scope of leases. The staff recommends that for the purpose of defining a lease, the current exclusions existing in GASB Statement 62 should be continued, for these reasons:

- a. Agreements that are contracts for services that do not transfer the right to use capital assets from one contracting party to the other do not meet the definition of leases. Leases to explore for or use of minerals, oil, natural gas, and similar nonregenerative resources should be excluded, because of the complexity of this topic. While many governments may be lessors in these types of arrangements, few are lessees. It would be difficult to explore accounting for these situations without a larger research effort into extractive activities. The FASB excluded these arrangements from its proposal for these reasons.
- b. Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights should be excluded because they are examples of intangible assets. The topic of intangible assets is complex, and was addressed in GASB Statement 51. The FASB's proposal excluded intangible assets from the scope in favor of reviewing all accounting issues related to intangibles in a separate project. The FASB's proposal removes references to these specific types in favor of excluding intangible assets in general.
- c. Agreements that meet the definition of a service concession arrangement (SCA) should be excluded because the guidance on SCA were provided in GASB Statement 60. The IASB similarly scoped out SCAs because it has separate guidance for those arrangements, though the project staff notes that the IASB's definition of SCA is slightly different from the GASB's definition.

Additionally, because of the complexity of the topics, the staff recommends that the following exclusions from the FASB's ED be added:

- a. Leases of intangible assets .
- b. Leases of biological assets, including timber.

Although the IASB listed the types of leased assets that the proposed standards should not apply to as a basis of measurement, the project staff believes the subject matter of this exclusion does not fall under the scope of leases but rather measurement basis. Therefore, these exclusions will not be included in this discussion of scope, but considered in future discussions on measurement.

Board Discussion Question

Question 7

Should the current exclusions continue for the scope of leases?

The project staff believes that scope exclusions, as discussed above, should continue to be consistent with those excluded by the FASB.

DRAFT OF A STANDARD

The following sections illustrate what a draft standard might look like based on the preceding discussions and staff recommendations. It also illustrates the changes to the codification to show the differences between current literature and potentially revised guidance.

Draft Standard - Scope and Applicability of This Statement

XX. This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For purposes of applying this Statement, a lease is defined as a contract that conveys the right to use an asset (the underlying assets) for a period of time in an exchange or exchange-like transaction. It includes contracts that, although not nominally identified as leases, meet the above definition. This definition does not include contracts for services that do not transfer the right to use capital assets from one contracting party to the other. However, contracts that do transfer the right to use capital assets meet the definition of a lease for purposes of applying this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

XX. This Statement does not apply to lease contracts concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does this Statement apply to leases of biological assets, including timber. This Statement does not apply to leases of intangible assets, including licensing contracts for items such as motion picture films, plays, manuscripts, patents, and copyrights. This Statement also does not apply to contracts that meet the definition of a service concession arrangement in Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*.

Question 8

What comments does the Board have about the draft text shown above?

The project staff believes the draft text illustrates the recommendations made previously in the paper.

APPENDIX A

FASB'S ED PARAGRAPHS 842-10-15-5 THROUGH 16

> > Fulfillment of the Contract Depends on the Use of an Identified Asset

842-10-15-5 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 (that is, the entity that provides the good or service under the contract) has the substantive right to substitute the asset throughout the term of the contract. 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.

842-10-15-6 A supplier's right to substitute an asset is substantive if both of the following conditions are met:

- a. The supplier can substitute alternative assets in place of the asset without requiring the consent of the customer (that is, the entity that receives the good or service under the contract).
- b. There are no barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets in place of the asset during the term of the contract. Examples of such barriers include, but are not limited to, the following:
 1. Costs associated with substituting the asset that are so high that they create an economic disincentive to substituting alternative assets during the term of the contract
 2. Operational barriers that would prevent or deter the supplier from substituting the asset (for example, alternative assets are neither readily available to the supplier nor could they be sourced by the supplier within a reasonable time period or without incurring significant costs).

842-10-15-7 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. In this case, fulfillment of the contract can depend on the use of an identified asset until the date that the right or obligation to substitute becomes effective.

842-10-15-8 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 fiber-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**

842-10-15-9 A contract conveys the right to control the use of an identified asset if, throughout the term of the contract, the customer has the ability to do both of the following:

- a. Direct the use of the identified asset (as described in paragraphs 842-10-15-10 through 15-14)
- b. Derive the benefits from use of the identified asset (as described in paragraphs 842-10-15-15 through 15-16).

> > > **Ability to Direct the Use**

842-10-15-10 A customer has the ability to direct the use of an asset when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract.

842-10-15-11 Examples of decisions that could most significantly affect the economic benefits to be derived from use of an asset include, but are not limited to, determining or being able to change any of the following:

- a. How and for what purpose the asset is employed during the term of the contract
- b. How the asset is operated during the term of the contract
- c. The operator of the asset.

842-10-15-12 In some contracts for which there are few, if any, substantive decisions to be made about the use of an asset after the **commencement date**, a customer's ability to direct the use of the asset may be obtained at or before that date. For example, a customer may be involved in designing the asset for its use or in determining the terms and conditions of the contract, so that the decisions about the use of the asset that most significantly affect the economic benefits to be derived from use are predetermined. In those cases, the customer has the ability to direct the use of the asset throughout the term of the contract as a result of the decisions that it made at or before the commencement of the contract.

842-10-15-13 A contract may include clauses that restrict a customer's use of an asset; for example, a contract may specify the maximum amount of use of an asset to protect the supplier's interest in the asset. Such protective rights that restrict a customer's use of an asset would not, in isolation, prevent the customer from having the ability to direct the use of the asset.

842-10-15-14 Rights that give a customer the ability to specify the output of an asset (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.

> > > Ability to Derive the Benefits from Use

842-10-15-15 A customer's ability to derive the benefits from use of an asset refers to its right to obtain substantially all of the potential economic benefits from use of the asset throughout the term of the contract. A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, consuming, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products in the form of products and services. Those economic benefits also include other economic benefits from use of the asset that could be realized from a commercial transaction with a third party.

842-10-15-16 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.
- 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.

Leases—Overall

Overview and Background

General

842-10-05-1 The **Leases** Topic includes the following Subtopics:

- a. Overall
- b. **Lessee**
- c. **Lessor**
- d. Sale and Leaseback Transactions.

842-10-05-2 Those Subtopics establish requirements of financial accounting and reporting for lessees and lessors.

842-10-05-3 Paragraphs presented in **bold** type in this Topic state the main principles. All paragraphs have equal authority.

Objectives

General

842-10-10-1 This Topic specifies the accounting for {add glossary link}leases{add glossary link}. The core principle of this Topic is that an entity should recognize assets and liabilities arising from a lease.

842-10-10-2 An entity should consider the terms and conditions of the **contract** and all related facts and circumstances when applying this Topic. An entity should apply this Topic consistently to leases with similar characteristics and in similar circumstances.

842-10-10-3 The objective of this Topic is to establish the principles that **lessees** and **lessors** should apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.

Scope and Scope Exceptions

General

842-10-15-1 An entity shall apply this Topic to all **leases** as defined in the following paragraph, including leases of **right-of-use assets** in a **sublease**, except for the following:

- a. Leases of intangible assets (see Topic 350)
- b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see Topics 930 and 932)

- c. Leases of biological assets, including timber (see Topic 905).

> Identifying a Lease

842-10-15-2 A lease is a **contract** that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.

842-10-15-3 At inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing both of the following:

- a. Whether fulfillment of the contract depends on the use of an identified asset (as described in paragraphs 842-10-15-5 through 15-8)
- b. Whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration (as described in paragraphs 842-10-15-9 through 15-16).

842-10-15-4 See Examples 1 through 5 (paragraphs 842-10-55-6 through 55-41) for illustrations of the requirements.

> > Fulfillment of the Contract Depends on the Use of an Identified Asset

842-10-15-5 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 (that is, the entity that provides the good or service under the contract) has the substantive right to substitute the asset throughout the term of the contract. 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.

842-10-15-6 A supplier's right to substitute an asset is substantive if both of the following conditions are met:

- a. The supplier can substitute alternative assets in place of the asset without requiring the consent of the customer (that is, the entity that receives the good or service under the contract).
- b. There are no barriers (economic or otherwise) that would prevent the supplier from substituting alternative assets in place of the asset during the term of the contract. Examples of such barriers include, but are not limited to, the following:
 - 1. Costs associated with substituting the asset that are so high that they create an economic disincentive to substituting alternative assets during the term of the contract
 - 2. Operational barriers that would prevent or deter the supplier from substituting the asset (for example, alternative assets are neither readily available to the supplier nor could they be sourced by the supplier within a reasonable time period or without incurring significant costs).

842-10-15-7 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. In this case, fulfillment of the contract can depend on the use of an identified asset until the date that the right or obligation to substitute becomes effective.

842-10-15-8 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 fiber-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

842-10-15-9 A contract conveys the right to control the use of an identified asset if, throughout the term of the contract, the customer has the ability to do both of the following:

- a. Direct the use of the identified asset (as described in paragraphs 842-10-15-10 through 15-14)
- b. Derive the benefits from use of the identified asset (as described in paragraphs 842-10-15-15 through 15-16).

> > Ability to Direct the Use

842-10-15-10 A customer has the ability to direct the use of an asset when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract.

842-10-15-11 Examples of decisions that could most significantly affect the economic benefits to be derived from use of an asset include, but are not limited to, determining or being able to change any of the following:

- a. How and for what purpose the asset is employed during the term of the contract
- b. How the asset is operated during the term of the contract
- c. The operator of the asset.

842-10-15-12 In some contracts for which there are few, if any, substantive decisions to be made about the use of an asset after the **commencement date**, a customer's ability to direct the use of the asset may be obtained at or before that date. For example, a customer may be involved in designing the asset for its use or in determining the terms and conditions of the contract, so that the decisions about the use of the asset that most significantly affect the economic benefits to be derived from use are predetermined. In those cases, the customer

has the ability to direct the use of the asset throughout the term of the contract as a result of the decisions that it made at or before the commencement of the contract.

842-10-15-13 A contract may include clauses that restrict a customer's use of an asset; for example, a contract may specify the maximum amount of use of an asset to protect the supplier's interest in the asset. Such protective rights that restrict a customer's use of an asset would not, in isolation, prevent the customer from having the ability to direct the use of the asset.

842-10-15-14 Rights that give a customer the ability to specify the output of an asset (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.

> > > Ability to Derive the Benefits from Use

842-10-15-15 A customer's ability to derive the benefits from use of an asset refers to its right to obtain substantially all of the potential economic benefits from use of the asset throughout the term of the contract. A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, consuming, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products in the form of products and services. Those economic benefits also include other economic benefits from use of the asset that could be realized from a commercial transaction with a third party.

842-10-15-16 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.
- 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.

> Separating Components of a Contract

842-10-15-17 After determining that a contract contains a lease in accordance with paragraphs 842-10-15-2 through 15-16, an entity shall identify each separate lease component within the contract. An entity shall consider the right to use an asset to be a separate lease component if both of the following criteria are met:

- a. The **lessee** can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the **lessor** or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events).
- b. The underlying asset is neither dependent on nor highly interrelated with the other underlying assets in the contract.

842-10-15-18 An entity shall account for each lease component as a separate lease, separately from nonlease components of a contract, except as described in paragraph 842-10-15-20(b)(2) through (c). An entity shall allocate the consideration in the contract to each separate lease component that has been identified in accordance with paragraphs 842-10-15-20 through 15-22.

842-10-15-19 See Examples 6 through 10 (paragraphs 842-10-55-42 through 55-60) for an illustration of the requirements.

> > Lessee

842-10-15-20 After identifying the lease components in a contract in accordance with paragraph 842-10-15-17, a lessee shall allocate the consideration in the contract as follows:

- a. If there are observable **standalone prices** for each component of the contract, a lessee shall allocate the consideration to each component on the basis of the relative standalone price of each component.
- b. If there are observable standalone prices for one or more, but not all, of the components of the contract, a lessee shall allocate both of the following:
 - 1. The standalone price of each component to the components of the contract with observable prices
 - 2. The remaining consideration in the contract to the components of the contract without observable prices. If one or more of the components without observable prices is a lease component, the lessee shall combine those components and account for them as a single lease component.
- c. If there are no observable standalone prices for any components of the contract, a lessee shall combine the components and account for them as a single lease component.

842-10-15-21 A price is observable if it is the price that either the lessor or similar suppliers charge for similar lease, good, or service components on a standalone basis.

> > **Lessor**

842-10-15-22 After identifying the lease components in a contract in accordance with paragraph 842-10-15-17, a lessor shall allocate the consideration in the contract using the requirements in paragraphs 70–76 of proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*.

Glossary

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Economic Life

Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

Gross Residual Asset

The amount a **lessor** expects to derive from an **underlying asset** following the end of the **lease term**, measured on a discounted basis.

Initial Direct Costs

Costs that are directly attributable to negotiating and arranging a **lease** and would not have been incurred without entering into the lease.

Lease

A **contract** that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.

Lease Liability

A **lessee's** obligation to make lease payments arising from a **lease**, measured on a discounted basis.

Lease Payments

Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, consisting of the following:

- a. Fixed payments, less any **lease** incentives received or receivable from the lessor

- b. **Variable lease payments** that depend on an index or a rate or are in-substance fixed payments
- c. The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option
- d. Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to nonlease components of a **contract** except when the lessee is required to combine nonlease and lease components and account for them as a single lease component.

For the lessor, lease payments also include lease payments structured as residual value guarantees. Lease payments do not include payments allocated to nonlease components.

Lease Receivable

A **lessor's** right to receive **lease payments** arising from a **lease**, measured on a discounted basis.

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with both of the following:

- a. Periods covered by an option to extend the **lease** if the lessee has a significant economic incentive to exercise that option
- b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

Lessee

An entity that enters into a **contract** to obtain the right to use an **underlying asset** for a period of time in exchange for consideration.

Lessee's Incremental Borrowing Rate

The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.

Lessor

An entity that enters into a **contract** to provide the right to use an **underlying asset** for a period of time in exchange for consideration.

Property

Land or a building, or part of a building, or both.

Rate Implicit in the Lease

The rate of interest that, at a given date, causes the sum of the present value of payments made by a **lessee** for the right to use an **underlying asset** and the present value of the amount a lessor expects to derive from the underlying asset following the end of the **lease term** to equal the fair value of the underlying asset.

Rate the Lessor Charges the Lessee

A discount rate that takes into account the nature of the transaction as well as the terms and conditions of the **lease**. The rate the lessor charges the lessee could be, for example, the **rate implicit in the lease**, or the property yield.

Residual Asset

An asset representing the rights to an **underlying asset** retained by a **lessor** during a **lease**.

Residual Value Guarantee

A guarantee made to a **lessor** that the value of an **underlying asset** returned to the lessor at the end of a **lease** will be at least a specified amount.

Right-of-Use Asset

An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.

Short-Term Lease

A **lease** that, at the **commencement date**, has a maximum possible term under the **contract**, including any options to extend, of 12 months or less. Any lease that contains a purchase option is not a short-term lease.

Standalone Price

The price at which a **lessee** would purchase a component of a **contract** separately.

Sublease

A transaction in which an **underlying asset** is re-leased by the original **lessee** (or intermediate lessor) to a third party, and the **lease** (or head lease) between the original **lessor** and lessee remains in effect.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Useful Life

The period over which an asset is expected to contribute directly or indirectly to future cash flows.

Variable Lease Payments

Payments made by a **lessee** to a **lessor** for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Recognition

General

> Lease Term

842-10-25-1 An entity shall determine the **lease term** as the noncancellable period of the **lease**, together with both of the following:

- a. Periods covered by an option to extend the lease if the **lessee** has a significant economic incentive to exercise that option
- b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

842-10-25-2 At the **commencement date**, an entity shall consider contract-based, asset-based, entity-based, and market-based factors when assessing whether a lessee has a significant economic incentive either to exercise an option to extend a lease or not to exercise an option to terminate a lease, as described in paragraph 842-10-55-4. Those factors shall be considered together, and the existence of any one factor does not necessarily signify that a lessee has a significant economic incentive to exercise, or not to exercise, the option.

842-10-25-3 An entity shall reassess the lease term only if either of the following occurs:

- a. There is a change in relevant factors, as described in paragraph 842-10-55-5, that would result in the lessee having or no longer having a significant economic incentive either to exercise an option to extend the lease or not to exercise an option to terminate the lease. A change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment of the lease term.
- b. The lessee does either of the following:
 1. Elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so

2. Does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

842-10-25-4 See paragraphs 842-10-55-1 through 55-5 for implementation guidance on lease term and significant economic incentive.

> Classification of Leases

842-10-25-5 At the commencement date, an entity shall classify a lease as either a Type A lease or a Type B lease. An entity shall not reassess the classification after the commencement date.

842-10-25-6 If the **underlying asset** is not **property**, an entity shall classify a lease as a Type A lease unless one of the following two criteria is met:

- a. The lease term is for an insignificant part of the total **economic life** of the underlying asset.
- b. The present value of the **lease payments** is insignificant relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease.

842-10-25-7 If the underlying asset is property, an entity shall classify a lease as a Type B lease unless one of the following two criteria is met:

- a. The lease term is for the major part of the remaining economic life of the underlying asset.
- b. The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type A lease.

842-10-25-8 Notwithstanding the requirements in paragraphs 842-10-25-6 through 25-7, a lease is classified as a Type A lease if a lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

842-10-25-9 If a lease component contains the right to use more than one asset, an entity shall determine the nature of the underlying asset on the basis of the nature of the primary asset within the lease component. An entity shall regard the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria in paragraphs 842-10-25-6 through 25-7.

842-10-25-10 Notwithstanding the requirements in the preceding paragraph, if a lease component contains both land and a building, an entity shall regard the economic life of the building to be the economic life of the underlying asset when applying the classification criteria in paragraph 842-10-25-7.

842-10-25-11 When classifying a **sublease**, an entity shall evaluate the sublease with reference to the underlying asset (for example, the item of property, plant, or

equipment that is the subject of the lease), rather than with reference to the **right-of-use asset**.

842-10-25-12 See Examples 11 and 12 (paragraphs 842-10-55-61 through 55-65) for illustrations of the requirements.

> > **Contract Modifications**

842-10-25-13 If the contractual terms and conditions of a lease are modified, resulting in a substantive change to the existing lease, an entity shall account for the modified **contract** as a new contract at the date that the modifications become effective. An entity shall recognize any difference between the carrying amounts of the assets and liabilities arising from the previous lease and those arising from any new lease in profit or loss. Examples of a substantive change arising from a contract modification include changes to the contractual lease term or to the amount of contractual lease payments that were not part of the original terms and conditions of the lease.

> **Short-Term Leases**

842-10-25-14 A lessee may elect, as an accounting policy, not to apply the requirements in Subtopic 842-20 to **short-term leases**. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term. The accounting policy election for short-term leases shall be made by class of underlying asset to which the right of use relates.

842-10-25-15 A **lessor** may elect, as an accounting policy, not to apply the requirements in Subtopic 842-30, except for the requirements in paragraph 842-30-50-5(d), to short-term leases. Instead, a lessor may recognize the lease payments in profit or loss over the lease term on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which income is earned from the underlying asset. The accounting policy election for short-term leases shall be made by class of underlying asset to which the right of use relates.

842-10-25-16 See Example 13 (paragraphs 842-10-55-66 through 55-69) for an illustration of the requirements.

Disclosure

General

> **Short-Term Leases**

842-10-50-1 An entity that accounts for **short-term leases** in accordance with paragraph 842-10-25-14 or 842-10-25-15 shall disclose that fact.

Implementation Guidance and Illustrations

General

> Implementation Guidance

> > Application of Lease Term

842-10-55-1 An entity should determine the noncancellable period of a **lease** when determining the **lease term**. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a **contract** and determine the period for which the contract is enforceable. A lease is no longer enforceable when both the **lessee** and the **lessor** each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

842-10-55-2 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-25-1.

842-10-55-3 The lease term begins at the **commencement date** and includes any rent-free periods provided to the lessee by the lessor.

> > Application of Significant Economic Incentive

842-10-55-4 At the commencement date, an entity assesses whether the lessee has a significant economic incentive to exercise, or not to exercise, an option by considering all factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity's assessment will often require the consideration of a combination of those factors because they are interrelated. Examples of factors to consider include, but are not limited to, any of the following:

- a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
 1. The amount of **lease payments** in any optional period
 2. The amount of any **variable lease payments** or other contingent payments, such as payments under termination penalties and **residual value guarantees**
 3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable.

- c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another **underlying asset** suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.
- d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

842-10-55-5 An entity should reassess whether the lessee has, or does not have, a significant economic incentive to exercise, or not to exercise, an option if there is a change in relevant factors as described in the preceding paragraph. However, a change in market-based factors (such as market rates to lease a comparable asset) should not, in isolation, trigger reassessment.

> Illustrations

> > Illustrations of Identifying a Lease

842-10-55-6 The following Examples illustrate how an entity determines whether a contract is, or contains, a lease.

> > > Example 1—Contract for Rail Cars

> > > > Example 1A: Contract for Rail Cars—Part A

842-10-55-7 A contract between Customer and a freight carrier (Carrier) provides Customer with the use of 10 rail cars of a particular specification owned by Carrier for 5 years. The contract specifies the type of car. Customer determines when, where, and which goods are to be transported using the cars. When the cars are not in use, they are kept at Customer's premises. Customer can use the cars for another purpose (for example, storage) if it so chooses. If a particular car needs to be serviced or repaired, Carrier is required to substitute an equivalent car of the same type. Otherwise, and other than on default by Customer, Carrier cannot retrieve the cars during the five-year period.

842-10-55-8 The contract also requires Carrier to provide an engine and a driver when requested by Customer and stipulates that, if Carrier is unable to do so, Customer has the right to hire an engine and a driver from other suppliers. Carrier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Carrier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods but also the goods of other customers (that is, if other customers require the transportation of goods to destinations close to the destination requested by Customer and within a similar time frame, Carrier can choose to attach up to 100 rail cars to the engine).

842-10-55-9 The contract contains a lease of rail cars. Customer has the right to use 10 rail cars for 5 years.

842-10-55-10 Fulfillment of the contract depends on the use of 10 identified cars. Once delivered to Customer, Carrier can substitute the cars only when they are not operating properly.

842-10-55-11 Customer has the right to control the use of the cars because of both of the following:

- a. Customer has the ability to direct the use of the cars. Customer determines how, when, and for what purpose the cars are used, not only when they are being used to transport Customer's goods but throughout the term of the contract.
- b. Customer has the ability to derive the benefits from use of the cars. The cars are available for Customer's use throughout the term of the contract, including when they are not being used to transport Customer's goods.

842-10-55-12 The contract also contains a nonlease (service) component that relates to the use of an engine and a driver. The contract does not convey the right to use an identified engine (see analysis in Example 1B).

> > > Example 1B: Contract for Rail Cars—Part B

842-10-55-13 The contract between Customer and Carrier requires Carrier to transport a specified quantity of goods in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified is equivalent to Customer having the use of 10 rail cars for 5 years. Carrier provides the rail cars, driver, and engine as part of the contract. The contract states the nature and quantity of the goods to be transported but does not include specific details about the cars or engine to be used to transport Customer's goods. Although transporting the goods identified in the contract requires cars similar to those identified in Example 1A, Carrier has a large pool of similar cars that can be used to transport Customer's goods. Similarly, Carrier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored in Carrier's premises when not being used to transport goods.

842-10-55-14 The contract does not contain a lease.

842-10-55-15 Fulfillment of the contract does not depend on the use of 10 identified rail cars or an identified engine because Carrier has substantive substitution rights. Carrier can choose the cars and engine without Customer's consent. There also are no economic barriers that prevent Carrier from using any car within the pool of cars of a particular specification, and any one of a number of engines, for each delivery of Customer's goods.

> > > Example 1C: Contract for Rail Cars—Part C

842-10-55-16 Assume the same facts as in Example 1B except that Carrier has only 10 rail cars of the specification required to transport Customer's goods. Carrier also can use those cars to fulfill other contracts if those cars are not being used to transport Customer's goods, and Carrier could decide to expand its fleet of cars during the term of the contract. Cars of the specification required to transport Customer's goods can be purchased from rail car suppliers and are readily available to Carrier.

842-10-55-17 The contract does not contain a lease.

842-10-55-18 Although the 10 rail cars owned by Carrier are identified at the commencement of the contract, Customer does not have the right to control their use throughout the term of the contract. Carrier controls the use of the rail cars. Carrier makes the substantive decisions about how the rail cars are used to deliver goods including, for example, whether to use the rail cars to fulfill other contracts. Carrier could fulfill the contract with Customer using rail cars other than those owned at the commencement of the contract if, for example, Carrier were to decide to expand its fleet of rail cars during the term of the contract.

842-10-55-19 Specifying the quantity of goods to be transported and the timetable for delivery, means, in effect, that Customer specifies the output from the use of rail cars but it does not give Customer the right to use the 10 rail cars for 5 years.

> > > Example 2—Contract for Coffee Services

842-10-55-20 Customer enters into a contract for coffee services for two years. Supplier puts 25 coffee machines in Customer's premises that are tailored for use with coffee consumables provided by Supplier. The coffee machines function only with the consumables provided by Supplier and have no use to Customer other than when they are used in conjunction with those consumables. Supplier is responsible for repairs and maintenance of the coffee machines. Customer's staff operate the machines (that is, they select the coffee they wish to drink, and the machines deliver the coffee).

842-10-55-21 The contract does not contain a lease.

842-10-55-22 Although fulfillment of the contract may depend on the use of the machines, the contract does not give Customer the right to control the use of those machines. That is because Customer does not have the ability to derive the benefits from use of the machines on their own; the machines function only with the consumables that are supplied by Supplier. Accordingly, the machines have no use or value to Customer without the consumables. The machines are incidental to the delivery of the coffee services. The machines and the consumables combine to deliver coffee services to Customer over the two-year term of the contract.

> > > Example 3—Contract for Medical Equipment

842-10-55-23 Customer enters into a contract for medical equipment for three years. Supplier puts 10 items of patient-monitoring equipment in Customer's premises that require the use of disposable consumables that connect the monitoring equipment to the patient. Although the contract requires Customer to purchase the consumables from Supplier, consumables that function with the monitoring equipment are readily available from other suppliers. Supplier carries out repairs and maintenance of the monitoring equipment when needed and can replace the equipment without the consent of Customer (although, because of the costs associated with replacing the equipment, Supplier would replace the equipment only if it is not operating properly). Customer determines how and when the equipment is used and operates the equipment to monitor patients.

842-10-55-24 The contract contains a lease of the patient-monitoring equipment.

842-10-55-25 Although the terms of the contract require Customer to use Supplier's consumables, consumables that function with the patient-monitoring equipment are readily available from other suppliers. Accordingly, Customer would be able to derive the benefits from use of the monitoring equipment on its own without Supplier's consumables. In addition, although the terms of the contract require Customer to use Supplier for repairs and maintenance, this is a nonlease (service) component of the contract that does not change the conclusion that Customer has the right to use the equipment. Consequently, the contract has three separate components: the right to use the equipment, the supply of consumables, and the maintenance of the equipment.

842-10-55-26 The contract conveys the right to use the patient-monitoring equipment to Customer for the following reasons:

- a. Fulfillment of the contract depends on the use of the equipment. Supplier's substitution rights are not substantive because the costs of replacing the equipment create an economic barrier that prevents Supplier from replacing the equipment other than when it is not operating properly.
- b. Customer has the right to control the use of the equipment because of the following:
 1. Customer has the ability to direct the use of the equipment. Customer determines how and when the equipment is used and it operates the equipment. Accordingly, Customer makes decisions about the use of the equipment that most significantly affect the economic benefits derived from use throughout the term of the contract.
 2. Customer has the ability to derive the benefits from use of the equipment. The equipment is available solely for Customer's use throughout the three-year term of the contract.

> > > Example 4—Contract for Fiber-Optic Cable

> > > > Example 4A: Contract for Fiber-Optic Cable—Part A

842-10-55-27 Customer enters into a 15-year contract for the right to use 3 specified, physically distinct dark fibers within a larger cable connecting Hong Kong to Tokyo. Customer makes all of the decisions about the use of the fibers by connecting each end of the fibers to its electronics equipment (that is, Customer “lights” the fibers). If the fibers are damaged, Supplier is responsible for the repairs and maintenance.

842-10-55-28 The contract contains a lease. Customer has the right to use the 3 dark fibers for 15 years.

842-10-55-29 Fulfillment of the contract depends on the use of the fibers. The fibers are explicitly specified in the contract and are physically distinct from other fibers within the cable.

842-10-55-30 Customer has the right to control the use of the dark fibers because of the following:

- a. Customer has the ability to direct the use of the dark fibers. Customer determines how, when, and for what purpose the fibers are used. Accordingly, Customer makes decisions about the use of the fibers that most significantly affect the economic benefits derived from use throughout the term of the contract.
- b. Customer has the ability to derive the benefits from use of the dark fibers. The fibers are available for Customer’s use throughout the 15-year term of the contract; they cannot be used by any other party unless Customer agrees to such use.

842-10-55-31 The contract also contains a nonlease (service) component for repairs and maintenance of the fibers.

> > > > Example 4B: Contract for Fiber-Optic Cable—Part B

842-10-55-32 Customer enters into a 15-year contract for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of 3 fiber strands within the cable (the cable contains 15 fibers with similar capacities). Supplier makes decisions about the transmission of data (that is, Supplier lights the fibers and makes decisions about which fibers are used to transmit Customer’s traffic).

842-10-55-33 The contract does not contain a lease.

842-10-55-34 Supplier makes all decisions about the transmission of Customer’s data, which requires the use of only a portion of the capacity of the cable. That capacity portion is not physically distinct from the remaining capacity of the cable.

Customer has contracted for the right to capacity within a cable. It does not have the right to use an identified asset.

> > > Example 5—Contract for Energy/Power

> > > Example 5A: Contract for Energy/Power—Part A

842-10-55-35 Customer enters into a contract to purchase substantially all of the energy produced by a new power plant for 20 years. The power plant is owned by Supplier and the energy cannot be provided from another plant. Supplier and Customer were both involved in designing the plant before it was constructed. Customer has the right to either operate and maintain the plant itself or appoint another party to operate and maintain the plant, in accordance with industry-approved operating practices.

842-10-55-36 The contract contains a lease. Customer has the right to use the power plant for 20 years.

842-10-55-37 Fulfillment of the contract depends on the use of the power plant. The energy cannot be supplied from another plant.

842-10-55-38 Customer has the right to control the use of the power plant because of the following:

- a. Customer has the ability to direct the use of the power plant. Customer has determined how the plant will be operated by both being involved in designing the plant and appointing the party that operates and maintains the plant. Customer's decision-making rights about the design and maintenance of the plant have given it the ability to make decisions about the use of the plant that most significantly affect the economic benefits derived from use throughout the term of the contract. Although another party might operate the plant on a daily basis, that party would be implementing decisions made by Customer about the use of the plant.
- b. Customer has the ability to derive the benefits from use of the plant. Customer has the right to obtain substantially all of the energy produced by the plant throughout the 20-year term of the contract.

> > > Example 5B: Contract for Energy/Power—Part B

842-10-55-39 An electricity provider (Customer) enters into a contract to purchase substantially all of the power produced by a power plant for three years. The power plant is owned and operated by a utility company (Supplier). Supplier cannot provide power from another plant. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer. Customer had no involvement in that design. Customer issues dispatch instructions to Supplier. Those instructions detail the quantity and timing of delivery of power to Customer. Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Customer

and Supplier agree to the plant's maintenance plan at the start of the contract. Customer's only decision-making authority relates to the dispatch instructions. Supplier is able to sell the power not taken by Customer to other customers.

842-10-55-40 The contract does not contain a lease.

842-10-55-41 Although fulfillment of the contract depends on the use of the power plant, Customer does not have the right to control its use because it does not have the ability to direct the use of the plant. Supplier has that ability. Supplier has made (and will make) all decisions about how the plant operates. Customer's ability to determine when power is produced, in effect, gives it the ability to specify the output from the plant. However, without any other decision-making authority, Customer has no ability to direct the use of the plant that is used to make the power.

> > Illustration of Allocating Consideration to Components of a Contract

842-10-55-42 The following Example illustrates the allocation of consideration in a contract to lease and nonlease components by a lessee.

> > > Example 6—Lessee Allocation of Consideration to Lease and Nonlease Components of a Contract

842-10-55-43 Customer enters into a 5-year contract with Supplier for a total consideration of CU200,000, payable annually in 5 amounts of CU40,000. The contract has two components:

- a. Component 1—lease of equipment for five years
- b. Component 2—maintenance of the equipment by Supplier for five years.

842-10-55-44 The contract does not specify prices for the individual components.

842-10-55-45 The manufacturer of the equipment requires that all lessors of the equipment include maintenance services as part of the contract with the lessee. Accordingly, Supplier cannot lease the equipment without also requiring the lessee to purchase maintenance services that relate to the equipment. The contract is priced as a package, and Customer is unable to obtain an observable **standalone price** for the lease component.

842-10-55-46 Customer, however, is able to obtain an observable standalone price for the service component on the basis of information that is available from other suppliers. Several other suppliers provide maintenance services that relate to similar equipment over a 5-year period at a standalone price of CU10,000 per year.

842-10-55-47 Because Customer has an observable standalone price for one component, but not both, it first allocates consideration to the component with an observable price and then allocates the remaining consideration to the component without an observable price. Customer concludes that the

consideration for the lease component is CU30,000 per year (CU40,000 per year – CU10,000 per year allocated to the service component of the contract).

> > Illustrations of Lease Components and Identifying the Primary Asset

842-10-55-48 The following Examples illustrate how an entity would identify separate lease components in a contract and the primary asset within one lease component that conveys the right to use more than one asset to the lessee.

> > > Example 7—Lease of Retail Space

842-10-55-49 A lessee enters into a lease of retail space together with the surrounding land that is used for parking and deliveries. Because of the location of the retail space, a retailer would not lease the building without the surrounding land. The lessee is a retailer that intends to use the building for its retail operations.

842-10-55-50 The contract contains one lease component. The retail space is dependent on the land for parking and deliveries. The lessee would be unable to access the benefits from use of the retail space without the surrounding land for parking and deliveries. Accordingly, the lessee cannot benefit from use of the retail space without also using the surrounding land that is part of the contract.

842-10-55-51 The primary asset is the retail building because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the surrounding land for parking and deliveries is to facilitate the lessee obtaining benefits from use of the retail space.

> > > Example 8—Lease of Retail Space plus an Additional Plot of Land

842-10-55-52 Assume the same facts as Example 7, except that the contract also conveys the right to use an additional plot of land that is located adjacent to the retail space. The additional plot of land could, for example, be redeveloped independently of the retail space.

842-10-55-53 The contract contains two lease components—a lease of the retail space (together with the surrounding land for parking and deliveries) and a lease of a plot of land.

842-10-55-54 The plot of land is neither dependent on, nor highly interrelated with, the retail space and vice versa. Accordingly, the lessee can benefit from use of the plot of land on its own and, as described in Example 7, the lessee can benefit from use of the retail space (together with the surrounding land for parking and deliveries) on its own.

> > > Example 9—Lease of a Manufacturing Plant

842-10-55-55 A lessee leases a manufacturing plant together with a large item of equipment that is installed within the plant. The lessor does not lease or sell the equipment separately, but other suppliers do. The plant is not tailored for use

only with that item of equipment, and the equipment could be used for a different manufacturing process within another plant.

842-10-55-56 The contract contains two lease components—a lease of the manufacturing building (together with the land on which the building is situated) and a lease of an item of manufacturing equipment.

842-10-55-57 The item of equipment is neither dependent on, nor highly interrelated with, the plant and vice versa; that is, both the plant and the equipment could be used for other purposes together with other assets. Accordingly, the lessee can benefit from use of the plant together with other resources that are readily available to it. The lessee also can benefit from use of the equipment together with other resources that are readily available to it.

> > > **Example 10—Lease of a Turbine Plant**

842-10-55-58 A lessee leases a turbine plant, which consists of a large turbine housed within a building, together with the land on which the turbine is situated. The building was designed specifically to house the turbine, and the life of the building is directly linked to the life of the turbine (that is, when the turbine can no longer be used and is dismantled, the building will be demolished or substantially rebuilt).

842-10-55-59 The contract contains one lease component. The building and the land on which the turbine is situated are highly interrelated with the turbine. Accordingly, the lessee cannot benefit from use of the building or the land without also using the turbine. Similarly, the lessee could not benefit from use of the turbine if it were not housed within the building.

842-10-55-60 The primary asset is the turbine because it is the predominant asset for which the lessee has contracted for the right to use. The main purpose of the building (and the land on which the turbine is situated) is to facilitate the lessee obtaining benefits from use of the turbine. The land and building would have little, if any, use or value to the lessee without the turbine.

> > **Illustrations of Lease Classification**

842-10-55-61 The following Examples illustrate lease classification.

> > > **Example 11—Equipment Lease Classification**

842-10-55-62 A lessee enters into a 2-year lease of an item of equipment, which has a total **economic life** of 12 years. The lease payments are CU9,000 per year, the present value of which is CU16,700, calculated using the **rate the lessor charges the lessee**. The fair value of the equipment at the commencement date is CU60,000.

842-10-55-63 The lessee determines that the lease is a Type A lease because of the following: