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INTERPRETATION OF
FINANCIAL
REPORTING STANDARD

INT FRS 104

**Determining Whether an Arrangement
Contains a Lease**

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FRS Interpretation 104 *Determining whether an Arrangement contains a Lease* (INT FRS 104) is set out in paragraphs 1-17 and the Appendix. INT FRS 104 is accompanied by Illustrative Examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 1 and 8-10 of the Preface to the Interpretations of Financial Reporting Standards.

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INTERPRETATION OF FINANCIAL REPORTING STANDARD INT FRS 104

Determining whether an Arrangement contains a Lease

References

- FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- FRS 16 *Property, Plant and Equipment* (as revised in 2004)
- FRS 17 *Leases* (as revised in 2004)
- FRS 38 *Intangible Assets* (as revised in 2004)

Background

- 1 An entity may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (e.g. an item of property, plant or equipment) in return for a payment or series of payments. Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:
 - outsourcing arrangements (e.g. the outsourcing of the data processing functions of an entity).
 - arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity.
 - take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (e.g. a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).
- 2 This Interpretation provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with FRS 17. It does not provide guidance for determining how such a lease should be classified under that Standard.
- 3 In some arrangements, the underlying asset that is the subject of the lease is a portion of a larger asset. This Interpretation does not address how to determine when a portion of a larger asset is itself the underlying asset for the purposes of applying FRS 17. Nevertheless, arrangements in which the underlying asset would represent a unit of account in either FRS 16 or FRS 38 are within the scope of this Interpretation.

Scope

- 4 This Interpretation does not apply to arrangements that are, or contain, leases excluded from the scope of FRS 17.

Issues

- 5 The issues addressed in this Interpretation are:
 - (a) how to determine whether an arrangement is, or contains, a lease as defined in FRS 17;
 - (b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and

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- (c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Consensus

Determining whether an arrangement is, or contains, a lease

- 6 Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:
 - (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and
 - (b) the arrangement conveys a right to use the asset.

Fulfilment of the arrangement is dependent on the use of a specific asset

- 7 Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. For example, if the supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfilment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease. A warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly does not preclude lease treatment. In addition, a contractual provision (contingent or otherwise) permitting or requiring the supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.
- 8 An asset has been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

Arrangement conveys a right to use the asset

- 9 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:
 - (a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
 - (b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
 - (c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Assessing or reassessing whether an arrangement is, or contains, a lease

- 10 The assessment of whether an arrangement contains a lease shall be made at the inception of the arrangement, being the earlier of the date of the arrangement and the date of commitment by the parties to the principal terms of the arrangement, on the basis of all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any one of the following conditions is met:

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- (a) There is a change in the contractual terms, unless the change only renews or extends the arrangement.
 - (b) A renewal option is exercised or an extension is agreed to by the parties to the arrangement, unless the term of the renewal or extension had initially been included in the lease term in accordance with paragraph 4 of FRS 17. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated under paragraphs 6-9 only with respect to the renewal or extension period.
 - (c) There is a change in the determination of whether fulfilment is dependent on a specified asset.
 - (d) There is a substantial change to the asset, for example a substantial physical change to property, plant or equipment.
- 11 A reassessment of an arrangement shall be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. If an arrangement is reassessed and is determined to contain a lease (or not to contain a lease), lease accounting shall be applied (or cease to apply) from:
- (a) in the case of (a), (c) or (d) in paragraph 10, when the change in circumstances giving rise to the reassessment occurs;
 - (b) in the case of (b) in paragraph 10, the inception of the renewal or extension period.

Separating payments for the lease from other payments

- 12 If an arrangement contains a lease, the parties to the arrangement shall apply the requirements of FRS 17 to the lease element of the arrangement, unless exempted from those requirements in accordance with paragraph 2 of FRS 17. Accordingly, if an arrangement contains a lease, that lease shall be classified as a finance lease or an operating lease in accordance with paragraphs 7-19 of FRS 17. Other elements of the arrangement not within the scope of FRS 17 shall be accounted for in accordance with other Standards.
- 13 For the purpose of applying the requirements of FRS 17, payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease and those for other elements on the basis of their relative fair values. The minimum lease payments as defined in paragraph 4 of FRS 17 include only payments for the lease (i.e. the right to use the asset) and exclude payments for other elements in the arrangement (e.g. for services and the cost of inputs).
- 14 In some cases, separating the payments for the lease from payments for other elements in the arrangement will require the purchaser to use an estimation technique. For example, a purchaser may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements, or by estimating the payments for the other elements in the arrangement by reference to comparable agreements and then deducting these payments from the total payments under the arrangement.
- 15 If a purchaser concludes that it is impracticable to separate the payments reliably, it shall:
- (a) in the case of a finance lease, recognise an asset and a liability at an amount equal to the fair value of the underlying asset that was identified in paragraphs 7 and 8 as the subject of the lease. Subsequently the liability shall be reduced as payments are made and an imputed finance charge on the liability recognised using the purchaser's incremental borrowing rate of interest.*

* i.e. the lessee's incremental borrowing rate of interest as defined in paragraph 4 of FRS 17.

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- (b) in the case of an operating lease, treat all payments under the arrangement as lease payments for the purposes of complying with the disclosure requirements of FRS 17, but
 - (i) disclose those payments separately from minimum lease payments of other arrangements that do not include payments for non-lease elements, and
 - (ii) state that the disclosed payments also include payments for non-lease elements in the arrangement.

Effective date

- 16 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies this Interpretation for a period beginning before 1 January 2006, it shall disclose that fact.

Transition

- 17 FRS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying this Interpretation. If an entity uses this exemption, it shall apply paragraphs 6-9 of the Interpretation to arrangements existing at the start of the earliest period for which comparative information under FRSs is presented on the basis of facts and circumstances existing at the start of that period.

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Appendix

Amendments to FRS 101 *First-time Adoption of Financial Reporting Standards*

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2006. If an entity applies this Interpretation for an earlier period, these amendments shall be applied for that earlier period.

- A1 FRS 101 *First-time Adoption of Financial Reporting Standards* and its accompanying documents are amended as described below.

In paragraph 12, the reference to paragraphs 13-25E is changed to 13-25F.

In paragraph 13, subparagraphs (i) and (j) are amended, and subparagraph (k) inserted, to read as follows:

- (i) insurance contracts (paragraph 25D);
- (j) decommissioning liabilities included in the cost of property, plant and equipment (paragraph 25E); and
- (k) leases (paragraph 25F).

After paragraph 25E a new heading and paragraph 25F are inserted as follows:

Leases

INT FRS 104 *Determining whether an Arrangement contains a Lease*

- 25F A first-time adopter may apply the transitional provisions in INT FRS 104 *Determining whether an Arrangement contains a Lease*. Therefore, a first-time adopter may determine whether an arrangement existing at the date of transition to FRSs contains a lease on the basis of facts and circumstances existing at that date.

In the Guidance on implementing FRS 101, after IG Example 201 the following heading, paragraphs and example are added:

INT FRS 104 *Determining whether an Arrangement contains a Lease*

- IG204 INT FRS 104 specifies criteria for determining, at the inception of an arrangement, whether the arrangement contains a lease. It also specifies when an arrangement should be reassessed subsequently.
- IG205 Paragraphs 25F of FRS 101 provides a transitional exemption. Instead of determining retrospectively whether an arrangement contains a lease at the inception of the arrangement and subsequently reassessing that arrangement as required in the periods before transition to FRSs, entities may determine whether arrangements in existence on the date of transition to FRSs contain leases by applying paragraphs 6-9 of INT FRS 104 to those arrangements on the basis of facts and circumstances existing on that date.

IG Example 202: Determining whether an Arrangement contains a Lease

BACKGROUND

An entity's first FRS financial statements have a reporting date of 31 December 2007 and include comparative information for 2006 only. Its date of transition to FRSs is therefore 1 January 2006.

On 1 January 1995, the entity entered into a take-or-pay arrangement to supply gas. On 1 January 2000, there was a change in the contractual terms of the arrangement.

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APPLICATION OF REQUIREMENTS

On 1 January 2006, the entity may determine whether the arrangement contains a lease by applying the criteria in paragraphs 6-9 of INT FRS 104 on the basis of facts and circumstances existing on that date. Alternatively, the entity applies those criteria on the basis of facts and circumstances existing on 1 January 1995 and reassesses the arrangement on 1 January 2000. If the arrangement is determined to contain a lease, the entity follows the guidance in paragraphs IG14-IG16.

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Illustrative Examples

These examples accompany, but are not part of, INT FRS 104.

Example of an arrangement that contains a lease

Facts

- IE1 A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:
- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
 - The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
 - The supplier is responsible for repairs, maintenance, and capital expenditures.
 - The supplier must stand ready to deliver a minimum quantity of gas each month.
 - Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
 - If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Assessment

- IE2 The arrangement contains a lease within the scope of FRS 17 *Leases*. An asset (the facility) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive. The purchaser has obtained the right to use the facility because, on the facts presented—in particular, that the facility is designed to meet only the purchaser's needs and the supplier has no plans to expand or modify the facility—it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility's output and the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Example of an arrangement that does not contain a lease

Facts

- IE3 A manufacturing company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a specific component part of its manufactured product for a specified period of time. The supplier designs and constructs a plant adjacent to the purchaser's factory to produce the component part. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

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- The supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfil the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomic.
- The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still pay only for the actual quantity taken.
- The supplier has the right to sell the component parts to other customers and has a history of doing so (by selling in the replacement parts market), so it is expected that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the supplier's plant.

Assessment

- IE4 The arrangement does not contain a lease within the scope of FRS 17. An asset (the plant) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. Although the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomic. However, the purchaser has not obtained the right to use the plant because the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and the likelihood that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the plant is more than remote, on the basis of the facts presented. In addition, the price that the purchaser pays is fixed per unit of output taken.

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Basis for Conclusions on INT FRS 104

This Basis for Conclusions accompanies, but is not part of, INT FRS 104.

Introduction

BC1 This Basis for Conclusions summarises the considerations in reaching the consensus.

Background (paragraphs 1-3)

BC2 It was noted that arrangements have developed in recent years that do not take the legal form of a lease but convey rights to use items for agreed periods of time in return for a payment or series of payments. Examples of such arrangements are set out in paragraph 1 of the Interpretation. It was observed that these arrangements share many features of a lease because a lease is defined in paragraph 4 of FRS 17 *Leases* 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’ (emphasis added). It was noted that all arrangements meeting the definition of a lease should be accounted for in accordance with FRS 17 (subject to the scope of that Standard) regardless of whether they take the legal form of a lease. In other words, just as it was concluded in INT FRS 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* that an arrangement that is described as a lease is not necessarily accounted for as a lease, it was concluded that an arrangement can be within the scope of FRS 17 even if it is not described as a lease. It was therefore decided that guidance should be issued to assist in determining whether an arrangement is, or contains, a lease.

BC3 ED INT FRS *Determining whether an Arrangement contains a Lease* was published for public comment in January 2004.

BC4 There was broad support for an Interpretation to be issued on this topic. However, some respondents to the ED INT FRS questioned whether the proposals were a legitimate interpretation of FRS 17. In particular, some suggested that the proposals anticipated a research project on leasing.

BC5 In considering these comments, it was concluded that they primarily arose from the observation in the Basis for Conclusions on the ED INT FRS that ‘the lease asset under FRS 17 is the right to use [and] that this asset should not be confused with the underlying item [in the arrangement]’ (e.g. an item of property, plant or equipment). As a result, it was understood that some respondents were concerned that the ED INT FRS was requiring (or permitting) purchasers (lessees) to recognise an intangible asset for the right of use, even for leases classified as operating leases.

BC6 During the redeliberation, the view that conceptually FRS 17 regards the asset as the right of use (although it acknowledged that in a finance lease, a lessee recognises an asset and accounts for that asset as if it were within the scope of FRS 16 *Property, Plant and Equipment* or FRS 38 *Intangible Assets*) was reaffirmed. However, the emphasis is that the objective of the Interpretation is only to identify whether an arrangement contains a lease, not to change the requirements of FRS 17. Accordingly, having identified a lease, an entity accounts for that lease in accordance with FRS 17. This includes following the requirements of paragraphs 7-19 of FRS 17 to determine whether the lease should be classified as an operating lease or as a finance lease. This means, for example, that if a purchaser satisfies the criteria in the Interpretation, it (a) recognises an asset only if substantially all the risks and rewards incidental to ownership are transferred and (b) treats the recognised asset as a leased item, rather than an intangible asset for the right to use that item.

BC7 The use of the term ‘item’ in the ED INT FRS was considered (as in right to use an item). It was noted that ‘item’ rather than ‘asset’ had been used to refer to the underlying asset in the arrangement (e.g. an item of property, plant or equipment) in order to emphasise that the asset that is the subject of the Interpretation is the right of use and not the underlying item or

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asset. However, given that many found the use of the term confusing, in finalising the Interpretation, the phrase in FRS 17 was reverted to 'right to use an asset'.

Multiple-element arrangements

- BC8 It was observed that many of the arrangements that fall within the scope of the Interpretation are likely to involve services as well as a right to use an asset. In other words, the arrangement is what is sometimes referred to as a multiple-element arrangement. It was concluded that FRS 17 allows for separate recognition of a lease that is embedded or contained within a multiple-element arrangement because FRS 17 states (paragraph 3) that it 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.' In addition, the definition of minimum lease payments in paragraph 4 of FRS 17 clarifies that such payments exclude costs for services. The Interpretation therefore addresses whether a multiple-element arrangement contains a lease and not just whether an entire arrangement is a lease.

Portions of an asset (paragraph 3)

- BC9 The Interpretation (like the ED INT FRS) does not address what constitutes the underlying asset in the arrangement. In other words, it does not address when a portion of a larger asset can be the subject of a lease.
- BC10 It was suggested that the omission pointed to a flaw in the proposals. There were concerns over the potential inconsistency between the accounting for a take-or-pay arrangement for substantially all of the output from a specific asset (which could have contained a lease) and one for a smaller portion of the output (which would not have been required to be treated as containing a lease). Other arguments were that the draft INT FRS would have allowed undue flexibility and that portions should be ruled out or additional guidance should be provided to clarify which portions should be recognised (for example, those that are physically distinguishable).
- BC11 From an early stage in this project, it was decided that the issue of portions should not be addressed and the main question should be focused on, i.e. what constitutes a lease. It was noted that the subject of portions was important in itself and had much wider applicability than the Interpretation. This view was affirmed during the redeliberations and therefore the suggestion that the portions should be addressed in the Interpretation was rejected. It was also concluded that it would be inappropriate to specify that the Interpretation should not be applied to an arrangement that contains a right to use a portion of an asset (whether that portion be a physically distinguishable portion of an asset, or defined by reference to the output of the asset or the time the asset is made available) because this would conflict with FRS 17. It was agreed that the phrase 'right to use an asset' does not preclude the asset being a portion of a larger asset.
- BC12 However, in the light of comments from respondents, it was decided that the Interpretation should clarify that it should be applied to arrangements in which the underlying asset would represent the unit of account in either FRS 16 or FRS 38.

Scope (paragraph 4)

- BC13 The objective of the Interpretation is to determine whether an arrangement contains a lease that falls within the scope of FRS 17. The lease is then accounted for in accordance with that Standard. Because the Interpretation should not be read as overriding any of the requirements of FRS 17, it was decided that there should be clarification if an arrangement is found to be, or contains, a lease or licensing agreement that is excluded from the scope of FRS 17, an entity need not apply FRS 17 to that lease or licensing agreement.
- BC14 The issue on whether the scope of the Interpretation might overlap with FRS 39 *Financial Instruments: Recognition and Measurement* was considered. In particular the view that an arrangement for output might meet the definition of a derivative under FRS 39 but also be

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determined to contain a lease under this Interpretation was noted. It was concluded that there should not be an overlap because an arrangement for output that is a derivative would not meet the criteria in paragraphs 6-9 of the Interpretation. In particular, it was noted that such an arrangement would be for a product with a quoted market price available in an active market and would therefore be unlikely to depend upon the use of a specifically identified asset.

Consensus (paragraphs 6-15)

Criteria for determining whether an arrangement contains a lease (paragraphs 6-9)

- BC15 In the draft INT FRS it was proposed that three criteria would all need to be satisfied for an arrangement to be, or contain, a lease:
- (a) The arrangement depends upon a specific item or items (the item). The item need not be explicitly identified by the contractual provisions of the arrangement. Rather it may be implicitly identified because it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative items.
 - (b) The arrangement conveys a right to use the item for a specific period of time such that the purchaser is able to exclude others from using the item.
 - (c) Payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item.
- BC16 The draft INT FRS also proposed that arrangements in which there is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output produced by an item would meet the second of the criteria above.
- BC17 In its Basis for Conclusions on the ED INT FRS, attention was drawn to the similarities between its Interpretation and Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease* published by the US Emerging Issues Task Force (EITF) in May 2003. It was concluded that '[a]lthough the wording of Issue 01-8 and the draft Interpretation differ, a similar assessment of whether an arrangement contains a lease is likely under both interpretations.'
- BC18 There were some disagreements with the conclusion and it was suggested that the differences between the two interpretations were, in fact, significant. However, the original conclusion was maintained. In particular, it was noted that both it and the EITF had concluded that a right of use can be conveyed in arrangements in which purchasers have rights to acquire the output that will be produced by an asset, regardless of any right or ability physically to operate or control access to that asset. Accordingly, many take-or-pay (and similar contracts) would have been similarly assessed under the two interpretations.
- BC19 Nonetheless, it was agreed that some arrangements would be regarded as leases under Issue 01-8 but not under the ED INT FRS. It was concluded that there were two main reasons for this. First, the effect of the third criterion in the ED INT FRS ('payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item') was that a purchaser would always be required to assume some pricing risk in an arrangement for there to be a lease. This is not the case under Issue 01-8. Secondly, the second criterion in the draft INT FRS ('the arrangement conveys a right to use the item ...such that the purchaser is able to exclude others from using the item') suggested that a right of use is conveyed in an arrangement for the output from an asset only when the purchaser is taking *substantially all* of the output from a specific asset. Under Issue 01-8, a right of use is also conveyed if the purchaser controls or operates the underlying specific asset while taking more than a *minor amount* of the output from an asset.
- BC20 It was noted that the definition of a lease in FRS 17 is similar to its definition in the US standard SFAS 13 *Accounting for Leases*. Given this, it was concluded that there was no compelling reason for different assessments of whether an arrangement contains a lease under FRSs and US GAAP. Furthermore, there were concerns over the practical difficulties highlighted by some respondents that would arise in cases when an agreement would need to

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be assessed against two similar, but different, sets of criteria. Therefore, it was decided that the differences between the approach in the draft INT FRS and Issue 01-8 should be eliminated for determining whether an arrangement contains a lease. It was concluded that the most effective way of achieving this objective would be to modify its criteria to conform them more fully to the approach in Issue 01-8.

- BC21 It was decided that the actual words from Issue 01-8 should be adopted as far as possible, subject to differences between FRS 17 and SFAS 13. It was concluded that differences in wording would not promote convergence and would be likely to cause confusion. Therefore, paragraphs 7-9 are virtually identical to Issue 01-8, except that:
- (a) the Interpretation uses the term 'asset' rather than 'property, plant or equipment' as in Issue 01-8. It was noted that FRS 17 covers a broader range of leases than SFAS 13 and that there was no reason for restricting this Interpretation only to items of property, plant or equipment.
 - (b) the phrase 'more than a minor amount of the output' in Issue 01-8 has been expressed as 'more than an insignificant amount of the output'. This is because the latter is the more customary form of words under FRSs and is therefore consistent with other Standards. In this context, however, it was intentional that 'minor' and 'insignificant' have the same meaning.
- BC22 Apart from small modifications to the wording of the first criterion in the ED INT FRS, the effect of converging fully with the criteria in Issue 01-8 for determining whether an arrangement contains a lease is that the second and third criteria in the ED INT FRS are replaced by one criterion, requiring the arrangement to convey to the purchaser the right to control the use of the underlying asset.
- BC23 Although the requirements for determining whether an arrangement contains a lease are the same under FRSs and US GAAP, it was emphasised that any lease identified by the Interpretation may be accounted for differently under FRSs and US GAAP because of differences between their respective leasing standards.

Fulfilment of the arrangement is dependent on the use of a specific asset (paragraphs 7 and 8)

- BC24 It was agreed that a specific asset needs to be identified in the arrangement for there to be a lease. It was concluded that this follows from the definition of a lease, which refers to a 'right to use an asset' (emphasis added). It was also observed that dependence on a specifically identified asset is a feature that distinguishes a lease from other arrangements that also convey rights to use assets but are not leases (e.g. some service arrangements).
- BC25 However, it was concluded that the identification of the asset in the arrangement need not be explicit. Rather, the facts and circumstances could implicitly identify an asset because it would not be economically feasible or practical for the supplier to perform its obligation by providing the use of alternative assets. Examples of when an asset may be implicitly identified are when the supplier owns only one suitable asset; the asset used to fulfil the contract needs to be at a particular location or specialized to the purchaser's needs; and the supplier is a special purpose entity formed for a limited purpose.
- BC26 Some respondents to the ED INT FRS noted that the effect of this first criterion is that the purchaser's accounting could depend on how the supplier chooses to fulfil the arrangement. They noted that the purchaser might have no control over this because (in form) the purchaser has contracted for output. Some respondents were also troubled by the lack of comparability, because similar arrangements for the output of an asset could be accounted for differently according to whether they depend on the use of a specific asset.
- BC27 In response to the first of these comments, it was noted that how an entity chooses to obtain a product normally determines the accounting treatment; for example, an entity requiring power may choose to lease a power plant or connect to the grid and the two options would result in different accounting. Although in the respondents' example the choice is the

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supplier's (rather than the purchaser's), it was concluded that the critical matter is the end position of the entity (i.e. is there a lease?) not how it got to that position (i.e. whether it chose that outcome or it was imposed).

BC28 In response to the second comment, it was observed that it is important to consider the combined effect of the criteria in the Interpretation rather than considering the criteria individually. On reconsidering the proposals in the ED INT FRS and the requirements of Issue 01-8, it was concluded that in the context of current FRSs, in which executory contracts are generally not accounted for, the Interpretation identifies contracts (or an element therein) that for a purchaser warrant recognition (if the definition of a finance lease is satisfied). It was concluded that identifying and accounting for the lease element would represent an improvement to existing accounting practice.

Arrangement conveys a right to use the asset (paragraph 9)

BC29 Following Issue 01-8, the Interpretation specifies that a right of use can be conveyed if any of three criteria is satisfied.

BC30 The first two criteria consider the purchaser's ability to control physically the use of the underlying asset, either through operations or access, while obtaining or controlling more than an insignificant amount of the output of the asset. For example, a purchaser's ability to operate the asset may be evidenced by its ability to hire, fire or replace the operator of the asset or its ability to specify significant operating policies and procedures in the arrangement (as opposed to a right to monitor the supplier's activities) with the supplier having no ability to change such policies and procedures.

BC31 In the ED INT FRS, it was explained that the ability of a purchaser to operate physically the underlying asset was not regarded as determinative of whether a right of use has been conveyed. It was noted that asset managers 'operate' assets, but this does not necessarily convey a right of use. However, it was noted that under Issue 01-8, in addition to the ability to operate the asset, the purchaser has to be taking more than a minor amount of the output. It was agreed that in such cases the arrangement would convey a right of use.

BC32 As agreed with the EITF, a right of use has been conveyed in arrangements in which the purchaser has the ability to control physically the use of the underlying asset through access (while obtaining or controlling more than a minor amount of the output of the asset). It was noted that in such arrangements the purchaser would have the ability to restrict the access of others to economic benefits of the underlying asset.

BC33 The third criterion for determining whether a right of use has been conveyed considers whether the purchaser is taking all or substantially all of the output or other utility of the underlying asset.

BC34 As noted above, the ED INT FRS similarly specified that a right of use could be conveyed in arrangements in which there is only a remote possibility that other parties could take more than an insignificant amount of the output of an asset. Among the respondents who disagreed with the proposals in the draft INT FRS, it was this criterion that was considered most troublesome. They disagreed that, in certain specified circumstances, a purchaser's right to acquire the output from an asset could be equated with a right of use that asset. Among the arguments put forth were:

- (a) A right of use requires the purchaser to have the ability to control the way in which the underlying asset is used during the term of the arrangement: for example, the right for the purchaser's employees to assist or supervise the operation of the asset.
- (b) In addition to the right to the output, the purchaser needs to have control over the delivery profile of the output; in other words it also needs the ability to determine when the output flows, otherwise it is simply consuming the output of the underlying asset rather than using the asset in its business.
- (c) In most supply arrangements, the purchaser would not have access to the plant in the event of default by the supplier but would receive damages. The absence of this right

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points to there not being a lease. If the arrangement did contain a lease, the purchaser would have the ability to receive the output from the plant in the arrangement by replacing the original supplier with another service provider.

- (d) The ED INT FRS dismisses 'risks and rewards incidental to ownership' of the asset in determining whether an arrangement contains a lease. Therefore, arrangements in which the supplier retains significantly all of the risks and rewards of operation and ownership of the asset could be deemed to contain leases. However, in such arrangements the supplier's cash flows may have significantly more potential for variability than a 'true' lessor and the supplier may demand a return significantly above the market rate for a lessor.

BC35 In its redeliberations, the view that a purchaser that is taking substantially all of the output from an asset has the ability to restrict the access of others to the output from that asset was reaffirmed. The purchaser therefore has a right of use because it controls access to the economic benefits to be derived from the asset. Therefore it was disagreed the absence of the ability to control physically the way in which the underlying asset is used precludes the existence of a right of use (although, as noted above, such an ability may indicate that a right of use has been conveyed).

BC36 With respect to the other points, the following were noted:

- (a) A purchaser that is taking substantially all of the output from an asset in cases when it is remote that others will be taking more than an insignificant amount of the output does in effect determine when the output flows.
- (b) In most straightforward leases, any lessee that terminates the lease because of default by the lessor would no longer have access to the asset. Furthermore, in many leases that contain both a right of use and a service element, the related service contract does not operate independently (e.g. the lessee cannot terminate the service element alone). Indeed, it was noted that the purchaser's entitlement to damages in the event of default by the supplier indicates that a right of use was originally conveyed, and that the supplier is compensating the purchaser for withdrawing that right.
- (c) Risks and rewards are in general relevant for determining lease classification rather than whether an arrangement is a lease. It was noted that in many straightforward short-term operating leases, substantially all the risks and rewards are retained by the lessor. Even if it were desirable to specify that a certain level of risks and rewards needed to be transferred for there to be a lease, it was doubtful that such a criterion could be made operable. Nonetheless, an arrangement that conveys the right to use an asset will also convey certain risks and rewards incidental to ownership. Therefore, the transfer of risks and rewards of ownership may indicate that the arrangement conveys the right to use an asset. For example, if an arrangement's pricing provides for a fixed capacity charge designed to recover the supplier's capital investment in the underlying asset, the pricing may be persuasive evidence that it is remote that parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset, and the criterion in paragraph 9(c) is satisfied.

BC37 In adopting the approach from Issue 01-8, an arrangement for all or substantially all of the output from a specific asset does not convey the right to use the asset if the price that the purchaser will pay is contractually fixed per unit of output or equal to the current market price per unit of output as of the time of delivery of the output has been specified. This is because in such cases the purchaser is paying for a product or service rather than paying for the right to use the asset. In the ED INT FRS, it was proposed that a similar distinction by the combination of the second and third criteria (see paragraph BC15(b) and (c) above) be made.

BC38 It was noted that the Interpretation could result in take-or-pay arrangements, in which purchasers are committed to purchase substantially all of the output from specific assets, being determined to contain leases. This is because in such arrangements the purchaser makes payments for the time that the underlying asset is made available for use rather than

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on the basis of actual use or output (resulting in the arrangement's pricing being neither fixed per unit of output nor equal to the current market price per unit of output). In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier regardless of whether the purchaser uses the underlying asset or obtains the output from that asset. Payments are therefore made for the right to use that asset. It was agreed that the overall effect of such a take-or-pay arrangement is similar to that of a lease plus contracts for related services and supplies (such as contracts for the operation of the asset and the purchase of inputs).

- BC39 It was observed that if an arrangement contains a lease, and the lease is an operating lease, applying the Interpretation is likely to result in the same assets, liabilities and expenses being recognised as if no lease had been identified. However, it was noted that FRS 17 requires lessors and lessees to recognise operating lease payments on a straight-line basis over the lease term (unless another systematic basis is more representative of the time pattern of the benefit derived from the leased asset), and thus adjustments to the recognition profile of the payments for the lease element might be required in some instances. Also, it was noted that the Interpretation would often result in additional disclosure, because FRS 17 requires the lessor and lessee to disclose the future minimum lease payments. It was observed that, for a purchaser, the arrangements discussed in the Interpretation typically represent significant future commitments, and yet these commitments are not specifically required to be disclosed in the financial statements by Standards other than FRS 17. It was concluded that bringing such arrangements within the scope of FRS 17 would provide users of financial statements with relevant information that is useful for assessing the purchaser's solvency, liquidity and adaptability. It was acknowledged that the disclosed information might relate only to the lease element of the arrangement; however, it was agreed that it would be beyond the scope of this Interpretation to address disclosure of executory contracts more generally.

Assessing or reassessing whether an arrangement contains a lease (paragraphs 10 and 11)

- BC40 In the ED INT FRS, it was proposed that the assessment of whether an arrangement contains a lease should be made at the inception of the arrangement on the basis of the facts and circumstances existing at that time and that, consistently with FRS 17, an arrangement should be reassessed only if there was a change in the terms of the arrangement. Hence, under the draft INT FRS, a supplier that subsequently obtained additional assets with which it could fulfill the arrangement, would not have reassessed the arrangement.
- BC41 Some respondents disagreed with this conclusion and argued that the analogy with the requirements for reclassifying a lease in FRS 17 was not relevant because the objective of the Interpretation is to determine whether an arrangement is within the scope of FRS 17. They noted that since this depends on factors such as whether the arrangement depends on a specific asset, it was logical that reassessment should be required if those factors change.
- BC42 Persuaded by this argument, it was concluded that it outweighed the concerns that were expressed in the draft INT FRS about it being unduly burdensome to require purchasers to reassess arrangements. It was also noted that the proposal in the draft INT FRS was different from Issue 01-8. Given that it the approach to determining whether a lease exists was modified to converge with Issue 01-8, it was decided that the same treatment as Issue 01-8 for reassessments should also be specified.
- BC43 It was noted that the requirements in paragraphs 10 and 11 relate only to determining when the arrangement should be reassessed and that they do not alter the requirements of FRS 17. Hence if an arrangement that contains a lease is required to be reassessed and found still to contain a lease, the lease is reclassified as a finance lease or operating lease only if so required by paragraph 13 of FRS 17.

Separating payments for the lease from other payments (paragraphs 12-15)

- BC44 The ED INT FRS proposed, and the Interpretation requires, payments in an arrangement containing both a lease and other elements (e.g. services) to be separated into those for the

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lease and those for other elements on the basis of their relative fair values. It was concluded that fair value is the most relevant and faithful representation of the underlying economics of the transaction.

- BC45 It was noted that this requirement could be more onerous for purchasers than for suppliers, particularly when a purchaser has no access to the supplier's pricing information. It was therefore agreed that some guidance should be provided to assist purchasers in separating the lease from other elements in the arrangement. Nonetheless, it was acknowledged that in rare cases it might be impracticable for the purchaser to separate the payments reliably. It was noted that if this was the case and the lease was a finance lease, then the requirements of FRS 17 would ensure that the purchaser would not capitalise an amount greater than the fair value of the asset (since paragraph 20 of FRS 17 requires a lessee to recognise a finance lease asset at the fair value of the leased property or, if lower, the present value of the minimum lease payments). Accordingly, it was specified that in such cases the purchaser should recognise the fair value of the underlying asset as the leased asset. If the lease is an operating lease and it is impracticable to separate the payments reliably, it was agreed, as a practical accommodation, that the purchaser should disclose all the payments under the arrangement when disclosing the minimum lease payments, and state that these also include payment for other elements in the arrangement.
- BC46 Some respondents to the draft INT FRS noted that if a purchaser with an operating lease does not separate the payments, the usefulness of the disclosures required by FRS 17 would be reduced. It was agreed that the minimum lease payments are often used by users of financial statements to estimate the value of assets held under operating leases and therefore concluded that lease payments that also include payments for other elements should be disclosed separately.

Transition (paragraph 17)

- BC47 The ED INT FRS proposed, and the Interpretation requires, retrospective application. Some respondents proposed that the Interpretation should be applied only to new arrangements starting after its effective date. Two main arguments were put forward in support of this view:
- (a) convergence with Issue 01-8 (which applies to arrangements starting or modified after the beginning of an entity's next reporting period beginning after 28 May 2003); and
 - (b) to ease transition, particularly in the case of longer arrangements that started some years ago and where it might be difficult to make the assessments required by the ED INT FRS retrospectively.
- BC48 It was noted that EITF Abstracts are usually applied prospectively. In contrast, FRSs (including Interpretations) are applied retrospectively following the principle articulated in FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. There was no compelling argument from departing from this principle. It was also noted that unless it were to specify exactly the same effective date as Issue 01-8 (which was before the draft INT FRS was published), reconciling items with US GAAP would still arise.
- BC49 In addition, it was decided that the continuation of some arrangements for many years emphasised the need for retrospective application. Without retrospective application, an entity could be accounting for similar arrangements differently for many years with a consequent loss of comparability.
- BC50 However, there were concerns to the practical difficulties raised by full retrospective application, in particular the difficulty of going back potentially many years and determining whether the criteria would have been satisfied at that time. Although FRS 8 provides relief from fully retrospective application in cases where such treatment would be impracticable, it was decided that transitional relief for existing preparers of FRSs should be provided in the Interpretation itself. There was emphasis that this relief does not alter the transition requirements of FRS 17 and therefore if an arrangement is determined to contain a lease an entity applies FRS 17 from the inception of the arrangement.

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