HK(IFRIC)-Int 4
Revised ~~February 2014~~September 2018

Effective for annual periods
beginning on or after 1 January 2006

HK(IFRIC) Interpretation 4

Determining whether an Arrangement contains a Lease

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

CONTENTS

HK(IFRIC) Interpretation 4 *Determining whether an Arrangement contains a Lease* (HK(IFRIC)-Int 4) is set out in paragraphs 1-17 and the Appendix. HK(IFRIC)-Int 4 is accompanied by illustrative examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

HK(IFRIC)-Int 4
Determining whether an Arrangement contains a Lease

References[ϕ]

- HKFRS 13 *Fair Value Measurement*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 17 *Leases*
- HKAS 38 *Intangible Assets*
- HK(IFRIC) - Int 12 *Service Concession Arrangements*

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 (eg 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 (eg 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 (eg 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 HKAS 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 HKAS 17. Nevertheless, arrangements in which the underlying asset would represent a unit of account in either HKAS 16 or HKAS 38 are within the scope of this Interpretation.

Scope

4 This Interpretation does not apply to arrangements that:

(a) are, or contain, leases excluded from the scope of HKAS 17; or

(b) are public-to-private service concession arrangements within the scope of HK(IFRIC)-Int 12.

[ϕ] With effect from 1 January 2005, all the existing Statements of Standard Accounting Practice (SSAPs) and Interpretations for which there are equivalent International Accounting Standards (IAS) and SIC Interpretations will be renamed as Hong Kong Accounting Standards (HKASs) and Hong Kong (SIC) Interpretations (HK(SIC)-Int) with numbers corresponding to the equivalent IAS and SIC Interpretations, respectively. For full details of this change, please click on the following link: http://www.hkicpa.org.hk/professionaltechnical/accounting/rm/memorandum.pdf. If an entity applies this Interpretation for a period beginning before 1 January 2005, the entity shall follow the requirements of SSAPs effective for that period, unless the entity is applying the relevant HKASs for that earlier period. Accordingly, references to the HKASs in this Interpretation should be read as references to the related superseded SSAPs as recorded in the table of concordance set out in the HKICPA website: http://www.hkicpa.org.hk/professionaltechnical/accounting/dueprocess/concordance.pdf, where appropriate.

Issues

5 The issues addressed in this Interpretation are:

(a) how to determine whether an arrangement is, or contains, a lease as defined in HKAS 17;

(b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and

(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.

Conclusions

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:

(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 HKAS 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 HKAS 17 to the lease element of the arrangement, unless exempted from those requirements in accordance with paragraph 2 of HKAS 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 HKAS 17. Other elements of the arrangement not within the scope of HKAS 17 shall be accounted for in accordance with other Standards.

13 For the purpose of applying the requirements of HKAS 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 HKAS 17 include only payments for the lease (ie the right to use the asset) and exclude payments for other elements in the arrangement (eg 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[1] 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.[2]

(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 HKAS 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.

16A An entity shall apply the amendment in paragraph 4(b) for annual periods beginning on or after 1 January 2008. If an entity applies HK(IFRIC)-Int 12 for an earlier period, the amendment shall be applied for that earlier period.

Transition

17. HKAS 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 the Interpretation. If an entity uses this exemption, it shall apply paragraphs 6-9 of this Interpretation to arrangements existing at the start of the earliest period for which comparative information under HKFRSs is presented on the basis of facts and circumstances existing at the start of that period.

[1] HKAS 17 uses the term 'fair value' in a way that differs in some respects from the definition of fair value in HKFRS 13. Therefore, when applying HKAS 17 an entity measures fair value in accordance with HKAS 17, not HKFRS 13.

[2] ie the lessee's incremental borrowing rate of interest as defined in paragraph 4 of HKAS 17.

Appendix

Amendments to HKFRS 1 *First-time Adoption of Hong Kong 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.

* * *

The amendments contained in this appendix when this Interpretation was issued have been incorporated into the relevant Standards.

IFRIC Interpretation 4
Illustrative Examples

These examples accompany, but are not part of, IFRIC 4.

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 IAS 17 *Leases.* An asset (the facility) is explicitly identified in the arrangement and fulfilment 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:

- 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 IAS 17. An asset (the plant) is explicitly identified in the arrangement and fulfilment 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.

Basis for Conclusions on IFRIC Interpretation 4 *Determining whether an Arrangement contains a Lease*

This Basis for Conclusions accompanies, but is not part of, IFRIC 4.

HK(IFRIC) Interpretation 4 is based on IFRIC Interpretation 4 *Determining whether an Arrangement contains a Lease*. In approving HK(IFRIC) Interpretation 4, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 4. Accordingly, there are no significant differences between HK(IFRIC) Interpretation 4 and IFRIC Interpretation 4. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 4 referred to below generally correspond with those in HK(IFRIC) Interpretation 4.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1-3)

BC2 The IFRIC 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. The IFRIC observed that these arrangements share many features of a lease because a lease is defined in paragraph 4 of IAS 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). The IFRIC noted that all arrangements meeting the definition of a lease should be accounted for in accordance with IAS 17 (subject to the scope of that Standard) regardless of whether they take the legal form of a lease. In other words, just as the Standing Interpretations Committee concluded in SIC-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, the IFRIC concluded that an arrangement can be within the scope of IAS 17 even if it is not described as a lease. The IFRIC therefore decided that it should issue guidance to assist in determining whether an arrangement is, or contains, a lease.

BC3 The IFRIC published Draft Interpretation D3 *Determining whether an Arrangement contains a Lease* for public comment in January 2004 and received 51 comment letters in response to its proposals. In addition, in order to understand better the practical issues that would have arisen on implementing the proposed Interpretation, IASB staff met a number of preparer constituents.

BC4 There was broad support for the IFRIC issuing an Interpretation on this topic (even among those respondents who disagreed with the criteria in D3 for determining whether a lease exists). However, some respondents to D3 questioned whether the proposals were a legitimate *interpretation* of IAS 17. In particular, some suggested that the proposals anticipated the Board's current research project on leasing.

BC5 In considering these comments, the IFRIC concluded that they primarily arose from its observation in the Basis for Conclusions on D3 that 'the lease asset under IAS 17 is the right to use [and] that this asset should not be confused with the underlying item [in the arrangement]' (eg an item of property, plant or equipment). As a result, the IFRIC understood that some respondents were concerned that D3 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 redeliberation, the IFRIC affirmed its view that conceptually IAS 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 IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*). However, the IFRIC decided to emphasise that the objective of the Interpretation is only to identify whether an arrangement contains a lease, not to change the requirements of IAS 17. Accordingly, having identified a lease, an entity accounts for that lease in accordance with IAS 17. This includes following the requirements of paragraphs 7-19 of IAS 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 IFRIC reconsidered its use of the term 'item' in D3 (as in right to use an item). The IFRIC noted that it had used 'item' rather than 'asset' to refer to the underlying asset in the arrangement (eg 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 asset. However, given that many found the use of the term confusing, the IFRIC decided in finalising the Interpretation to revert to the phrase in IAS 17 'right to use an asset'.

Multiple-element arrangements

BC8 The IFRIC 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. The IFRIC concluded that IAS 17 allows for separate recognition of a lease that is embedded or contained within a multiple-element arrangement because IAS 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 IAS 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 D3) 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 Some respondents to D3 suggested that this omission pointed to a flaw in the proposals. They were troubled by 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 respondents argued that D3 would have allowed undue flexibility and that the IFRIC should either explicitly rule out portions or provide additional guidance to clarify which portions should be recognised (for example, those that are physically distinguishable).

BC11 From an early stage in this project, the IFRIC decided that it should not address the issue of portions and should focus on the main question, ie what constitutes a lease. The IFRIC noted that the subject of portions was important in itself and had much wider applicability than the Interpretation. The IFRIC affirmed this view during its redeliberations and therefore rejected the suggestion that it also should address portions in the Interpretation. The IFRIC 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 IAS 17. The IFRIC 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, the IFRIC decided to clarify that the Interpretation should be applied to arrangements in which the underlying asset would represent the unit of account in either IAS 16 or IAS 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 IAS 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 IAS 17, the IFRIC decided that it should clarify that if an arrangement is found to be, or contains, a lease or licensing agreement that is excluded from the scope of IAS 17, an entity need not apply IAS 17 to that lease or licensing agreement.

BC14 The IFRIC considered whether the scope of the Interpretation might overlap with IAS 39 *Financial Instruments: Recognition and Measurement.*[*] In particular it noted the view that an arrangement for output might meet the definition of a derivative under IAS 39 but also be determined to contain a lease under this Interpretation. The IFRIC 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, the IFRIC 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.

BC14A The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 12, which was developed from draft Interpretations D12-D14. In particular it noted the views expressed by some respondents to the proposals that the contractual terms of some public-to-private service concession arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion of D12-D14. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. The IFRIC therefore amended IFRIC 4 to specify that if a public-to-private service concession arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

Consensus (paragraphs 6-15)

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

BC15 In D3 the IFRIC 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 D3 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 D3, the IFRIC drew attention 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. The IFRIC 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 Some respondents disagreed with the IFRIC's conclusion and suggested that the differences between the two interpretations were, in fact, significant. The IFRIC, however, maintained its original conclusion. In particular, it 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, the IFRIC agreed that some arrangements would be regarded as leases under Issue 01-8 but not under D3. The IFRIC concluded that there were two main reasons for this. First, the effect of the third criterion in D3 ('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 D3 ('the arrangement conveys a right to use the item …such that the purchaser is able to exclude others

[*] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

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 The IFRIC noted that the definition of a lease in IAS 17 is similar to its definition in the US standard SFAS 13 *Accounting for Leases*. Given this, the IFRIC concluded that there was no compelling reason for different assessments of whether an arrangement contains a lease under IFRSs and US GAAP. Furthermore, the IFRIC was sympathetic to the practical difficulties highlighted by some respondents that would arise in cases when an agreement would need to be assessed against two similar, but different, sets of criteria. Therefore, the IFRIC decided that it should seek to eliminate the differences between the approach in D3 and Issue 01-8 for determining whether an arrangement contains a lease. The IFRIC 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 The IFRIC decided that as far as possible it should adopt the actual words from Issue 01-8, subject to differences between IAS 17 and SFAS 13. It 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. The IFRIC noted that IAS 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 IFRSs and is therefore consistent with other Standards. In this context, however, the IFRIC intends 'minor' and 'insignificant' to have the same meaning.

BC22 Apart from small modifications to the wording of the first criterion in D3, 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 D3 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 IFRSs and US GAAP, the IFRIC emphasises that any lease identified by the Interpretation may be accounted for differently under IFRSs 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 The IFRIC agreed that a specific asset needs to be identified in the arrangement for there to be a lease. The IFRIC concluded that this follows from the definition of a lease, which refers to a 'right to use *an* asset' (emphasis added). The IFRIC 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 (eg some service arrangements).

BC25 However, the IFRIC 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 specialised to the purchaser's needs; and the supplier is a special purpose entity formed for a limited purpose.[*]

[*] SIC-12 *Consolidation – Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

BC26 Some respondents to D3 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, the IFRIC 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 supplier's (rather than the purchaser's), the IFRIC concluded that the critical matter is the end position of the entity (ie is there a lease?) not how it got to that position (ie whether it chose that outcome or it was imposed).

BC28 In response to the second comment, the IFRIC 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 D3 and the requirements of Issue 01-8, the IFRIC concluded that in the context of current IFRSs, 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). The IFRIC 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 D3 the IFRIC explained that it did not regard the ability of a purchaser to operate physically the underlying asset as determinative of whether a right of use has been conveyed. The IFRIC noted that asset managers 'operate' assets, but this does not necessarily convey a right of use. However, the IFRIC 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. The IFRIC agreed that in such cases the arrangement would convey a right of use.

BC32 The IFRIC agreed with the EITF that 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). The IFRIC 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, D3 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 D3, 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 to the IFRIC 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 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) D3 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 IFRIC reaffirmed its 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. The purchaser therefore has a right of use because it controls access to the economic benefits to be derived from the asset. The IFRIC therefore did not agree that 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 IFRIC noted the following:

(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 (eg the lessee cannot terminate the service element alone). Indeed, the IFRIC 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. The IFRIC 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, the IFRIC 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, the IFRIC has specified that 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. 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 D3, the IFRIC proposed making a similar distinction by the combination of the second and third criteria (see paragraph BC15(b) and (c) above).

BC38 The IFRIC noted that its 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 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. The IFRIC 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 The IFRIC 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, the IFRIC noted that IAS 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, the IFRIC noted that the Interpretation would often result in additional disclosure, because IAS 17 requires the lessor and lessee to disclose the future minimum lease payments. The IFRIC 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 IAS 17. The IFRIC concluded that bringing such arrangements within the scope of IAS 17 would provide users of financial statements with relevant information that is useful for assessing the purchaser's solvency, liquidity and adaptability. The IFRIC acknowledged that the disclosed information might relate only to the lease element of the arrangement; however, it 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 D3 the IFRIC 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 IAS 17, an arrangement should be reassessed only if there was a change in the terms of the arrangement. Hence, under D3, a supplier that subsequently obtained additional assets with which it could fulfil 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 IAS 17 was not relevant because the objective of the Interpretation is to determine whether an arrangement is within the scope of IAS 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 The IFRIC was persuaded by this argument and concluded that it outweighed the concerns that it had expressed in D3 about it being unduly burdensome to require purchasers to reassess arrangements. The IFRIC also noted that its proposal in D3 was different from Issue 01-8. Given that it had modified its approach to determining whether a lease exists to converge with Issue 01-8, the IFRIC decided that it should also specify the same treatment as Issue 01-8 for reassessments.

BC43 The IFRIC 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 IAS 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 IAS 17.

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

BC44 D3 proposed, and the Interpretation requires, payments in an arrangement containing both a lease and other elements (eg services) to be separated into those for the lease and those for other elements on the basis of their relative fair values. The IFRIC concluded that fair value is the most relevant and faithful representation of the underlying economics of the transaction.

BC45 The IFRIC 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. The IFRIC therefore agreed that it should provide some guidance to assist purchasers in separating the lease from other elements in the arrangement. Nonetheless, the IFRIC acknowledged that in rare cases it might be impracticable for the purchaser to separate the payments reliably. The IFRIC noted that if this was the case and the lease was a finance lease, then the requirements of IAS 17 would ensure that the purchaser would not capitalise an amount greater than the fair value of the asset (since paragraph 20 of IAS 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, the IFRIC decided to specify 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, the IFRIC 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 D3 noted that if a purchaser with an operating lease does not separate the payments, the usefulness of the disclosures required by IAS 17 would be reduced. The IFRIC 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 D3 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 D3 retrospectively.

BC48 The IFRIC noted that EITF Abstracts are usually applied prospectively. In contrast, IFRSs (including Interpretations) are applied retrospectively following the principle articulated in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* The IFRIC could see no compelling argument ~~from~~ for departing from this principle. The IFRIC also noted that unless it were to specify exactly the same effective date as Issue 01-8 (which was before D3 was published), reconciling items with US GAAP would still arise.

BC49 In addition, the IFRIC 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, the IFRIC was sympathetic 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 IAS 8 provides relief from fully retrospective application in cases where such treatment would be impracticable, the IFRIC decided that it should provide transitional relief for existing preparers of IFRSs in the Interpretation itself. The IFRIC emphasises that this relief does not alter the transition requirements of IAS 17 and therefore if an arrangement is determined to contain a lease an entity applies IAS 17 from the inception of the arrangement.