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IFRS industry insights

The Leases Project – An update for the manufacturing industry

Respondents from the manufacturing industry expressed concern over a number of proposals in the ED …

In August 2010, the IASB and FASB (the "Boards") took a major step towards overhauling the existing lease accounting rules by issuing a set of proposals in the form of an exposure draft (ED). The proposals would significantly affect the accounting for lease contracts for both lessees and lessors across all industries. Since issuing the ED, the Boards have conducted extensive outreach. The comment period, which ended on 15 December 2010, garnered over 750 responses, and resulted in roundtable sessions that included participants from all constituencies, including preparers, users and auditors from a wide cross section of industries. Respondents from the manufacturing industry expressed concern over a number of proposals in the ED, including the definition of a lease, contracts containing lease and service components, expense recognition pattern for lessees, variable lease payments and lease term.

Definition of a lease

The ED defines a lease as "a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration." The ED includes the following two principles, based on the existing guidance in IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, relating to that definition:

- The fulfilment of the contract depends on providing a specified asset or assets; and
- The contract conveys the right to control the use of a specified asset for an agreed period of time.

Several respondents from the manufacturing industry expressed concern with the broad nature of the proposed definition in the ED, requesting clarity as to whether a "specified asset" should be identified as a specific asset (e.g., unique asset serial number) or an asset of a particular specification (e.g., asset model or type) and requested the Boards reconsider the guidance for determining whether a contract conveys the right to control by applying an approach consistent with the forthcoming revenue recognition and consolidation standards.

In April 2011, the Boards tentatively decided that a "specified asset" would be an identifiable asset that is explicitly or implicitly identified in the contract. An asset would be implicitly identified only if it would not be practical and economically feasible for the owner to substitute alternative assets in place of the underlying asset during the lease term. Conversely, a contract would not be a lease if it would be practical and economically feasible for the owner of the asset to substitute the underlying asset and substitution could occur at any time without the customer's consent. In reaching this tentative decision, the Boards rejected the view of defining a specified asset more broadly as an asset of a particular specification rather than as an asset that is uniquely identified.

The Boards also tentatively decided that a contract would convey the right to control the use of the underlying asset if the customer has the ability to direct the use, and receive the benefit from use, of a specified asset throughout the lease term. The ability to direct the use of a specified asset would include determining how, when, and in what manner the specified asset is used or determining how the specified asset is used in conjunction with other assets or resources to deliver the benefit from its use to the customer.

The proposed definition of a lease could have a significant effect on those manufacturing entities that enter into long-term supply arrangements that are treated as leases …

If a customer can specify the output or benefit from use of the asset, but is unable to make decisions about the input or process that results in that output, the ability to specify the output would not, in and of itself, be determinative that the customer has the ability to direct the use of the asset. A customer's ability to receive the benefit from use of a specified asset refers to its present right to obtain substantially all of the potential economic benefits from use of that asset throughout the lease term. The tentative decision does not refer to the pricing of the output as a consideration in determining whether a purchaser has the right to control the use of the underlying asset.

In circumstances in which the supplier directs the use of the specified asset used to perform services requested by the customer, the Boards tentatively decided that customers and suppliers would be required to assess whether the use of the asset is an inseparable part of the services requested by the customer (if inseparable, the entire contract would be accounted for as a service contract because the customer has not obtained the right to control the use of the asset) or a separable part of the services provided. The Boards directed the staffs to clarify the wording and perform outreach activities to understand any potential problems with this tentative decision. It is therefore uncertain at this time how the separable versus inseparable guidance would affect the conclusion as to whether a supply arrangement is a lease or a service.

The proposed definition of a lease could have a significant effect on those manufacturing entities that enter into long-term supply arrangements that are treated as leases under IFRIC 4. Specifically, if the purchaser of the product is unable to make decisions about the input or process that results in the output (the manufactured product), it appears that the purchaser would lack the ability to direct the use of the asset, and therefore, the contract would likely not be considered a lease. That is, purchasing substantially all of the output from specified manufacturing assets would not, in and of itself, result in a supply contract meeting the definition of a lease regardless of the arrangement's pricing terms. The purchaser would need to have the ability to make decisions about using the specified assets that significantly affect the benefits received from that use throughout the contract term. For example, the purchaser may need to determine (1) how, when, and in what manner the manufacturing assets are used or (2) how the manufacturing assets are used in conjunction with other assets or resources to deliver the benefit from its use to the purchaser, in order for the purchaser to conclude that it has the right to control the underlying asset.

In contrast, under paragraph 9(c) of IFRIC 4, a purchaser considers whether the possibility 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 is remote, 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. Both the amount of output purchased and the pricing terms are considered in determining whether a contract would convey the right to control the use of the underlying asset. However, the tentative decisions would require that the purchaser have the ability to make some decisions about using the specified asset for a contract to be a lease and would eliminate the consideration of pricing of the output.

Example

An auto manufacturer that negotiates a contract with a supplier for the production of certain components to be used in the assembly of its vehicles would need to consider whether the contract to manufacture the components is a lease. The auto manufacturer would determine whether fulfilment of the contract depends on providing specified assets. In doing so, the auto manufacturer would need to assess whether the assets used for production are implicitly or explicitly identified in the contract and whether the supplier has a substantive right to substitute the assets used to manufacture the components without requiring the auto manufacturer's consent.

The auto manufacturer would then need to determine whether the contract conveys the right to control the use of the specified assets for an agreed period of time. In doing so, the auto manufacturer would evaluate a number of factors, including whether:

- it controls physical access to the assets being used to manufacture the components or the supplier operates the assets according to the instructions of the auto manufacturer;
- the specified assets used to produce the components were designed specifically for the auto manufacturer;
- it has the ability to direct the use of the specified assets used to produce the components; and
- it has rights to obtain substantially all of the economic benefits from use of the components throughout the lease term.

In contrast to the analysis under paragraph 9(c) of IFRIC 4, this analysis would not consider the pricing terms of the contract even in those situations where the auto manufacturer is purchasing substantially all of the output.

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Contracts containing both lease and service components

The ED would generally not apply to the "distinct" service components of a contract that also contains a lease. A service component would be considered "distinct" if the entity or another entity either sells an identical or similar service separately or the entity could sell the service separately because the service has a distinct function and a distinct profit margin. Lessees and lessors would allocate the payments required under the contract between the distinct service and lease components in proportion to the standalone selling price of each component. However, if the lessee or lessor is unable to allocate the payments, the entire contract would be accounted for as a lease. If the service component is not distinct from the lease component, the entire contract would be accounted for as a lease.

In March 2011, the Boards tentatively decided that in contracts that include both lease and non-lease components, lessees and lessors would identify and separately account for the non-lease components in the contract. The distinct versus non-distinct guidance included in the ED would not be carried forward to the final standard. Further, the Boards tentatively decided that lessees would be required to allocate between lease and non-lease components based on their relative standalone purchase prices. If the purchase price of one component in a contract that contains a lease is observable, a lessee would apply the residual method to allocate the price to the component for which there are no observable purchase prices. The Boards tentatively decided that lessees would treat the entire contract as a lease when there are no observable prices for any of the components.

Respondents from the manufacturing industry noted that the ED did not specify whether items such as property insurance, property taxes and maintenance would satisfy the distinct test; noting that property tax and property insurance are often a cost pass-through and may not satisfy the distinct margin test, while maintenance may not be considered distinct in common area maintenance environments. This issue was addressed by the Boards' tentative decision to eliminate the distinct versus non-distinct guidance that was included in the ED. However, the tentative decision to require separation of lease and non-lease components will require lessees to determine the components of an arrangement based on the revised definition of a lease. The tentative decision to allocate based on observable purchase prices will require lessees to obtain the information relating to the pricing of the components from lessors or other third party sources.

Expense recognition pattern for lessees

The ED proposed that rental expense would be replaced with amortisation expense and interest expense, with total expense being recognised earlier in the lease term. Many respondents to the ED did not agree with the proposal because it would result in:

- higher expenses in earlier periods of the lease; and
- further divergence from the cash payments made in lease contracts.

In addition, for leases previously accounted for as operating leases, some financial statement users indicated they would prefer to see lease payments treated as rental expense in profit or loss.

In April 2011, the Boards tentatively decided that there should be two types of leases for lessees and lessors – finance and other-than-finance leases – and the determination of whether a lease is a finance or other-than-finance lease would be based on the existing indicators in paragraphs 7-12 of IAS 17 *Leases*.

For both finance and other-than-finance leases, the liability to make lease payments and the right-of-use asset would be initially measured at the present value of the lease payments. However, the pattern of expense recognition for a finance lease would be on an accelerated basis while the pattern of expense for an other-than-finance lease would be on a straight-line basis. The liability to make lease payments would be measured using the effective interest method and amortisation / depreciation of the right-of-use asset would be based on the difference between the straight-line amount and the interest expense amount, unless another systematic basis is more representative of the time pattern of the total lease expense. The interest and amortisation/depreciation expense amounts would be presented on a single-line item as rental expense in profit or loss.

The tentative decision to have two types of leases does not affect the proposal in the ED that would require a lessee to recognise an asset and liability under the right-of-use model but would alleviate concerns expressed by manufacturing industry respondents regarding the accelerated expense recognition pattern.

Variable lease payments

The ED would require the use of a probability-weighted expected outcome approach to estimate lease payments including contingent rentals, term option penalties and residual value guarantees. Many manufacturing industry respondents expressed concerns that the proposal would result in unreliable estimates and high volatility in earnings as a result of the required reassessment of the estimate. Further, respondents highlighted the asymmetry between the lessee and lessor accounting models.

In April 2011, the Boards tentatively decided that variable lease payments should not be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable unless the variable lease payments are "disguised minimum lease payments". Disguised minimum lease payments are variable lease payments structured in such a way that they are in-substance fixed lease payments. The final standard is expected to include guidance to assist in identifying disguised minimum lease payments.

The Boards' tentative decision to limit recognition of variable lease payments to disguised minimum lease payments will alleviate many concerns expressed by manufacturing industry respondents. The Boards are expected to discuss the additional disclosure requirements surrounding variable lease payment arrangements shortly.

Lease term

The ED defines the lease term as the "longest possible term that is more likely than not to occur." The comment letters overwhelmingly disagreed with this proposal because many entities thought that a renewal option does not represent a liability until the lessee has actually exercised the option and estimating the lease term would be burdensome and costly to implement and could result in unreliable estimates for leases with multiple renewal options.

In February 2011, the Boards tentatively decided that "lease term" should be defined for the lessee and lessor as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a "significant economic incentive" for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. Factors such as the existence of a bargain renewal option and a penalty for not renewing the lease would be considered in determining the lease term but past practice and management intent would not. The lease term would be reassessed only when there is a significant change in facts and circumstances.

The tentative decision to include renewal options in the lease term when there is a "significant economic incentive" to exercise the option represents a change from the ED because it raises the threshold for when renewal options would be included in the lease term. Judgement will be required, but the tentative decision is more closely aligned with IAS 17 that uses a "reasonably certain" threshold. The tentative decision to reassess the lease term would represent a change from the current guidance.

Looking ahead

The Boards still have a number of issues to discuss and will need to determine whether re-exposure of the proposals is necessary. The final standard is expected to be issued by the end of 2011. We will provide you periodic updates as significant decisions are reached by the Boards.

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