Alerte de votre conseiller –
Aperçu d’IFRS 16 – Définition d’un contrat de location

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Aperçu
L’équipe IFRS de Grant Thornton International a publié le bulletin Insights into IFRS 16 – Definition of a lease (en anglais seulement).

La série Insights into IFRS 16 fournit des informations sur l’application d’IFRS 16, Contrats de location, dans des domaines clés. Chaque édition mettra l’accent sur un aspect d’IFRS 16 afin de vous aider à vous préparer aux changements apportés par l’adoption de la norme.

Le bulletin Insights into IFRS 16 – Definition of a lease donne des indications concernant la définition d’un contrat de location.

Enjeu
La norme IFRS 16 modifie la définition d’un contrat de location par rapport à l’évaluation actuelle dans IFRIC 4, Déterminer si un accord contient un contrat de location, et fournit des indications sur l’application de cette nouvelle définition. En conséquence, certains contrats qui ne contiennent pas un contrat de location actuellement répondront à la définition d’un contrat de location selon IFRS 16, et vice-versa.

Le bulletin explique la nouvelle définition d’un contrat de location et les trois évaluations clés nécessaires pour déterminer si le contrat est ou contient un contrat de location.

Ressource
Le bulletin Insights into IFRS 16 – Definition of a lease est joint à la présente Alerte de votre conseiller.

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Insights into IFRS 16

Definition of a lease

IFRS 16 represents the first major overhaul of lease accounting in over 30 years. The new Standard will affect most companies that report under IFRS and are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment.

Since accounting for leases under IFRS 16 results in substantially all leases being recognised on a lessee’s balance sheet, the evaluation of whether a contract is (or contains) a lease becomes even more important than it is under IAS 17 and IFRIC 4. In practice, the main impact will be on contracts that are not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease – such as outsourcing, contract manufacturing, transportation and power supply agreements. Currently, this evaluation is based on IFRIC 4; however, IFRS 16 replaces IFRIC 4 with new guidance that differs in some important respects.

IFRS 16 changes the definition of a lease and provides guidance on how to apply this new definition. As a result, some contracts that do not contain a lease today will meet the definition of a lease under IFRS 16, and vice versa.

Under IFRS 16 a lease is defined as ‘a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration’.

A contract can be (or contain) a lease only if the underlying asset is ‘identified’. Having the right to control the use of an identified asset means having the right to direct, and obtain all of the economic benefits from, the use of that asset. These rights must be in place for a period of time, which may also be determined by a specified amount of use. Put simply, if the customer controls the use of an identified asset for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way it makes decisions about the use of assets it owns outright. In such cases, the customer (ie the lessee) is required to recognise these rights on its balance sheet as a ‘right-of-use’ asset. In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service and so there is no right-of-use asset to recognise.
Applying the new definition involves three key evaluations, all of which must be met in order to conclude that a contract is or contains a lease. These evaluations are summarised in the following flowchart:

### Flowchart: the three key evaluations

1. **Is there an identified asset?**
   - Yes
   - No

2. **Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use?**
   - Yes
   - No

3. **Does the customer have the right to direct the use of the identified asset throughout the period of use?**
   - Yes
   - No

**Contract is not (does not contain) a lease**

**Contract is (contains) a lease**

Let’s examine each of these in more detail.

### Is there an identified asset?

An identified asset is an asset that is either:
- explicitly identified in the contract, or
- is implicitly specified by being identified at the time that the asset is made available for use by the customer.

Even if an asset is explicitly specified, a customer does not have the right to use an identified asset if the supplier has a **substantive substitution right** throughout the period of use.

### What is a substantive substitution right?

A substantive substitution right exists if the supplier has the practical ability to substitute alternative assets throughout the period of use and the economic benefits of substituting the asset would exceed the cost (or in other words, the supplier would benefit economically from substituting the asset). When the asset is located at the customer’s premises, the costs associated with substituting the asset are likely to be higher, making it less likely that the supplier would economically benefit from making a substitution.

The assessment of whether a supplier’s substitution right is substantive is based on facts and circumstances present at inception of the contract. This means that the customer ignores events that are not likely to occur in future such as:
- an agreement by a future customer to pay an above-market rate for use of the asset
- the introduction of new technology that is not substantially developed at inception of the contract
- a substantial difference between the performance or customer’s use of an asset, and the use or performance considered likely at inception of the contract, and
- a substantial difference between the actual market price of the asset during the period of use, and the market price considered likely at inception of the contract.

If the supplier has the right or obligation to substitute the asset for repair purposes or to provide routine maintenance services (e.g., to allow it to install a technical upgrade that has become available), a customer is not precluded from having the right to use an identified asset. A customer is also not required to perform an exhaustive search to determine if a supplier has a substantive substitution right. If a customer cannot readily determine whether a supplier has such a right, it may conclude that a right does not exist.

### Example 1 – Rail cars

In a contract between a customer and a supplier, the supplier needs to transport goods using a particular type of rail car in line with a specified timetable over a three-year period. The timetable and quantity of goods stipulated are equivalent to the customer having the use of six rail cars for three years. The supplier makes available the cars, driver and engines as part of the arrangement. The supplier has a large supply of similar cars and engines that are available to fulfil the obligations of the arrangement. The rail cars and engines are kept at the supplier’s premises when they are not being used to transport the goods.

**Analysis**

The contract does not contain a lease of either rail cars or engines.

The rail cars and engines used to transport the customer’s goods are not identified assets. The supplier has a substantive substitution right to replace the rail cars and engines as a result of:
- the supplier having the practical ability to substitute each car and engine throughout the period of use. Alternative cars and engines are readily available to the supplier and these can be substituted without the customer’s approval, and
- the supplier being able to economically benefit from substituting each car and engine. There would be very little cost associated with substituting these assets as the cars and engines are stored at the supplier’s premises and the supplier has a large pool of similar cars and engines.

Therefore, the customer does not have the right to obtain substantially all of the economic benefits from the use of an identified rail car or an engine or directs their use. The supplier chooses which rail cars and engines are used for each delivery and therefore directs them. It has substantially all of the economic benefits from use of the rail cars and engines.
Can a portion of an asset be an identified asset?
A portion of an asset is an identified asset if it is physically distinct (e.g., a single floor of an apartment building). Where a portion of an asset is not physically distinct (e.g., 20% of the capacity of an oil pipeline), the portion of the asset is not an identified asset unless it represents substantially all of the capacity of the asset. If neither of these situations exist, the customer is not provided with the right to obtain substantially all the economic benefits from use of the asset and an identified asset does not exist.

Example 2 – Fibre-optic cable
A customer enters into a 10-year contract with a utilities company (the supplier) for the right to use five individually specified, physically distinct fibre-optic strands (fibres) within a larger cable running between New York and London. The customer makes all relevant decisions concerning the use of the individual fibres by connecting them to its own electronic equipment (i.e., the customer “lights” the fibres) and deciding what data, and how much data, each strand will carry. If any of the strands are damaged, the supplier is responsible for effecting any necessary repairs. The supplier owns additional fibres both within the same cable and in adjacent cables but can only substitute those for the customer’s strands when performing ongoing maintenance or effecting necessary repairs.

Analysis
The contract represents a lease of unlit fibre-optic strands (the identified assets).

The fibre optic strands are identified assets because they are explicitly specified in the contract and are physically distinct from other fibres within the cable. The supplier cannot substitute the fibres for reasons other than repair, maintenance or malfunction.

Conversely, if the customer was entitled only to use an amount of capacity equivalent to five fibres within a cable made up of 15 strands, but not five specific strands, the contract would contain neither an identified asset nor a lease because the capacity represented by five fibres does not represent substantially all the capacity of the 15-strand cable. In this case, the supplier would only be providing data capacity (i.e., a service).

Does the customer have the right to obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use?
The second evaluation involves determining whether a customer has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use. There are many ways that a customer can obtain those economic benefits such as by using, holding or sub-leasing the asset.

When making this evaluation, a customer considers its rights within the defined scope of the contract. For example, if a contract specifies that a customer can only print up to a specified number of pages during the period of use of a printer, the customer considers only the economic benefits arising from use of the printer for those pages, and not beyond.

Variable lease payments based on the customer’s use of the asset (e.g., variable payments based on sales) do not prevent a customer from obtaining substantially all of the economic benefits from the use of the asset. Although the customer passes on some of the benefits to the supplier through variable payments, the customer is still the party that receives the economic benefits arising from use of the asset (in this case, the cash flows arising from the sales). IFRS 16 is explicit on this point to eliminate the possibility that companies might include variable lease payments solely to avoid the arrangement being classified as a lease and therefore lease accounting.

Does the customer have the right to direct the use of the identified asset throughout the period of use?
In evaluating whether the customer has the right to direct the use of an identified asset, a customer must have the right to direct “how and for what purpose” the asset is used throughout the period of use. In making this evaluation, a customer considers the decisions that most directly impact the economic benefits to be derived from the use of the asset, including:

- rights to decide the type of output to be produced by the asset(s);
- rights to decide when the output is produced;
- rights to decide where the output is produced; and
- rights to decide whether the output is produced and the quantity thereof.
In many cases, contracts will include terms and conditions that protect the supplier’s interest in the asset, protect its personnel and/or ensure the supplier complies with laws and regulations. These rights are considered to be protective and do not, in isolation, prevent the customer from having the right to direct the use of the asset within the scope of the contract.

Examples of protective rights noted in IFRS 16 include:
• specifying the maximum amount of use of an asset (eg an aircraft lease with a maximum usage allowed of 15,000 engine hours per year)
• limiting where or when the customer can use the asset (eg an automotive lease specifying that the identified vehicle can only be driven in France)
• requiring the customer to follow certain operating practices (eg a lease of retail space where opening hours are limited to specific times of the day)
• requiring the customer to notify the supplier if the customer changes how the asset will be used (eg a warehouse lease where the customer must notify the supplier if they plan to change the use of the space from storing inventory to a retail area).

Lastly, IFRS 16 is clear that rights to operate or maintain an asset do not give a customer the right to direct how and for what purpose the asset is used, except for when the ‘how and for what purpose’ decisions are predetermined. In this case, the customer will control the asset if the customer has the right to operate the asset throughout the period of use or the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Example 3 – Ship
A customer enters into a contract with a shipping company (the supplier) to transport cars from Tokyo to Singapore. The contract specifies the particular ship to be used, the dates of pick-up and delivery, and the cars to be transported (which will occupy the full capacity of the ship). The supplier operates and maintains the ship and is responsible for the safe passage of the cars. The customer is not able to make changes (ie to either the destination or the nature of the cargo) once the contract has been signed.

Analysis
The contract does not contain a lease.

After signing the contract, the customer is not able to direct how and for what purpose the ship is used and does not therefore control the use of the asset. The contract pre-determines how and for what purpose the ship will be used and customer neither operates nor designed the ship.

Transition considerations
On transition to IFRS 16, both lessees and lessors can choose whether to apply the new lease definition to all of their contracts or apply transitional relief from reassessing whether contracts in place at the date of initial application are, or contain, a lease. If an entity chooses to apply this relief, then the new lease definition will be applied to contracts entered into or modified on or after the date of initial application (1 January 2019 for calendar year end entities).