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Tentative Agenda Decision and comment letters: Definition of a Lease—Substitution Rights (IFRS 16)

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The IFRS Interpretations Committee (Committee) discussed the following matter and tentatively decided not to add a standard-setting project to the work plan. The Committee will reconsider this tentative decision, including the reasons for not adding a standard-setting project, at a future meeting. The Committee invites comments on the tentative agenda decision. All comments will be on the public record and posted on our website unless a respondent requests confidentiality and we grant that request. We do not normally grant such requests unless they are supported by good reason, for example, commercial confidence.

Tentative Agenda Decision

The Committee received a request about how to assess whether a contract contains a lease. The request asked about:

- a. the level at which to evaluate whether a contract contains a lease—by considering each asset separately or all assets together—when the contract is for the use of more than one similar asset.
- b. how to assess whether a contract contains a lease applying IFRS 16 when the supplier has particular substitution rights—ie the supplier:
 - i. has the practical ability to substitute alternative assets throughout the period of use; but
 - ii. would not benefit economically from the exercise of its right to substitute the asset throughout the period of use.

The definition of a lease

Paragraph 9 of IFRS 16 states that ‘a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration’. Applying paragraph B9 of IFRS 16, to meet the definition of a lease the customer must have both:

- a. the right to obtain substantially all the economic benefits from use of an identified asset throughout the period of use; and
- b. the right to direct the use of the identified asset throughout the period of use.

The period of use is ‘the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)’. (Appendix A to IFRS 16)

Paragraph B12 of IFRS 16 states that ‘an entity shall assess whether a contract contains a lease for each potential separate lease component’ and directs an entity to paragraph B32 of IFRS 16 for application guidance on separate lease components. Paragraph B32 specifies that the right to use an underlying asset is a separate lease component if both:

- a. the lessee can benefit from use of the underlying asset either on its own or together with other resources readily available to it; and
- b. the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

Identified asset

The first requirement for a contract to meet the definition of a lease is that a customer controls the use of an identified asset. Paragraphs B13–B20 of IFRS 16 provide application guidance on an identified asset.

Paragraph B13 states that ‘an asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer’.

But ‘even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use’ (paragraph B14). In that case, the supplier—rather than the customer—controls the use of the asset. As a consequence, there is no identified asset; the contract does not contain a lease.

For a substitution right to be *substantive*, paragraph B14 states that both of the following conditions must exist:

- a. the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and
- b. the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

Paragraph B16 states that ‘an entity’s evaluation of whether a supplier’s substitution right is substantive excludes consideration of future events that, at inception of the contract, are not considered likely to occur.’

Paragraphs B15–B18 specify requirements that mean, in each of the following situations, a supplier’s substitution right is *not* substantive (or the customer is not precluded from having the right to use an identified asset):

- a. the supplier has the right or obligation to substitute the asset only on or after a particular date or the occurrence of a specified event;
- b. the supplier would benefit economically from the exercise of its right only on the occurrence of a future event that, at inception of the contract, is not considered likely to occur; or
- c. the supplier has the right or obligation to substitute the asset only for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available.

Paragraph B17 notes that the costs of substitution are more likely to exceed the associated benefits when the asset is located at the customer’s premises or elsewhere. Paragraph B19 requires the customer to presume that a supplier’s substitution right is *not* substantive if the customer cannot readily determine whether the supplier has a substantive substitution right.

Paragraph BC113 of the Basis for Conclusions on IFRS 16 explains the IASB’s rationale in developing the requirements on substitution rights and states that ‘the IASB’s intention in including [these requirements] is to differentiate between:

- a. substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset; and
- b. substitution rights that do not change the substance or character of the contract because it is not likely, or practically or economically feasible, for the supplier to exercise those rights’.

Paragraph BC113 goes on to explain that, at the time of developing IFRS 16, the IASB was of the view ‘that, in many cases, it will be clear that the supplier would not benefit from the exercise of a substitution right because of the costs associated with substituting an asset’. ‘If

substitution rights are substantive, then the IASB thinks that this would be relatively clear from the facts and circumstances' (paragraph BC115).

Consequently, the Committee observed that the requirements in paragraphs B13–B19 set a high hurdle for a customer to conclude that there is no identified asset when an asset is explicitly or implicitly specified. The Committee also observed that determining whether a supplier's right to substitute an asset is substantive *throughout* the period of use requires judgement.

Application of the requirements in IFRS 16 to the fact pattern described in the request

In the fact pattern described in the request:

- a. *a customer enters into a 10-year contract with a supplier for the use of 100 similar new assets—batteries used in electric buses. The customer uses each battery together with other resources readily available to it (each battery is used in a bus that the customer owns or leases from a party unrelated to the supplier).*
- b. *applying the requirements in paragraphs B14–B18, it is determined that the supplier has the practical ability to substitute alternative assets throughout the contract term such that the condition in paragraph B14(a) exists.*
- c. *if a battery were to be substituted, the supplier would be required to compensate the customer for any revenue lost or costs incurred while the substitution takes place. Whether substitution is economically beneficial for the supplier at a point in time depends on both the amount of compensation payable to the customer and the condition of the battery. At inception of the contract, it is expected that the supplier would not benefit economically from substituting a battery that has been used for less than three years but could benefit economically from substituting a battery that has been used for three years or more.*

The level at which to evaluate whether a contract contains a lease

In the fact pattern described in the request, the customer is able to benefit from use of each asset (a battery) together with other resources (a bus) available to it and each battery is neither highly dependent on, nor highly interrelated with, the other batteries in the contract.

Therefore, the Committee concluded that, in the fact pattern described in the request, applying paragraph B12, the customer assesses whether the contract contains a lease—including evaluating whether the supplier's substitution right is substantive—for each potential separate lease component, ie for each battery.

Identified asset

In the fact pattern described in the request, each battery is specified. Even if not explicitly specified in the contract, a battery would be implicitly specified at the time it is made

available for the customer's use. Therefore, the Committee observed that, unless the supplier has the substantive right to substitute the battery throughout the period of use, each battery is an identified asset.

In the fact pattern described in the request, the condition in paragraph B14(a)—the supplier has the practical ability to substitute alternative assets throughout the period of use—is assumed to exist. The Committee observed, however, that the condition in paragraph B14(b) does not exist throughout the period of use because the supplier is not expected to benefit economically from exercising its right to substitute a battery for at least the first three years of the contract. Those years are part of the period of use. Consequently, the supplier's substitution right is not substantive throughout the period of use.

Therefore, the Committee concluded that, in the fact pattern described in the request, each battery is an identified asset. To assess whether the contract contains a lease, the customer would then apply the requirements in paragraphs B21–B30 of IFRS 16 to determine whether, throughout the period of use, it has the right to obtain substantially all the economic benefits from use, and direct the use, of each battery.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to evaluate the level at which to assess whether the contract contains a lease and whether there is an identified asset in the fact pattern described in the request. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

The deadline for commenting on the tentative agenda decision is **6 February 2023**. The Committee will consider all comments received in writing by that date; agenda papers analysing comments received will include analysis only of comments received by that date.

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