

## IFRS Developments

# IFRS IC agenda decision: Definition of a Lease – Substitution Rights (IFRS 16 *Leases*)

### What you need to know

- ▶ In an Agenda Decision issued in April 2023, the IFRS IC concluded that IFRS standards provide an adequate basis 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.
- ▶ Entities with arrangements containing a substitution right need to review the Agenda Decision to determine whether their accounting could be affected.

### Highlights

On 26 April 2023, the International Accounting Standards Board (the IASB) met to determine whether to publish the IFRS Interpretations Committee's (the IFRS IC or the Committee) Agenda Decision *Definition of a Lease - Substitution Rights* (the Agenda Decision) in accordance with the due process for agenda decisions. No members of the IASB objected, and the Agenda Decision was published in April 2023.

The Agenda Decision considers the definition of a lease and, in particular, how to determine whether there is an identified asset when an arrangement contains a substitution right.

Although the fact pattern described in the request is very specific (a 10-year contract with a supplier for the use of 100 similar batteries that are used in electric buses), the resulting Agenda Decision includes guidance that is relevant to other arrangements that contain substitution rights.

### Background

The transaction described in the Agenda Decision is, as follows:

- ▶ A customer enters into a 10-year contract with a supplier for the use of 100 similar new assets – batteries for use 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).
- ▶ It is assumed that the supplier has the practical ability to substitute alternative assets throughout the contract term such that the condition in IFRS 16 *Leases* paragraph B14(a) exists.

- ▶ 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.

## General considerations

Before applying the guidance in IFRS 16 to the submitted fact pattern, the Agenda Decision describes the guidance that would be applied to arrangements that contain substitution rights.

The Agenda Decision sets out that for a contract 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 the 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)'.

The Agenda Decision then proceeds to refer to the specific guidance in IFRS 16 that relates to the use of an identified asset in paragraphs B13 to B20.

In the analysis, 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, as required by paragraph B14, requires judgement. In particular, the Committee noted that paragraph B14(a) specifies that a supplier has the practical ability to substitute alternative assets throughout the period of use even if the supplier does not already have alternative assets, but could source those assets within a reasonable period of time. According to the Committee, this illustrates that the term 'throughout the period of use' does not mean at all times within that period.

## Applying the requirements in IFRS 16 to the fact pattern described in the request

The request asked about:

- ▶ 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
- ▶ How to assess whether a contract contains a lease applying IFRS 16 when the supplier has particular substitution rights, i.e., the supplier:
  - ▶ Has the practical ability to substitute alternative assets throughout the period of use; but
  - ▶ Would not benefit economically from the exercise of its right to substitute the asset throughout the period of use

In response to the first question, 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, i.e., for each battery. The Committee also noted that, 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.

In response to the second question, the Committee noted that, 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 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, the condition in paragraph B14(b) does not exist throughout the period of use.

Therefore, the Committee concluded that the supplier does not have the substantive right to substitute a battery throughout the period of use.

## How we see it

Determining whether a supplier's substitution right is substantive throughout the period of use can require judgement. Although the facts and circumstances in the fact pattern are specific to the transportation sector, arrangements containing substitution rights exist in a wide range of industries. Entities are, therefore, encouraged to consider carefully their current accounting for such arrangements in light of the Agenda Decision.

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