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Technical Line

IRU contracts: A purchaser's guide to identifying and classifying leases (after the adoption of ASC 842)

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What you need to know

- Accounting for indefeasible rights of use can be complicated, and determining whether such a contract is or contains a lease in accordance with ASC 842 requires careful consideration of the terms of the contract.
- After determining that an indefeasible right of use is a lease, an entity must evaluate whether to classify it as an operating lease or a finance lease. An indefeasible right of use that does not meet the definition of a lease should be accounted for as a service contract.
- This publication walks through the criteria that a purchaser (lessee) should consider when determining whether an indefeasible right of use contract is or contains a lease and, if so, whether a lessee should classify the lease as an operating or finance lease.

Overview

Companies that own fiber optic communications networks often seek to maximize usage and recover the significant costs they incurred to build the networks by granting to others the right to use network capacity. This type of contract, which typically has a significant up-front payment, is called an indefeasible right of use (IRU) contract.

Accounting for IRU contracts can be complicated because entities must first determine whether the IRU contract is or contains a lease and, if so, whether the lease should be classified as an operating or finance lease. An IRU contract that does not meet the definition of a lease is accounted for as a service contract.

Building a better working world

This publication complements our Financial reporting developments (FRD) publication, ***Lease accounting: Accounting Standards Codification 842, Leases***, which provides an in-depth discussion of Accounting Standards Codification (ASC) 842, *Leases*. We refer to that publication as our ASC 842 FRD.

This publication is intended to help a lessee determine how to identify a lease in an IRU contract after it adopts ASC 842, and, if a lease exists, how to classify the lease. Companies entering into IRU contracts typically are telecommunications (telecom) companies, but other entities, including technology companies, also enter into IRU contracts. While the definition of a lease applies to all entities, for guidance on lease classification for lessors and lessor accounting, see our ASC 842 FRD.

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration. See the appendix for a flowchart from ASC 842 of how to determine whether an arrangement is a lease or contains a lease.

Identified asset

The requirement that there be an identified asset is fundamental to the definition of a lease. Under ASC 842, an identified asset can be either implicitly or explicitly specified in a contract.

“ A lease must involve the use of an identified asset.

An identified asset also can be a physically distinct portion of a larger asset. Examples include a fiber strand that is part of a fiber cable, the "last mile" of a telecommunications network that connects a single customer to a larger network or a floor of a building. However, a capacity portion or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fiber optic strand) is not an identified asset unless it represents substantially all of the capacity of the asset and, therefore, provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

The term "substantially all" is not defined in ASC 842. However, a purchaser might refer to the description in ASC 842-10-55-2 of how "substantially all of the fair value of the underlying asset" could be evaluated in the context of lease classification. In that paragraph, the Financial Accounting Standards Board (FASB) states that "one reasonable approach" would be to conclude that "[n]inety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset."

In some cases, an IRU contract may explicitly identify the asset in the contract but may allow the seller to carry the purchaser's traffic on any of the seller's fiber strands (or cables). Even if an asset is specified, a purchaser does not have the right to use an identified asset if, at inception of the contract, the seller has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfill a contract with the purchaser, including the sum of any nonconsecutive periods of time). If the substitution right is substantive (that is, if throughout the period of use, the seller would benefit economically from carrying the purchaser's traffic on other assets of the seller and has the practical ability to do so), the purchaser does not have the right to use an identified asset. Therefore, the contract would not contain a lease.

Illustration 1 — Physically distinct portion of a larger asset is an identified asset

Telecom Company B (purchaser) enters into a 12-year contract with Telecom Company A (seller) for the right to use three fiber strands in a fiber optic cable between New York and London. The contract identifies three of the cable's 20 fiber strands for use by Telecom Company B. The three fibers are dedicated solely to Telecom Company B's data for the duration of the contract term. Assume that Telecom Company A does not have a substantive substitution right.

Analysis: The three fiber strands are identified assets because they are physically distinct and explicitly specified in the contract.

Illustration 2 — Capacity portion of an asset isn't an identified asset

Telecom Company C (seller) owns a large fiber network and enters into a contract with Telecom Company D (purchaser) that allows Telecom Company D to use Company C's network to carry its customers' traffic from New York to London.

The contract is for a 10-year period and requires Telecom Company D to make one fixed up-front payment for the right to 70% of the capacity of a specified fiber strand. Telecom Company C has the right and ability to offer the other 30% of capacity on the fiber strand to other customers. In fact, the price of the contract is consistent with an expectation that Telecom Company C will sell the other 30% of capacity on the specified fiber strand to other parties.

Analysis: The capacity portion of the fiber strand is not an identified asset because 70% of the fiber strand's capacity is less than substantially all of the capacity of the fiber strand.

"Determining whether an IRU is a lease may require judgment.

How we see it

Entities should carefully analyze the terms of their contracts to determine whether IRUs include the right to use an identified asset. For example, judgment may be required to determine whether a capacity portion of a fiber strand (or cable) represents substantially all of the capacity of the fiber strand (or cable) or whether a seller has a substantive substitution right (i.e., the seller has the practical ability to substitute an alternative asset and would benefit economically from doing so).

Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the purchaser has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

Right to obtain substantially all of the economic benefits from the use of the identified asset

A purchaser can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the fiber cable or fiber strand(s)). The term "substantially all" is not defined in ASC 842. A purchaser would evaluate this criterion in the same manner as it evaluates whether a portion of a fiber cable or strand represents "substantially all" of the capacity of that asset. Refer to the *Identified asset* section for a discussion about evaluating "substantially all."

Right to direct the use of the identified asset

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose the asset is used are predetermined, and the customer either (1) has the right to operate the asset or direct others to operate the asset in a manner it determines throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. Which decision-making rights are most relevant is likely to depend on the nature of the asset and the terms and conditions of the contract. For example, the decision-making rights that are most relevant in an IRU contract may include determining what data is transmitted, and when and how much data is transmitted.

Illustration 3 — Right to control the use of the identified asset

Assume the same facts as in Illustration 1. The contract states that Telecom Company B has the exclusive use of the telecom strands throughout the 12-year period of use (that is, Telecom Company A cannot use the fiber strands to carry other customers' data). Telecom Company B is the party that determines what data is transmitted, and when and how much data is transmitted.

Analysis: This contract contains a lease. As discussed in Illustration 1, the three fiber strands are identified assets.

Telecom Company B has the right to control the use of the fiber strands throughout the 12-year period of use because:

- Telecom Company B has the right to obtain substantially all of the economic benefits from the use of the specified fiber strands throughout the period of use (i.e., the fiber strands are dedicated solely to Telecom Company B for the duration of the contract).
- Telecom Company B has the right to direct the use of the specified fiber strands because it has the right to determine what data is transmitted, and when and how much data is transmitted along each fiber strand throughout the period of use.

How we see it

Entities need to carefully analyze the terms of their contracts to determine whether the purchaser has the right to control the use of the identified asset(s). Questions that entities should ask include:

- Is the purchaser the only user that has the right to obtain economic benefits from the fiber (i.e., is the fiber cable or the fiber strand dedicated solely to the purchaser)?
- Does the IRU provide the purchaser with the right to determine whether the asset can be used (i.e., what data is transmitted, when and how much data to transmit)?

If an IRU contract does not meet the definition of a lease, it should be accounted for as a service contract.

Lease classification

If a purchaser determines that an IRU contract meets the definition of a lease, it needs to determine the appropriate lease classification to account for the lease.

At lease commencement, a lessee classifies a lease as a finance lease if the lease meets **any one** of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset's economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

> "If a purchaser determines that an IRU contract is a lease, it needs to determine how to classify the lease.

A lessee classifies a lease as an operating lease when it does not meet any of these criteria.

Most IRU contracts do not include terms that transfer ownership or purchase options, and the fiber is generally not of a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term. Therefore, a purchaser would generally look to the lease term and lease payments criteria to determine whether an IRU contract is a finance lease. However, each arrangement is unique, and purchasers should consider all of the criteria to determine the classification of a lease.

For guidance on lessee accounting for operating and finance leases, refer to our ASC 842 FRD.

Appendix: How to determine whether an arrangement is or contains a lease

The following flowchart is included in ASC 842's implementation guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease. Refer to our ASC 842 FRD for further guidance on these topics.