Title: Determining Whether an Arrangement Contains a Lease


References: FASB Statement No. 5, Accounting for Contingencies
FASB Statement No. 13, Accounting for Leases
FASB Statement No. 23, Inception of the Lease
FASB Statement No. 66, Accounting for Sales of Real Estate
FASB Statement No. 98, Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases
FASB Statement No. 109, Accounting for Income Taxes
FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities
FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
FASB Statement No. 141, Business Combinations
FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets
FASB Interpretation No. 21, Accounting for Leases in a Business Combination
FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
FASB Technical Bulletin No. 88-1, Issues Relating to Accounting for Leases
FASB Concepts Statement No. 6, Elements of Financial Statements
AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures
International Accounting Standard 17, Leases
International Financial Reporting Interpretations Committee Draft Interpretation, “Determining whether an Agreement contains a Lease”
1. Prior to its rescission, Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities,"\(^1\) required that when the trading criteria in the consensus are met, energy contracts (including energy-related contracts such as capacity contracts, requirements contracts, and transportation contracts) should be accounted for at fair value. Paragraph 5 of that Issue stated, however, that "in certain circumstances, transportation and other energy-related contracts may represent lease transactions that should be accounted for in accordance with Statement 13 and, therefore, are not within the scope of this Issue," and went on to state that "the determination of whether a transportation contract or some other type of energy-related contract is a lease is a judgmental decision based on the substance of each contract."

2. In connection with the discussion of Issue No. 00-17, "Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10,"\(^2\) the Task Force reiterated the observation that in certain circumstances, transportation and other energy-related contracts may represent lease transactions that should be accounted for in accordance with Statement 13. At the July 19–20, 2000 meeting, the Task Force agreed to add Issue 01-8 to the EITF agenda as a separate issue to provide guidance for use in determining whether an energy-related contract should be considered a lease subject to the

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\(^1\)At its October 25, 2002 meeting, the Task Force reached a consensus on Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," to rescind Issue 98-10 and the related interpretive guidance of Issue No. 00-17, "Measuring the Fair Value of Energy-Related Contracts in Applying Issue 98-10," and Topic No. D-105, "Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10." However, the scope of this Issue was expanded to include all arrangements, not just energy trading contracts, because of the diversity in practice in determining whether or not an arrangement contains a lease.

\(^2\)Refer to footnote 1.
requirements of Statement 13. At the September 20, 2001 meeting, the Task Force agreed to form a working group to address this Issue and subsequently agreed to expand the Issue to address all arrangements, not just those involving energy trading contracts.

3. The issue is how to determine whether an arrangement contains a lease that is within the scope of Statement 13.

4. In applying this Issue, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary.

5. Leases that are within the scope of Statement 13 are not derivative instruments subject to Statement 133, although a derivative embedded in a lease may be subject to the requirements of Statement 133.

6. This Issue does not address whether an undivided interest or a pro rata portion of property, plant, or equipment could be the subject of a lease. That is, the issue of how to determine when a component part of property, plant, or equipment is itself property, plant, or equipment for purposes of applying Statement 13 is not the subject of this Issue. Nevertheless, arrangements that identify a physically distinguishable portion of property, plant, or equipment are within the scope of this Issue.
7. The Task Force reached a consensus that the guidance beginning in paragraph 8 should be used to determine whether an arrangement contains a lease that is within the scope of Statement 13. Examples illustrating the application of the guidance in this Issue are included in Exhibit 01-8A. Exhibit 01-8B summarizes the considerations that the Task Force deemed significant in reaching the consensus. Paragraph 1 of Statement 13 defines a lease as:

. . . an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.\(^1\) This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. [Emphasis added.]

\(^1\)Heat supply (also called "burn-up") contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.

Paragraph 64 of Statement 13 also indicates that "the Board's conclusion that nuclear fuel leases meet the definition of a lease as expressed in paragraph 1 is based on the fact that under present generally accepted accounting principles a nuclear fuel installation constitutes a depreciable asset. Thus, a nuclear fuel lease conveys the right to use a depreciable asset. . . ."
Consensus Guidance

8. The evaluation of whether an arrangement contains a lease within the scope of Statement 13 should be based on the substance of the arrangement using the following guidance.

Property, Plant, or Equipment

9. Property, plant, or equipment, as used in Statement 13, includes only land and/or depreciable assets. Therefore, inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease for accounting purposes because those assets are not depreciable. Additionally, intangibles (for example, motion picture film licensing rights or workforce) and rights to explore for minerals, precious metals, or other natural resources are not depreciable assets (they are amortized or depleted) so they may not be the subject of a lease.3

10. Although specific property, plant, or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant, or equipment. For example, if the owner/seller is obligated to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other property, plant, or equipment not specified in the arrangement,4 then fulfillment of the arrangement is not

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3Paragraph 1 of Statement 13 states that "this Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights."

4Other property, plant, or equipment not specified in the arrangement may include property, plant, or equipment owned or controlled by the owner/seller, or it may include a third party's property, plant, or equipment (for example, when the owner/seller purchases goods or services in the spot market to fulfill its obligation under the arrangement).
dependent on the specified property, plant, or equipment and the arrangement does not contain a lease. A warranty obligation that permits or requires the substitution of the same or similar property, plant, or equipment when the specified property, plant, or equipment is not operating properly does not preclude lease treatment. In addition, a contractual provision (contingent or otherwise) permitting or requiring the owner/seller to substitute other property, plant, or equipment for any reason on or after a specified date does not preclude lease treatment prior to the date of substitution.

11. Property, plant, or equipment has been implicitly specified if, for example, the seller owns or leases only one asset with which to fulfill the obligation and it is not economically feasible or practicable for the owner/seller to perform its obligation through the use of alternative property, plant, or equipment.

Right to Use Property, Plant, or Equipment

12. An arrangement conveys the right to use property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if any one of the following conditions is met:

a. The purchaser has the ability or right to operate the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment,5

5The purchaser's ability to operate the property, plant, or equipment may be evidenced by (but is not limited to) the purchaser's ability to hire, fire, or replace the property's operator or the purchaser's ability to specify significant operating policies and procedures in the arrangement with the owner/seller having no ability to change such policies and procedures. A requirement to follow "prudent operating practices" (or other similar requirements) generally does not convey the right to control the underlying property, plant, or equipment. Similarly, a contractual requirement designed to enable the purchaser to monitor or ensure the seller's compliance with performance, safety, pollution control, or other general standards generally does not establish control over the underlying property, plant, or equipment.
b. The purchaser has the ability or right to control physical access to the underlying property, plant, or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment, or
c. Facts and circumstances indicate that it is remote⁶ that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment during the term of the arrangement,⁷ and the price that the purchaser (lessee) 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.

Reassessment of the Arrangement

13. The Task Force reached a consensus that the assessment of whether an arrangement contains a lease should be made at inception of the arrangement based on all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if (a) there is a change in the contractual terms, (b) a renewal option is exercised or an extension is agreed to by the parties to the arrangement, (c) there is a change in the determination as to whether or not fulfillment is dependent on specified property, plant, or equipment, or (d) there is a substantial physical change to the specified property, plant, or equipment. A reassessment of an arrangement should be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. The following more fully describes the conclusions of the Task Force in that regard.

⁶As the term is used in Statement 5.
⁷All evidence should be considered when making the assessment as to the possibility that other parties will take more than a minor amount of the output, including evidence provided by the arrangement's pricing. For example, if an arrangement's pricing provides for a fixed capacity charge designed to recover the supplier's capital investment in the subject property, plant, or equipment, the pricing may be persuasive evidence that it is remote that parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment.
a. **Change in contractual terms.** The arrangement should be reassessed under the Consensus Guidance in this Issue if the contractual arrangement among the parties involved changes, unless the change only renews or extends the arrangement.

b. **Renewal or extension.** A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement prior to the end of the term of the original arrangement should be evaluated under the Consensus Guidance in this Issue only with respect to the renewal or extension period. The accounting for the remaining term of the original arrangement should continue without modification. The exercise of a renewal option that was included in the lease term\(^8\) at the inception of the arrangement would not be considered a renewal for the purpose of reevaluating the arrangement. For example, a lease with a base term of 10 years and a purchaser renewal option for a second 10-year period would have been classified as having a 20-year term if the lease imposed a penalty on the lessee in such an amount that, at inception of the lease, the renewal option was determined to be reasonably assured of being exercised. Accordingly, the exercise of the renewal option would not trigger a reassessment under the Consensus Guidance in this Issue.

c. **Dependency upon specific property, plant, or equipment.** A change in the determination as to whether or not fulfillment is dependent on specified property, plant, or equipment requires a reassessment of the arrangement under the Consensus Guidance in this Issue to determine whether the arrangement contains a lease on a prospective basis. For example, if an arrangement was initially determined to include a lease because, in part, fulfillment of the arrangement was initially dependent upon specific property, plant, or equipment and an event or events occurred subsequent to the inception of the arrangement such that fulfillment was no longer dependent upon the specific property, plant, or equipment (for example, an active market for the product develops subsequent to inception of the arrangement), the arrangement would be reassessed to determine if the arrangement contains a lease as of the date that the arrangement is no longer dependent upon specific property, plant, or equipment.

d. **Physical change to specific property, plant, or equipment.** A substantial physical change to the specified property, plant, or equipment requires a reassessment of the arrangement under the Consensus Guidance in this Issue to determine whether the arrangement contains a lease on a prospective basis. For purposes of determining if a physical change to the specified property, plant, or equipment gives rise to a reassessment, increases or decreases in productive capacity that result from adding or subtracting a physically distinct unit of property, plant, or equipment should be ignored if fulfillment of the arrangement is dependent upon a distinct unit of property, plant, or equipment that remains unchanged. For example, a machine generates 100 units of productive capacity at inception. If the seller increases capacity to 200 units by installing a second machine that is physically distinct from, and capable of being operated independently of, the original machine, the increase in capacity would not give rise to a reassessment if the original machine is specified in the arrangement and fulfillment of the arrangement is dependent on the specified

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\(^8\)As defined by paragraph 5(f) of Statement 13, as amended.
machine. (However, if the seller is able to provide output from either machine, a reassessment under the guidance in subparagraph 13(c), above, may be warranted.) Conversely, if the original machine were replaced by a new machine that is capable of generating 200 units of productive capacity, reassessment would be appropriate.

14. The Task Force reached a consensus that when an arrangement (or a portion of an arrangement) ceases to be a lease or becomes a lease due to a modification to the arrangement or other change discussed above, the following guidance shall be applied to account for the revised categorization of the arrangement:

a. Supply arrangement to operating lease for the Purchaser/Lessee. Any recognized asset (such as a prepaid asset or a derivative) for the purchase contract is considered part of the minimum lease payments and is initially recognized as prepaid rent. Any recognized liability (such as a payable or a derivative) for the purchase contract is considered a reduction of the minimum lease payments and is initially recognized as a lease payable.

b. Supply arrangement to operating lease for the Seller/Lessor. Any recognized liability (such as a deferred revenue or derivative) for the sales contract is considered part of the minimum lease payments and is initially recognized as deferred rent. Any recognized asset (such as a receivable or derivative) for the sales contract is considered a reduction of the minimum lease payments and is initially recognized as a lease receivable provided the asset is recoverable from future receipts.

c. Supply arrangement to capital lease for the Purchaser/Lessee. Any recognized asset or liability (such as a prepaid asset, a payable, or a derivative) for the purchase contract is included in the basis of the leased asset or lease obligation.

d. Supply arrangement to sales-type lease for the Seller/Lessor. If the criteria for sale treatment in paragraph 8 of Statement 13 (or other applicable literature, such as Statement 66) are met, the property, plant, or equipment is derecognized and any recognized asset or liability for the supply arrangement is recognized in earnings as an adjustment of the minimum lease payments. If the criteria for sale treatment are not met, any recognized asset or liability for the supply arrangement is considered a reduction of (or part of) the minimum lease payments and Statement 13 should be followed with respect to recognition of the lease.

e. Operating lease to supply arrangement for the Purchaser/Lessee. Any recognized prepaid rent or rent payable is initially recognized as an asset or liability associated with the purchase contract.

f. Operating lease to supply arrangement for the Seller/Lessor. Any recognized deferred rent or rent receivable is initially recognized as a liability or an asset associated with the sales contract, subject to a recoverability test.

g. Capital lease to supply arrangement for the Purchaser/Lessee. If the leased asset is real estate, including integral equipment, derecognition of the property, plant, or equipment and related capital lease obligation is subject to Statement 66. If the
leased asset is other than real estate, including integral equipment, the property, plant, or equipment and related lease obligation are derecognized. Prior to recognizing a sale, the asset subject to the capital lease should be assessed for impairment under Statement 144. That assessment should consider the terms of any revisions to the arrangement that caused the reassessment. Any difference between the capital lease asset and obligation (after reducing the asset for any impairment) is initially recognized as an asset or liability associated with the supply arrangement.

h. Direct-financing or sales-type lease to supply arrangement for the Seller/Lessor. The property, plant, or equipment should be recognized at the lower of (1) the original cost of the property, plant, or equipment, (2) the present fair value of the property, plant, or equipment, or (3) the present carrying amount of the lease receivable.

Multiple Element Arrangements That Contain a Lease

15. If an arrangement contains a lease and related executory costs, as well as other non-lease elements, the classification, recognition, measurement, and disclosure requirements of Statement 13 shall be applied by both the purchaser and the supplier to the lease element of the arrangement. Other elements of the arrangement not within the scope of Statement 13 shall be accounted for in accordance with other applicable generally accepted accounting principles. For purposes of applying Statement 13, payments and other consideration called for by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into (a) those for the lease, including the related executory costs and profits thereon, and (b) those for other services on a relative fair value basis, consistent with the guidance in paragraph 4(a) of Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables."
Transition

16. The consensus in this Issue should be applied to (a) arrangements agreed to or committed to,\(^9\) if earlier, after the beginning of an entity's next reporting period beginning after May 28, 2003, (b) arrangements modified after the beginning of an entity's next reporting period beginning after May 28, 2003, and (c) arrangements acquired in business combinations initiated after the beginning of an entity's next reporting period beginning after May 28, 2003. Arrangements that are determined to be leases based on application of this Issue are not subject to Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction," if the construction project was committed to\(^10\) prior to May 28, 2003, provided that construction has commenced by December 31, 2004.

Board Ratification

17. At its May 28, 2003 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

STATUS

18. No further EITF discussion is planned.

\(^9\)Consistent with paragraph 5(b) of Statement 13, as amended.
\(^10\)Consistent with the phrase used in Issue 97-10.
Example 1

A production company (the purchaser) enters into an arrangement with a third party to supply a minimum quantity of a specialty gas needed in its production process for a specified period of time. The supplier designs and constructs a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
- The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- The supplier is responsible for repairs, maintenance, and capital expenditures.
- The supplier must stand ready to deliver a minimum quantity of gas each month.
- On a monthly basis, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which comprise approximately 90 percent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- In the event that the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Evaluation: The arrangement contains a lease within the scope of Statement 13. Property, plant, or equipment (the facility) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. While the supplier has the right to supply gas from other sources, its ability to do so is nonsubstantive. The
purchaser has obtained the right to use the facility because, based on the facts presented—in particular, the fact that the facility is designed to meet only the purchaser's needs and the fact that the supplier has no plans to expand or modify the facility—it is remote that one or more parties other than the purchaser will take more than a minor amount of the facility's output and the price the purchaser will pay 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.

**Example 2**

A manufacturing company (the purchaser) enters into an arrangement with a third party to supply a specific component part of its manufactured product for a specified period of time. The supplier designs and constructs a plant adjacent to the purchaser's manufacturing facility to produce the component part. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for the following:

- The supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfill the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomical.
- The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still only pay for the actual quantity taken.
- The supplier has the right to sell the component parts to other customers and has a history of doing so (by selling in the replacement parts market) such that it is expected that parties other than the purchaser will take more than a minor amount of the component parts produced at the supplier's plant.
Evaluation: The arrangement is not within the scope of this Issue. Property, plant, or equipment (the plant) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. While the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomical. However, the purchaser has not obtained the right to use the plant because (a) the purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant, and (b) the likelihood that parties other than the purchaser will take more than a minor amount of the component parts produced at the plant is more than remote, based on the facts presented.
Exhibit 01-8B

BACKGROUND INFORMATION AND BASIS FOR CONSENSUS

Introduction
B1. This exhibit summarizes considerations that Task Force members deemed significant in reaching the conclusions in this consensus. It includes reasons for accepting certain approaches and rejecting others. Individual Task Force members gave greater weight to some factors than to others.

Scope of Issue
B2. The Task Force originally raised the Issue during its deliberations on the accounting for energy trading activities. However, the issue of whether an arrangement contains a lease is not unique to energy-related contracts. The same issue may arise in outsourcing arrangements, such as the outsourcing of the data processing functions of an enterprise (it may be a significant element, particularly in those arrangements that require a substantial investment in computer hardware and terminals devoted solely to the use of a single customer); in the telecommunications industry where providers of network capacity (primarily in the form of conduit, fiber optic cables, and related equipment) often grant rights to capacity on the basis of an indefeasible right of use; and in some take-or-pay contracts. The Task Force agreed that the scope of this Issue should be expanded to address the broader question of how to determine whether any arrangement contains a lease within the scope of Statement 13.

Approach to Address Issue
B3. Based on the definition of a lease in paragraph 1 of Statement 13, determining whether an arrangement contains a lease requires the evaluation of whether the arrangement conveys the right to use the underlying property, plant, or equipment to a non-owner. The Task Force discussed whether that evaluation should be based on the explicit terms in the arrangement or whether it should be based on the substance of the arrangement. That is, whether the evaluation should depend on whether the arrangement explicitly provides for the use of specific property, plant, or equipment, or whether the substance of each arrangement should be evaluated in order to determine whether the right to use property, plant, or equipment is conveyed (perhaps implicitly).

B4. The Task Force agreed that the evaluation of whether an arrangement conveys the right to use the underlying property, plant, or equipment should be based on the substance of the arrangement. Prior to its rescission, paragraph 5 of Issue 98-10 stated that "the determination of whether a transportation contract or some other type of energy-related contract is a lease is a judgmental decision based on the substance of each contract" (emphasis added). The fact that a contract is labeled a "transportation contract" is not determinative that the contract is not a lease and the fact that a contract is labeled a "lease" is not determinative that the contract is a lease. Additionally, the fact that the definition of a lease in paragraph 1 of Statement 13 includes agreements that may not be nominally identified as leases implies that the evaluation should be based on the substance of the arrangement. The SEC, in addressing reporting by hotel management companies, has also indicated that "determining whether a contract is a service agreement or a lease is dependent on the facts and circumstances, and requires a rigorous analysis of the rights, obligations, risks and rewards of the management company and the property"
owner" (Division of Corporate Finance's *Current Accounting and Disclosure Issues*—March 2001).

**Multiple Element Arrangements That Contain a Lease**

B5. The Task Force agreed that Statement 13 provides for separate recognition of a lease that is embedded in a multiple element arrangement, based on the language in paragraph 1 and the definition of minimum lease payments in paragraph 5(j) (which excludes any portion of the payment attributable to executory costs, including amounts paid for maintenance, insurance, and taxes) used for purposes of determining lease classification. To clarify that this Issue addresses multiple element arrangements that include a lease (and not just whether an entire arrangement is a lease), the title of the Issue was changed to more appropriately reflect that point ("Determining Whether an Arrangement Contains a Lease").

B6. The Task Force discussed how arrangement consideration should be allocated among separate units of accounting when the arrangement contains a lease and other non-lease elements. At issue is whether *all* products and services provided by the lessor in a multiple element arrangement are considered *executory costs* as that term is used in Statement 13 and, therefore, should be deducted from total consideration that the lessee is obligated to pay or can be required to pay in connection with the leased property in arriving at the minimum lease payments. The Task Force reached a consensus that substantial services provided by the lessor (for example, significant operating services) are not executory costs within the scope of Statement 13. The Task Force agreed that for purposes of applying Statement 13, payments and other consideration called for by the
arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease, including the related executory costs and profits thereon, and those for other services on a relative fair value basis, consistent with the guidance in paragraph 4(a) of Issue 00-21.

**Property, Plant, or Equipment**

B7. The Task Force discussed the scope of *property, plant, or equipment* as that term is used in Statement 13. In practice, there appear to be differing views as to what constitutes "property, plant, or equipment." Paragraph 1 of Statement 13 parenthetically defines property, plant, or equipment as "land and/or depreciable assets." However, some constituents have argued that certain arrangements involving non-depreciable assets are within the scope of Statement 13. For example, "parts leasing" arrangements are being marketed to the aviation and computer parts industries. Under those arrangements, the parts manufacturer or supplier and the parts user agree on a list of parts that comprise the "leased asset." The user makes a periodic (or usage) payment to the supplier, and ownership of the parts (as evidenced by UCC filings) resides with the supplier. At the end of the arrangement's term, the user has the ability to purchase the parts at the then fair value or to return any unused parts. Another example of an arrangement in which non-depreciable assets are the subject of a "lease" involves precious metals. A supplier "leases" a quantity of precious metals to a manufacturer. The manufacturer uses the precious metals in its manufacturing process and salvages the same metals from used product. At the end of the arrangement, the manufacturer returns
the same quantity of precious metals (either from salvage or by purchasing from others) to the supplier.\textsuperscript{11}

B8. The Task Force agreed that property, plant, or equipment, as used in Statement 13, must be land and/or depreciable assets. Therefore, inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease because those assets are not depreciable.\textsuperscript{12}

B9. The Task Force discussed whether specific property, plant, or equipment needs to be identified (either explicitly or implicitly) in the arrangement in order for the arrangement to contain a lease. The Task Force agreed that the subject of the lease must be specified no later than the beginning of the lease term. However, the identification of the property in the arrangement need not be explicit; it may be implicit. For example, in the case of a power purchase contract, if the seller of the power is an SPE that owns a single power plant, that power plant is implicitly specified in the contract because it is unlikely that the SPE could obtain replacement power to fulfill its obligations under the contract because an SPE generally has limited capital resources. Similarly, in the case of a throughput contract, the seller may have only a single pipeline and the prospect of obtaining access to a second pipeline may not be economically feasible. In that case, the seller's pipeline is implicitly specified in the contract. If, on the other hand, no property, plant, or equipment is explicitly specified in the contract and it is economically feasible

\textsuperscript{11}This arrangement likely contains an embedded derivative that would need to be analyzed pursuant to Statement 133 (for example, a gold loan is a loan host contract with an embedded forward contract).

\textsuperscript{12}Additionally, Statement 13 explicitly excludes "lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber" and "licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights."
for the seller to perform its obligation independent of the operation of a particular asset, there would be no implicit specification of the property, plant, or equipment and such a contract would not contain a lease.
Lease Term

B10. The Task Force discussed whether a period of time needs to be stated in order for an arrangement to contain a lease. The Task Force agreed that although a lease normally provides for the use of property, plant, or equipment for a specified period of time, an arrangement providing for a specified measure of use (for example, a number of units produced) would be within the scope of Statement 13. The arrangement must include a "lease term" as defined in paragraph 5(f) of Statement 13 (as amended by paragraph 22 of Statement 98). The "term of the lease" could be a period of time or measure of use. This does not preclude the measure of time from being specified as contingent on a future event. For example, a lease of school buses could expire "at the end of the 2004–2005 school year." The fact that the school district had not yet set the calendar for the last day of school in 2005 should not lead to a conclusion that the contract is a service arrangement.

B11. The Task Force agreed that Statement 13, as amended, is sufficiently clear in defining the lease term so there is no need to provide additional guidance in this Issue.

Right to Use

B12. When specific property, plant, or equipment is explicitly identified and the benefits of the property, plant, or equipment are conveyed based on time, application of paragraph 1 of Statement 13 is fairly simple (the arrangement likely contains a lease). The difficulty in determining whether an arrangement contains a lease arises when the right to use the underlying property, plant, or equipment is conveyed in some other manner (for example, based on the output of the property, plant, or equipment). With that, the Task
Force focused on how to determine whether an arrangement conveys the *right to use* the specified property, plant, or equipment when the purchaser receives some or all of the output from the property, plant, or equipment. The Task Force agreed that an arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to physically control the use of the underlying property, plant, or equipment, either through operations or access, while obtaining or controlling more than a minor amount of the output of the property, plant, or equipment.

Similarly, the purchaser (lessee) may obtain the right to use property, plant, or equipment through its contractual ability to exclude others' use of the property, plant, or equipment (for example, by obtaining or having the right to obtain all or substantially all of the output of the property, plant, or equipment).

B13. Task Force members generally agreed that the *right to use* property, plant, or equipment is conveyed in arrangements in which the purchaser has the right or ability to take all or substantially all of the output or other utility that will be produced or generated by the property, plant, or equipment (or, said another way, when other parties will not take more than a minor amount of the output) if the arrangement's pricing contains an element that is designed to recover some or all of the supplier's capital investment in such property, plant, or equipment irrespective of the quantity of output taken by the purchaser. In such arrangements, the purchaser's rights under the arrangement essentially restrict others' ability to use, or to obtain the benefits of, the property, plant, or equipment, even though the property, plant, or equipment may be physically in the possession of, or operated by, the supplier or a third party. The Task Force noted that some arrangements that provide that the purchaser (lessee) will take all or substantially
all of the output from specific property, plant, or equipment may not convey the *right to use* the property, plant, or equipment if the purchaser is essentially paying for a product or service rather than paying for a *right to use* specific property, plant, or equipment. If the price that the purchaser will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the purchaser is paying for a product or service rather than paying for the *right to use* the property, plant, or equipment.

B14. Some Task Force members believe that the determination of whether the purchaser has obtained the *right to use* the property, plant, or equipment specified in the arrangement should include more of an assessment of the risks and rewards inherent in owning the property, plant, or equipment. For example, some members suggested that if the purchaser guarantees the future value of the asset or has a bargain purchase option on the asset, then the purchaser may have obtained the *right to use* the property, plant, or equipment. Others suggested that if an arrangement meets one of the four criteria in paragraph 7 of Statement 13 to be classified as a capital lease by the lessee, the arrangement should automatically be a lease within the scope of Statement 13 (that is, this Issue should affirmatively include those arrangements within its scope). However, the focus of this Issue is on identifying when an arrangement contains a lease. The fact that an arrangement conveys certain risks and rewards incident to ownership is not in and of itself determinative that the arrangement conveys the *right to use* the underlying
property, plant, or equipment. In reaching the consensus, the Task Force generally agreed that

13 However, an arrangement that conveys the right to use property, plant, or equipment will typically also convey certain risks and rewards of ownership. Therefore, the transfer of risks and rewards of ownership may be indicative that the arrangement conveys the right to use property, plant, or equipment.
risks and rewards of ownership are characteristics relevant to lease classification not to whether or not a lease exists, and potential lease classification is not a basis for determining whether the arrangement contains a lease.

B15. The effect of clarifying right to use in the manner provided for by the consensus may result in many take-or-pay arrangements being recognized as leases. That is because the purchaser makes payments for the time that the property, plant, or equipment is made available for use rather than on the basis of actual use or output (resulting in the arrangement's pricing being neither fixed per unit of output nor indexed to market prices). In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier irrespective of whether the purchaser actually uses the property, plant, or equipment or obtains the output from the property, plant, or equipment. In such arrangements, the purchaser is paying for the right to use the property, plant, or equipment.

**Undivided Interests (or a Pro Rata Portion of Property, Plant, or Equipment)**

B16. The Task Force is divided on the issue of whether a pro rata portion of the output of an asset (for example, a pro rata undivided interest) can be the subject of a lease. Some Task Force members note the guidance in SOP 78-9 on accounting for an investment in real estate in which the investor has a direct undivided ownership interest and the guidance relating to partial sales of real estate in Statement 66. They also note the longstanding practice in project finance of leasing undivided interests in power or extractive facilities. Still other Task Force members argue that an undivided interest in property, plant, or equipment is different in character than a physical asset because the
undivided interest represents an economic right with respect to the physical asset rather than the physical asset itself. They note that the Statement 13 definition of a lease is based on the right to use a physical asset (land and/or depreciable assets). They also look to Technical Bulletin No. 88-1, which indicates that the right to control the use of the leased asset is the equivalent of physical use, inferring that an undivided interest owner must be able to physically use the property, plant, or equipment.

B17. In the interest of making progress on this Issue, the Task Force agreed to be silent on the issue of whether a pro rata undivided interest can be the subject of a lease. However, the Task Force agreed that a non-pro rata portion of property, plant, or equipment could be the subject of a lease. That is, when a portion of an asset is physically distinguishable from the larger asset, that portion could be the subject of a lease (for example, one or more floors of an office building).

**Derivatives**

B18. The Task Force discussed the scope of this Issue and the concern of some of its members that the scope may include contracts that may be derivatives pursuant to Statement 133. Issue No. 01-12, "The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease," addressed a similar scope question by resolving the overlap between Statement 13 and Statement 133 with respect to residual value guarantees. In Issue 01-12, the Task Force reached a consensus that residual value guarantees that are subject to the requirements of the lease accounting literature (including Statement 13) are not subject to the requirements of Statement 133 due in part to the fact that Statement 133 did not amend Statement 13 (concluding that
the Board did not intend to change the accounting for leases in relation to Issue 01-12). Consistent with the consensus in Issue 01-12, the Task Force believes the fact that the Board did not amend Statement 13 to exclude derivatives that are subject to Statement 133 from its scope suggests that the Board did not intend to change the scope of Statement 13. As such, this Issue explicitly states that leases within the scope of Statement 13 are not derivative instruments subject to Statement 133, although a derivative embedded in a lease is subject to Statement 133.

B19. Notwithstanding the discussion in paragraph B18, above, in most cases, a lease would never be a derivative and vice versa (that is, the two standards should not overlap). A derivative is a right to the changes in value of the asset related to the underlying, whereas a lease is a right to use the asset (property, plant, or equipment). Additionally, paragraph 10(e)(2) of Statement 133 excludes from its scope contracts that are not traded on an exchange if the underlying is the price or value of a nonfinancial asset that is not readily convertible to cash. However, some Task Force members questioned whether the guidance in this Issue contradicts the guidance in paragraph 59(c) of Statement 133 regarding that statement's assessment of take-or-pay contracts. Paragraph 59(c) states:

**Take-or-pay contracts.** Under a take-or-pay contract, an entity agrees to pay a specified price for a specified quantity of a product whether or not it takes delivery. Whether a take-or-pay contract is subject to this Statement depends on its terms. For example, if the product to be delivered is not readily convertible to cash and there is no net settlement option, the contract fails to meet the criterion in paragraph 6(c) and is not subject to the requirements of this Statement. However, a contract that meets all of the following conditions is subject to the requirements of this Statement: (1) the product to be delivered is readily convertible to cash, (2) the contract does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (3) little or no initial net investment in the contract is required. [Emphasis added.]
B20. The fact that a contract is labeled as "take-or-pay" is not determinative that the contract is not a lease. Whether a "take-or-pay" contract is subject to Statement 13, to Statement 133, or to neither depends on its terms. Statement 13 and the guidance in this Issue should be applied first to determine whether a “take-or-pay” contract is within the scope of Statement 13. Any portion of the arrangement that is not a lease may be subject to Statement 133 (or any other GAAP) and any lease portion of the arrangement may contain an embedded derivative that is subject to Statement 133. Nevertheless, a "take-or-pay" contract that meets all of the conditions in paragraph 59(c) of Statement 133 will, in most cases, not be a lease due to the requirement that the product to be delivered be readily convertible to cash. In order for an asset to be readily convertible to cash, it must have quoted market prices available in an active market.14 Most arrangements that call for delivery of an asset that has quoted market prices available in an active market will generally not be dependent upon specific property, plant, or equipment to fulfill the arrangement. However, in the unlikely event that the arrangement is dependent upon specific property, plant, or equipment and the other criteria in this Issue are met, Statement 13 is applied to the lease portion of the arrangement.

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14Refer to footnote 5 to paragraph 9(c) of Statement 133.