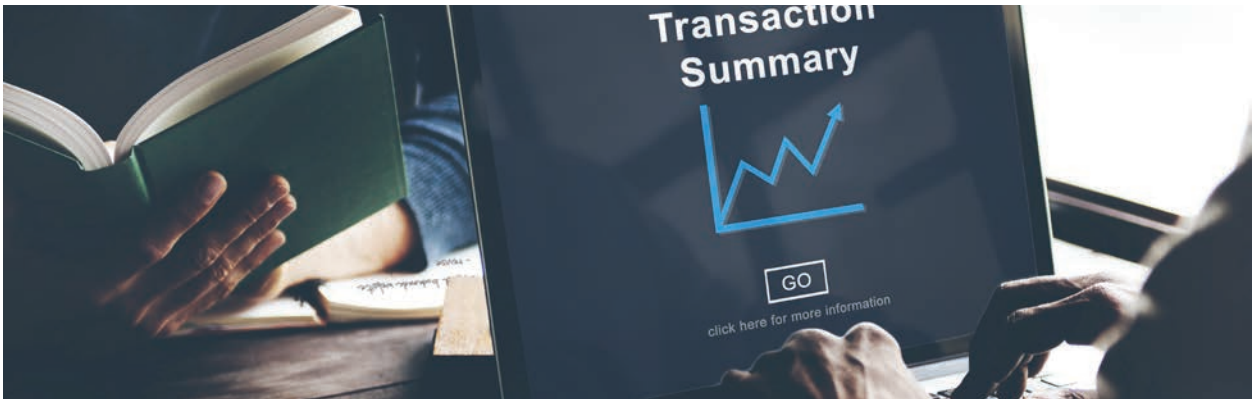
Agreements Conveying the Right to Use an Asset – Assessing the Substance of the Transaction



With the advent of Ind AS, companies are required to re-evaluate long standing arrangements, including financial instruments, arrangements existing amongst group entities and others primarily with a view to determine if such arrangements convey the right to use an asset and the associated fair value of the transaction. In many industries, entities enter into arrangements that do not take the legal form of a lease but convey the right to use assets for agreed periods of time in return for a fee. The assets which are the subject matter of the transaction are specifically identified and are generally available for the exclusive/ dedicated use of the other party. Since such agreements are not "leasing agreements" in the legal sense, such transactions were not accounted for as a "lease" as per the guidance under AS 19 – Leases. Under the Ind AS regime, however, such transactions need to be evaluated in accordance with the guidance available under Ind AS 17 – Leases and the appendices thereto. Read on to know more….

Determining whether an Arrangement contains a Lease

Appendix C to Ind AS 17 provides guidance regarding evaluation of transactions that do not take the legal form of a leasing arrangement, but are however, in substance, a lease. The topic prescribes the evaluation of an arrangement on the basis of 'control' over the assets that are the subject of the arrangement. If the arrangement between the parties is determined to be a lease in substance, then this topic requires the accounting for the arrangement as per the regular provisions of Ind AS 17 Leases.

Certain examples where such arrangements have been found to be in operation include –

- Automotive industry – Providing tools, dies etc. by suppliers to the original equipment manufacturers (OEMs) for their dedicated use and as per specifications required by OEMs;
- Oil and gas industry - The right to use storage facilities at ports by companies operating in the oil and gas industry for storage of liquid products such as oil. Such rights are provided by the legal owner of the storage facilities;
- Oil and gas industry – The right to use bottling facilities by companies operating in the oil and gas industry for filling up cylinders of LPG/ CNG. Such rights are provided by the legal owner of the bottling facility;
- General - A solar power setup wherein the owner of the solar plant installs the setup at the premises of the receiver and the output i.e. energy is consumed solely by the receiver.

Such arrangements generally award a certain degree of exclusivity to the receiver of the asset/ service such that the asset is in a way dedicatedly available for the user and the receiver operates the asset in a manner most convenient and beneficial to it.

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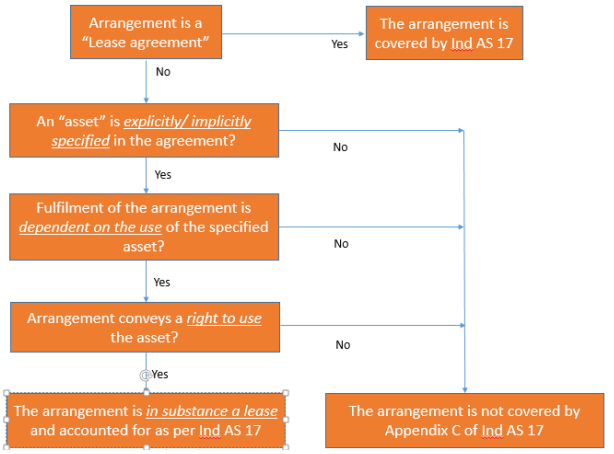
Usually, such assets are specifically designed/ procured by the legal owner keeping in mind the requirements of the user and are typically entered into for longer periods of time, allowing the legal owner to recover the investment made in the asset.

An overview of the requirements of Appendix C of Ind AS 17 has been presented in the following chart:



Determining whether an arrangement is, or contains, a lease is a two-step process, requiring evaluation of the following criteria:
Step I. Fulfilment of the arrangement is dependent on the use of a specific asset or assets; and
Step II. The arrangement conveys a right to use the asset.

Step I. Fulfilment of the arrangement is dependent on the use of a specific asset or assets

This is the first step in the two step process. This step requires establishing the fact whether an asset has been specified in the agreement.
An asset may be specified either -

- explicitly, i.e. by way of specific mention of the make, model no., identification no. etc. of the asset; or
- implicitly, i.e. if the supplier has only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

Further, the arrangement should be dependent on the use of the asset specified, such that, the arrangement cannot be fulfilled without the use of the specified asset. This implies that if the arrangement can be fulfilled by the use of any alternate asset provided by the supplier, then this criteria is not fulfilled.

In a nutshell, the first condition requires that the arrangement should be dependent on a specific asset and it is not practically and economically feasible for the supplier to provide alternate assets to the receiver. (However, a situation where an alternate asset has been provided by the supplier due to break-down of the original asset will not preclude the applicability of the topic to the original asset).

Step II. The arrangement conveys a right to use the asset

This is the second step in the evaluation. An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed *if any one of the following conditions is met*:

(a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
This condition implies that the purchaser has the right to determine the manner of operation/ operating procedure, production scheduling, defining the maintenance cycle etc. of the asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
This implies that the purchaser has the right to determine the manner in which the excess capacity of the asset can be utilized by third parties.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output at of the time of delivery of the output.

The third condition attempts to ensure that the payment being made by the receiver is for the use of asset rather than for purchase of output. Thus, in a situation where the price for output has been fixed on a per unit basis, the underlying intention of the arrangement is that of supply of output, rather than conveying the right to use an asset. Whereas, an arrangement where the receiver is required to make fixed payments for the use of an asset, on the basis of period of use of the asset, indicates that the arrangement has been made with an intention to convey the right to use the asset. Such is the case in take-or-pay arrangements, wherein the receiver is required to make payments for the entire utility of the asset, regardless of the actual quantity purchased by the receiver.

To summarize, the receiver of the asset needs to demonstrate control over the asset either by way of possessing the ability to operate the asset or by way of obtaining the ability to determine the manner of utilization of excess capacity of the asset.

Alternatively, as per the terms of the contract, the price for the output produced by the asset is neither fixed per unit nor equal to market prices.

This has to be coupled with the fact that the purchaser obtains or controls more than an insignificant quantity of the output of the asset.

Illustrations

A. Example of an arrangement that contains a lease

Facts

A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds 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.*
- *Each month, 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 amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.*
- *If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.*

Assessment

The arrangement contains a lease within the scope of Ind AS 17 Leases. An asset (the facility) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive. The purchaser has obtained the right to use the facility because, on the facts presented—in particular, that the facility is designed to meet only the purchaser's needs and 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 an insignificant 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 at the time of delivery of the output.

B. Example of an arrangement that does not contain a lease

Facts

A manufacturing company (the purchaser) enters into an arrangement with a third party (the supplier) 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 factory 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 fulfil 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 uneconomic.*
- *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 pay only 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), so it is expected that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the supplier's plant.*

Assessment

The arrangement does not contain a lease within the scope of Ind AS 17. An asset (the plant) is explicitly identified in the arrangement and fulfilment of the arrangement is dependent on the facility. Although 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 uneconomic. However, the purchaser has not obtained the right to use the plant because 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 the likelihood that parties other than the purchaser will take more than an insignificant amount of the component parts produced at the plant is more than remote, on the basis of the facts presented. In addition, the price that the purchaser pays is fixed per unit of output taken.

Based on the completion of the two-step evaluation process, if it is concluded that an arrangement contains a lease, that lease shall be classified as a finance lease or an operating lease in accordance with Ind AS 17 Leases.

For the purpose of applying the requirements of Ind AS 17, payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease and those for other elements on the basis of their relative fair values.

The conclusion of an arrangement as an operating lease may not result in significant implications with the impact being restricted to re-classification of the expense in the statement of P&L and presentation of related disclosures.

However, in case the arrangement is determined to be in the nature of a finance lease, it may have far reaching consequences such as capitalisation of the asset in the books of the asset receiver, who is not the legal owner of the asset. At the same time, the legal owner may be required to de-recognise the asset from the Balance Sheet and need to record a lease receivable, in line with Ind AS 17.

First time adoption of Ind AS

An entity adopting Ind AS for the first time will need to assess the existence of such arrangements as on the date of transition to Ind AS. While evaluating the entity should only consider the facts and circumstances that existed as on the date of transition to Ind AS, i.e. use of hindsight is not permitted.

Impact on disclosures

If an arrangement qualifies for lease accounting as per Ind AS 17, then all the disclosures as required under Ind AS 17, as applicable to operating and finance lease respectively, would be required to be made as part of the notes to accounts.

Conclusion

To conclude, entities will need to re-look their existing arrangements which convey the right to use assets. Such evaluation shall be required to be done by both the asset supplier and receiver. While evaluating arrangements, entities will need to give due weightage to the underlying purpose of the arrangement rather than merely going by the terms written in the agreement.

References:

i. Ind AS 17 Leases
ii. Ind AS 101 First-time adoption of Indian Accounting Standards
iii. IFRIC Interpretation 4 Determining whether an Arrangement contains a Lease
iv. Basis for conclusions on IFRIC Interpretation 4
v. Examples accompanying IFRIC 4 ■