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IFRS Today

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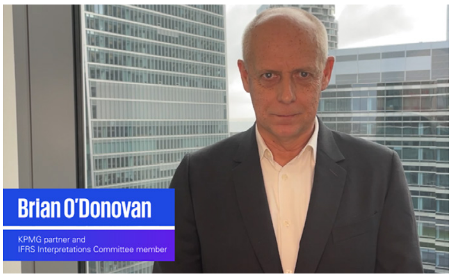

"The Committee's discussion illustrated the complexity of applying existing standards to new technologies – in this case, batteries to be used in electric vehicles."

VIDEO TRANSCRIPT

IFRIC agenda decisions – Definition of a lease and substitution rights

Brian O'Donovan
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Hello, I'm Brian O'Donovan. I'm a partner at KPMG and a member of the IFRS Interpretations Committee.

In its November meeting, the Committee discussed a case that illustrated the challenge of applying existing accounting standards to new technology. In this case, batteries to be used in electric vehicles.

The specific case was about the application of the lease definition to a contract to supply batteries that includes a really interesting substitution clause.

This case could set an important precedent in a rapidly expanding industry sector.

How does the substitution right work?

The Committee discussed a ten-year contract under which the supplier provides multiple batteries that will be used in buses operated by the customer. The supplier can substitute a battery for an alternative battery at pretty much any time.

The supplier's decision as to when to substitute a battery depends on two things. Firstly, the rate at which the performance of the battery deteriorates over time. And secondly, the amount of compensation the supplier has to pay to the customer for taking a bus out of service to change the battery. The supplier expects that substitution will not be economically beneficial until a battery is three or more years older.

The questions are: firstly, do you apply the lease definition to the contract as a whole or to the individual batteries? And secondly, how does this substitution right impact the assessment of whether there is a lease?

What did the Committee decide?

The Committee concluded quite quickly that you have to drill down into the contract and consider each battery separately, essentially because each battery can be used independently of the others. In contrast, we spent a lot more time on the second question.

The relevant test in the standard is whether a substitution right is substantive throughout the period of use. The notion of a substantive right contains the idea that substitution must be economically beneficial for the supplier.

Now, most Committee members felt that relying on a substitution right to avoid lease accounting is a high hurdle. That hurdle is particularly high for a customer who will typically have less information about the costs and benefits of substitution than the supplier.

And the tricky thing about this particular substitution right is that the supplier expects that the economically beneficial test will be failed for three years, but passed after that. It seems that the Board didn't contemplate this scenario when preparing the leases standard.

Ultimately, the Committee concluded that the substitution right was not substantive throughout the period of use. So if the other parts of the lease definition are met, there is a lease of the batteries.

Next steps

The Committee agreed to issue a tentative agenda decision. It's in the IFRIC Update open for comment until early February.

Take a look. See if you agree with the Committee's analysis. Have a think about whether you want to submit a comment letter.

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