

# The leases lab



**IFRS 16 gives rise to many challenges, so Professor Lee Singh starts a new experiment – this time with his assistant Dr Holger Meurer**

## Hypothesis

A lessee must recognise a right-of-use asset and a lease liability for almost every lease contract under the new standard. Substitution rights may be an obvious way to avoid lease accounting. If there is a substitution right, the leased asset can't be identified and hence there is no lease to recognise!

## Testing and analysis

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. There is, however, no identified asset if the supplier has a right to substitute the asset and that right is substantive.

Substitution rights are substantive if the supplier;

- has the practical ability to substitute an alternative asset throughout the period of use; and
- benefits economically from substituting the asset.

The supplier's substitution right is not substantive if the supplier has a right or obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event.

Let's look at some examples:

### Example 1

A customer enters into a contract with a supplier for the right to control the use of an asset for six years. The supplier has the right to substitute the underlying asset at three years from the commencement of the contract, that is, only at that particular point in time.

### Example 2

A customer enters into a contract with a supplier for the right to control the use of an asset for six years. The supplier has the right to substitute the underlying asset throughout the term of the contract if a particular event occurs.

In both examples, the supplier does not have the right to substitute the asset throughout the entire period of use and therefore the substitution right is not substantive. The lease term in both examples is six years.



## Conclusion

Unfortunately, the hypothesis is incorrect.

A substitution right by itself is not sufficient to prevent the contract from being a lease. The substitution right also needs to be substantive and available throughout the period of use.

## Practical application

The analysis of whether or not a substitution right is substantive is often complex. There is a range of factors that need to be considered such as the benefits and costs of substituting.

Substantive substitution rights might allow customers to avoid lease accounting. However, suppliers should weight this 'desirable outcome' against any practical aspects and inconvenience that allowing such a substantive right might entail.

For more on substitution rights and the assessment of whether or not they are substantive, see our In depth, [IFRS 16 – A new era of lease accounting](#).

Our full range of leases content can be found on [PwC Inform](#), including [videos on various aspects of the new standard](#).