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Technical Line

IRU arrangements: A purchaser's guide to identifying and classifying leases

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What you need to know

- Accounting for indefeasible rights of use can be complicated, and determining whether such an agreement qualifies as a lease depends on the terms of the arrangement.
- 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 capital lease. An indefeasible right of use that does not meet the definition of a lease should be accounted for as a service agreement.
- This publication walks through the criteria that should be considered when determining whether an indefeasible right of use agreement is a lease and, if so, how such lease should be classified.

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 agreement, which is typically long-term (e.g., 10 or 20 years) and may have a significant up-front payment, is called an indefeasible right of use (IRU).

Accounting for IRUs can be complicated because entities must first determine whether the IRU is a lease and, if so, how it should be classified. IRU agreements that do not meet the definition of a lease are accounted for like other service agreements.

This publication is intended to help purchasers or lessees in IRU agreements determine how to account for them. The appendix contains a flowchart of the considerations we discuss in this publication.

Companies entering into IRU agreements typically are telecommunications (telecom) companies, but technology companies also are beginning to enter into IRU agreements.

For guidance on lessor accounting (i.e., accounting by sellers of capacity under an IRU agreement), see our Financial reporting developments publication, *Lease accounting*.

Determination of a lease

For an arrangement to be considered a lease, ASC 840-10-15 requires that it meet all of the following conditions:

- The arrangement involves the use of property, plant or equipment (PPE).
- The PPE in the arrangement is either explicitly or implicitly identified.
- The arrangement conveys to the purchaser/lessee the "right to use" the specified PPE.

The use of PPE

A fiber line or a single fiber strand would meet the definition of PPE because they are tangible depreciable assets. Whether the owner/seller of the fiber line accounts for each fiber strand individually or as a whole is not relevant to determining whether the fiber line or a fiber strand is PPE.

A lease must involve the use of PPE (i.e., land and/or depreciable assets).

PPE must be explicitly or implicitly identified

If the PPE (e.g., the fiber line or a single fiber strand) is not specified in the contract and it is economically feasible for the seller to perform its obligation independently of the operation of a particular asset (i.e., a specified asset), the contract does not contain a lease.

In some cases, an IRU agreement may explicitly identify the asset subject to the agreement but may allow the seller to carry the purchaser's traffic on any of the seller's fiber strands (or lines). If, in addition to being contractually permitted, it is economically feasible and practicable for the seller to carry the purchaser's traffic on other assets of the seller, the arrangement does not depend on the use of specified PPE and therefore would not be a lease.

Illustration 1 — Determining whether an agreement contains specified PPE

Scenario 1

Telecom Company A (seller) owns a large fiber network and enters into an agreement with Telecom Company B (purchaser). The agreement specifies that fiber strands four, five and six will be used to carry the traffic of Telecom Company B's customers for a 10-year period in exchange for a fixed up-front capacity payment. Telecom Company B will handle all transmissions by connecting its switching equipment to the ends of the fiber strands (i.e., Telecom Company B will "light the fiber"). Telecom Company A cannot substitute other fiber strands to fulfill the agreement.

In this scenario, the agreement involves the use of explicitly identified PPE (i.e., fiber strands four, five and six). To determine whether the agreement is a lease, the entities would still need to assess whether the agreement conveys the right to use the PPE to Telecom Customer B. See Illustration 2.

Scenario 2

Assume the same facts as in Scenario 1, except that the agreement does not specify which fiber strands will carry the traffic of Telecom Company B's customers. Telecom Company A has the right and ability (i.e., Telecom Company A has multiple fiber strands available to transmit the data and it is feasible and practicable to use other assets of the seller to do so) to use any of its fiber strands to carry Telecom Company B's customers' traffic.

Although the agreement involves the use of PPE, fulfillment of the agreement does not depend on specified PPE. Therefore, this agreement is not a lease and would be accounted for as a service agreement.

Scenario 3

Assume the same facts as in Scenario 1, except that the agreement does not specify which fiber strands will carry the traffic of Telecom Company B's customers. In addition, assume that for the route involved, Telecom Company A has only one fiber strand available that can be used to fulfill the agreement because the others were previously leased to other customers on an exclusive basis for the contract term.

In this case, the agreement depends on the use of implicitly identified PPE (i.e., the one available fiber). To determine whether the agreement is a lease, the entities would still need to assess whether the agreement conveys the right to use the PPE to Telecom Company B. See Illustration 2.

Determining whether an IRU is a lease can be complicated.

How we see it

Entities should carefully analyze the terms of their agreements to determine whether IRUs depend on the use of implicitly or explicitly specified PPE. If an agreement provides the seller the substantive right or ability to direct traffic to flow on any available fiber strand, and it is feasible and practicable to use other assets of the seller to do so (i.e., other capacity of the seller is readily available and there are not performance or economic concerns associated with any decision to change), fulfillment of the contract would not depend on a specified asset. Judgment may be required to determine whether an asset is implicitly specified or whether it is economically feasible and practicable for a seller to substitute an alternative asset.

Right to use specified PPE

The right to use the underlying PPE is conveyed if any one of the following conditions is met:

- The purchaser has the ability or right to operate the PPE or direct others to operate the PPE in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the PPE.
- The purchaser has the ability or right to control physical access to the underlying PPE while obtaining or controlling more than a minor amount of the output or utility of the PPE.
- Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or utility that will be produced or generated by the PPE 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 as of the time of the delivery of the output.

Ability or right to operate PPE

To meet this condition, the purchaser must have the ability or right to operate the fiber line or fiber strand(s) or to direct others to operate the fiber line or fiber strand(s) and obtain/control more than a minor amount of the output in an IRU agreement. For example, the purchaser's ability to hire, fire or replace the fiber line's operator or the purchaser's ability to specify the significant operating policies of the fiber line without the seller (or owner) having the ability to change those policies and procedures may indicate that the purchaser has such a right.

Ability or right to control physical access to the PPE

To meet this condition, the purchaser must have the ability or right to control physical access to the fiber while obtaining or controlling more than a minor amount of the output of the fiber. Typically, IRU agreements do not give the purchaser the right to control physical access to the fiber line or fiber strand(s) because they are located in the seller's facilities along with other assets of the seller.

Facts and circumstances related to the output or utility of the PPE

Generally, IRU agreements that designate the purchaser as the sole user of the capacity of a specified fiber line or fiber strand would meet the first part of this condition because the purchaser will take substantially all of the utility or output of the fiber line or fiber strand. If an IRU agreement does not cover the entire capacity of a specified fiber line or fiber strand or the agreement does not specify a fiber line or fiber strand, a purchaser will need to perform an analysis of the agreement's facts and circumstances and the assets that will be involved to conclude whether it will take substantially all of the output or utility of a fiber strand or fiber line.

In addition, IRU agreements generally would meet the second part of this condition because there is no fixed price per unit of output and there is no current market price per unit of output. The fixed price criterion means absolutely fixed per unit of output, with no variance per unit based on underlying costs or volumes (either discounts or step pricing), no matter how minor. The fixed per unit of output is applicable when there is an output of the asset (e.g., a manufactured good) and a buyer pays a fixed price for what is delivered (versus made available). A purchase of capacity would not qualify for the fixed per unit of output exception because it makes an asset available versus delivery output.

The reference to current market price per unit of output is intended to apply only to extremely limited situations, such as the active trading markets that power and utility companies can tap for electricity, where they pay the current market price (at time of conveyance) for each unit of output. In an IRU agreement, a purchaser may wonder whether it meets this condition because it is entering into the agreement at "market terms," but that would not be the case. The FASB intended for this criterion to apply only when there is active trading in a unit of output to determine the "market" price. In an IRU, a purchaser typically pays a set up-front fee regardless of the level of "output" or amount of traffic it carries on the fiber. That is, the purchaser pays for the availability of the fiber service rather than for its use of the fiber output.

Illustration 2 — Right to use the PPE

Scenario 1

Assume the same facts as in Illustration 1, Scenario 1. In addition, Telecom Company A (seller) retains physical control over the PPE and the ability to operate the PPE (i.e., it will "light the fiber"). However, Telecom Company B (purchaser) will obtain substantially all of the output and utility of the specified fibers (i.e., no other customers will be able to use the specified fibers). The price of the agreement is fixed, regardless of how much Telecom Company B uses the fiber.

In this scenario, Telecom Company B does not have the ability or right to direct the operation of or control physical access to the PPE. However, the contract conveys the right to use specified PPE because Telecom Company B will take substantially all of the PPE's output (i.e., the likelihood is remote that one or more parties other than Telecom Company B will take more than a minor amount of the output), and the price it will pay is neither fixed per unit of output nor equal to the market price per unit. Therefore, this contract meets the definition of a lease.

Scenario 2

Telecom Company C (seller) owns a large fiber network and enters into an agreement with Telecom Company D (purchaser) that allows Telecom Company D to carry its customers' traffic from New York to London. Telecom Company C retains physical control over the PPE and the ability to operate the PPE (i.e., it will light the fiber and make all related operation decisions).

The agreement is for a 10-year period and requires Company D to make one fixed up-front payment for 80% of the capacity of a fiber strand. The agreement specifies that Telecom Company D's traffic will be carried on a specific fiber. Telecom Company C cannot substitute other fiber to fulfill the agreement. Telecom Company C can use this excess capacity for other customers' traffic. Telecom Company C has access to several customers that would use any excess capacity, and the likelihood of the excess capacity being used by Company C to service other customers is more than remote. The price of the agreement is consistent with an expectation that Telecom Company C will sell excess capacity on the specified fiber to third parties.

In this scenario, Telecom Company D concludes that the likelihood is more than remote that another purchaser (i.e., other than Telecom Company D) will take more than a minor amount of the output of the specified fiber. Because Telecom Company D does not have the right or the ability to direct the use of the fiber or control physical access to the fiber, the agreement does not convey the right to use the specified PPE. Therefore, this contract does not meet the definition of a lease.

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

How we see it

Entities need to carefully analyze the terms of their agreements to determine whether the right to use specified PPE is conveyed to the purchaser. Questions that entities should ask include:

- Does the IRU provide the purchaser with the ability to direct the operation of the fiber or to control physical access to the fiber?
- Is the purchaser the only user that will receive output or utility from the fiber (i.e., is the fiber line or the fiber strand dedicated to the purchaser)? If not, are there other purchasers that could receive output or utility from the fiber line or fiber strand, and what is the likelihood that they will (and is the pricing of the agreement consistent with that expectation)?
- Is the price that the purchaser will pay for the output contractually fixed per unit of output at the time of delivery?

If an IRU agreement does not meet the definition of a lease, it should be accounted for like other service agreements.

Lease classification

If a purchaser determines that an IRU agreement meets the definition of a lease, it needs to determine the appropriate lease classification. In accordance with ASC 840, leases that transfer substantially all of the benefits and risks incident to the ownership of property are accounted for as capital leases. Leases that do not transfer substantially all of these benefits and risks are treated as operating leases.

Before a lessee can evaluate whether an IRU agreement is a capital lease or an operating lease, it must first determine the appropriate unit of account. If the fiber or fiber strand meets the definition of integral equipment, the lessee will need to consider the guidance in ASC 840 on leases of real estate.

Definition of integral equipment

The term "integral equipment" (as defined in ASC 360-20-20) refers to any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring significant cost. Fiber lines (which are equipment) can be laid in a number of ways. They can be buried underground, run through a conduit laid on the ground or underground (e.g., through a subway system, over roadways), over poles or along the sea bottom. A purchaser will need to evaluate whether the fiber line it has contracted to use can be removed from the real estate to which it is attached and used separately without incurring significant costs (refer to ASC 360-20-15-4 through 15-8 for further details on making this assessment). In most cases, due to the significant cost associated with removing fiber lines and the practical issues associated with attempting to do so (i.e., physical disturbance associated with removing buried fiber, repairing it if possible and reinstalling it), fiber lines and strands will qualify as integral equipment.

In the rare instance a lessee determines that the fiber specified in an IRU agreement is not integral equipment, the lessee should classify the lease in a manner similar to other equipment leases under ASC 840.

Equipment lease classification criteria (non-integral equipment)

Lessees should classify non-integral equipment leases at the inception date as either capital or operating leases based on the criteria in ASC 840.

A lease is a capital lease if it meets any one of the following criteria:

- Ownership is transferred to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term is at least 75% of the property's estimated remaining economic life (this criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term).
- The present value of the minimum lease payments at the beginning of the lease term is 90% or more of the fair value of the leased property to the lessor at the inception date (this criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term).

Leases that do not meet any of these criteria are classified as operating leases.

Leases of only part of a larger asset

If the leased property is part of a larger asset (e.g., fiber strands five and six out of eight strands), its cost (or carrying amount) and fair value may not be objectively determinable. If a lessee cannot objectively determine the fair value of the portion of the property it leases, the 90% of fair value criterion cannot be applied, and the only applicable criterion for capital lease classification is the 75% of economic life test.[1] Assessing the applicability of this exception (ASC 840-10-25-3) will be a matter of judgment based on the individual agreement.

Integral equipment lease classification criteria

A lessee of fiber that is integral equipment should review the contract to determine whether any rights to the land conveyed to the lessee meet the definition of a lease.

Leases of integral equipment only

If there is no lease of land (i.e., only the use of the fiber meets the definition of a lease), the lessee should follow the lease classification criteria discussed above. That is, the lessee would classify the lease as a capital lease if it meets any one of the following criteria:

- Ownership is transferred to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term is at least 75% of the property's estimated remaining economic life (this criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term).
- The present value of the minimum lease payments at the beginning of the lease term is 90% or more of the fair value of the leased property to the lessor at the inception date (this criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term).

The lessee would also consider the guidance relating to a lease of only part of a larger asset as appropriate.

Leases of land and integral equipment

However, if the contract contains leases of both the land and the fiber line or fiber strand(s), the lessee should apply the guidance in ASC 840-10-25-38 to determine whether there are one or two units of account. ASC 840 provides additional lease classification guidance for circumstances in which the lessee is leasing land and buildings. The land and building may be accounted for as a single unit of account or separately. ASC 840 does not specifically address leases of land and integral equipment. However, we believe it is appropriate to apply the unit of account guidance for land and building leases by analogy to leases of land and property improvements or integral equipment (e.g., IRUs) that cannot be removed and used separately from the real estate without incurring significant costs. For fiber that is considered integral equipment, the fiber or fiber strand(s) specified in the IRU is analogous to the "building."

If a lease of land and integral equipment transfers ownership to the lessee or contains a bargain purchase option, the land and fiber (i.e., "building") elements should be classified as capital leases by the lessee. Lessees should capitalize the two elements separately by allocating the minimum lease payments in proportion to the elements' fair value at the inception date. The fiber (i.e., "building") element should be amortized using the lessee's depreciation policy for similar owned assets. The land element normally would not be amortized. It is rare for an IRU agreement to transfer ownership or contain a bargain purchase option. However, each agreement is unique, and these criteria should be considered for all agreements.

If the lease does not transfer ownership to the lessee or contain a bargain purchase option, the lessee should determine the proportion of the fair value of the land to that of the leased property at lease inception, as described below.

Fair value of land is 25% or more of fair value of leased property

If the fair value of the land is 25% or more of the total fair value of the leased property, the lessee must consider the land and fiber (i.e., "building") elements separately when performing the 75% of economic life test and the 90% of fair value test for the fiber element. The annual minimum lease payments applicable to the land element are determined by multiplying the fair value of the land by the lessee's incremental borrowing rate. The balance of the minimum lease payments (including the portion relating to residual value or first-loss guarantees) are attributed to the fiber element. If either of the tests is met for the fiber ("building") element, it should be classified as a capital lease, and the land element should be classified as an operating lease. If neither of the tests is met for the fiber ("building") element, both it and the land element should be classified as operating leases.

Fair value of land is less than 25% of fair value of leased property

If the fair value of the land element is less than 25% of the total fair value of the leased property at lease inception, the contract should be treated as a single unit of account when evaluating lease classification. The estimated economic life of the fiber should be used for applying the 75% of economic life test. If either the 75% of economic life test or the 90% of fair value test is met, the lessee should classify the lease (i.e., lease of land and fiber) as a capital lease. If neither test is met, the lease should be classified as an operating lease.

Endnote:

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[1] The bargain purchase option and transfer of ownership criteria would not be present in that ownership of part of an asset would not be conveyed. If a bargain purchase option or transfer of ownership were present, it would not be considered a lease of part of an asset.

Appendix: IRU agreement decision tree