Project **Leases**

Topic **Lessor accounting - Accounting for arrangements with service and lease components under the derecognition approach**

Purpose

1. The purpose of this paper is to discuss lessor accounting for a lease with service components under a derecognition approach. If the lessor is unable to identify service components in an arrangement, there is concern that under the derecognition approach there would be an overstatement of revenue at lease commencement. This is because the lessor would recognise revenue for services before those services have been provided.

2. This is less of a problem under the performance obligation approach because under that approach, the lessor has a single performance obligation to continue to permit the lessee to use the leased asset over the lease term and that performance obligation would be satisfied, and revenue recognised, continuously over the lease term.

3. At the March 2010 joint meeting, the boards discussed how to account for arrangements that contain both service components and lease components under the performance obligation approach to lessor accounting.

4. As requested by some Board members at the May 2010 joint meeting, this paper considers how to account for a lease when the lease includes services that are integral to the lease, in addition to when lease and service components are distinct.

5. The staff do not try to define what ‘integral’ means. The staff think that as the revenue recognition requirements already define ‘distinct’, it is appropriate to interpret ‘integral’as ‘not distinct’ opposite in meaning to ‘distinct’.

6. The staff recommend that under the derecognition approach to lessor accounting lessors should separate services from leases even when the services and leases are not distinct by estimating the costs (and a margin) of providing services for the purpose of allocating the lease payments.

7. This paper is structured as follows:

   (a) Background

   (b) Staff analysis

   (c) Staff recommendation.

Background

8. At the March 2010 joint meeting, the boards discussed how to account for arrangements that contain both service components and lease components under the performance obligation approach to lessor accounting. The boards tentatively decided that:

   (a) Both lessors and lessees would be required to evaluate whether the lease payments should be allocated between service and lease components, considering all concurrently negotiated contracts with a third party.

   (b) A lessor would be subject to the revenue recognition requirements regarding the identification of separate performance obligations within an arrangement. That is, if the service component is not considered distinct, total payments under the arrangement should be accounted for as a lease. If the service component is considered distinct, total payments under the arrangement should be allocated between the service and lease components using the same principles as those proposed in the revenue recognition project.

(c) If the lessor or lessee is unable to reliably measure the service and/or lease components in an arrangement for allocation, the entire arrangement should be considered and accounted for as a lease. The boards noted that it would be rare that an entity has identified the service component as distinct yet it is unable to determine an allocation of the total payments between the service and lease components.

9. At the May 2010 joint meeting, the boards instructed the staff to consider how to account for a lease when the lease includes services that are integral to the lease under a derecognition approach to lessor accounting.

Staff analysis

10. Under the derecognition approach to lessor accounting, the lessor has promised to deliver a right-of-use asset to the lessee. Therefore, under the derecognition approach the promised good is the right-of-use asset. Under the proposed revenue recognition requirements, because the lessor has a single performance obligation (to deliver the right-of-use asset) and transfers the promised asset at lease commencement (at a point in time), the lessor satisfies that performance obligation at that point (assuming there are no other elements in a lease, such as services).

11. The current draft of the proposed revenue recognition guidance states with regard to satisfaction of performance obligations as follows:

> An entity shall recognize revenue when it satisfies a performance obligation … by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains *control* of that good or service.

12. The notion that there is a single performance obligation from the lessor's perspective under a derecognition approach to lessor accounting is consistent with the proposed lessee accounting model. Under the proposed lessee model, the lessee recognises an obligation for its payments under a lease upon lease commencement. This indicates that the lessee has received and accepted a good, and therefore has an unconditional obligation to pay the lessor for the benefits of using that good.

13. However, it could be argued that the lessor has more than a single performance obligation if there are other elements in a lease such as services, even under the derecognition approach.

When service component is distinct (two or more performance obligations under the revenue recognition project)

14. The proposed revenue recognition requirements state that an entity shall account for each promised good or service as a separate performance obligation only if the promised good or service is *distinct* from other goods or services promised in the contract. Goods or services are distinct if either:

> (a) the entity, or another entity, sells an identical or similar good or service separately; or
>
> > (b) the entity could sell the good or service separately because the good or service meets both of the following conditions:
> >
> > (i) it has a distinct function—a good or service has a distinct function if it has utility either on its own or together with other goods or services available in the marketplace; and
> >
> > (ii) it has a distinct profit margin—a good or service has a distinct profit margin if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service.

15. When a lease includes service and lease components that are distinct, consistent with the boards' tentative decisions on the revenue recognition project and this project (paragraph 7), a lessor would be required to allocate lease payments between service and lease components and account for the service component in accordance with the revenue recognition requirements.

When service component is not distinct, integral to the lease (one performance obligation under the revenue recognition project)

16. The staff have considered four possible approaches that the boards could adopt for the lessor to separate payments between lease and service components when the services are not distinct:

(a) treating all payments as lease payments;

(b) treating all payments as payments for services;

(c) requiring an estimate of future service costs for the allocation of the consideration between service and lease elements; and

(d) recognising a liability for the costs of future services.

Approach (a) - Treating all payments as lease payments

17. Treating all payments as lease payments is consistent with the tentative conclusion reached by the boards for lessees and under the performance obligation approach to lessor accounting.

18. However, under the derecognition approach this would result in the recognition of revenue for the service component at lease commencement. This could lead to service revenue being recognised before the services have been provided which would be inconsistent with the proposed revenue recognition guidance. Consequently, the staff do not recommend this approach.

Approach (b) – Treating all payments as payments for services

19. This approach is consistent with the proposed revenue recognition guidance and is similar to the performance obligation approach to lessor accounting as it would result in no revenue at lease commencement, and it would result in revenue recognised over the lease term.

20. Under the revenue recognition requirements, a good or service has a distinct function if it has utility either on its own or together with other goods or services available in the marketplace. A good or service with utility on its own is an asset that, on its own, can be consumed, disposed, held, or otherwise used in a way that generates economic benefits. Even if a good or service does not have utility on its own, it nevertheless would be an asset if it has utility together with other goods or services that are available in the marketplace either from the entity or from other entities.

21. If a good or service does not have a distinct function, then it is questionable whether it is an asset of which the customer could obtain control. Hence, the

boards think that requiring a good or service to have a distinct function would emphasise that an entity can have a performance obligation only for contractual promises that result in the transfer of an asset to the customer when fulfilled.

22. Therefore, if a promised good or service is not distinct, an entity would not account for that promised good or service as a separate performance obligation. Consequently, if service and lease components are not distinct, then it can be argued that a right-of-use has not been transferred to the customer, and therefore no leases exist. The contract would be accounted for in accordance with the revenue recognition requirements, and would result in revenue recognised over the contract term.

Approach (c) - Requiring an estimate of future service costs for the allocation of the consideration between service and lease elements

23. The concern with recognising all revenue at lease commencement would disappear if lessors always identified and accounted for any service component separately (beyond what would be required under the revenue recognition project).

24. The service component would be accounted for in accordance with the revenue recognition requirements, separate from the accounting for the right-of-use asset.

25. That service component would include any of the lessor's performance obligations (eg security, maintenance, cleaning services, etc. that are required in terms of the lease) that are not part of the right to use the underlying asset.

26. Although the service component may not be distinct as defined in the revenue recognition project, the staff think that lessors are able to allocate costs between the components. Lessors have the information on the additional service costs and the profit, if any, expected to be earned from the lease. Consequently, it may still be practicable for lessors to identify the service component based upon the costs required to fulfill that part of the arrangement.

27. This view is supported by comments received from constituents from the leasing industry:

> Normally a lessor should be able to bifurcate lease payments into their constituent elements, as one would wonder how they were able to price a lease without being able to do so [from a working group member in September 2009].
>
> A lessor will **always** be able to distinguish and bifurcate the portion of the rentals attributable to these services from the payments it receives for the right to use the physical asset. Indeed it is the lessor's business to be able to do so [unsolicited comment letter from Leaseurope dated March 2010].
>
> No sensible lessor of any sort (property or otherwise) will sign a lease with an all-inclusive rental that covers services whose cost cannot be reliably estimated [unsolicited comment letter from Leaseurope dated May 2010].

28. Based on discussions with constituents, the staff think that in all situations it would be possible for the lessor to develop a reasonable methodology to determine specific costs attributable to services for the purpose of allocating payments under a lease contract between the lease and service components. Lessors can reliably estimate service costs (and an appropriate margin) on a reasonable basis (for example, by allocating based upon square footage occupied in property leases shared among tenants or by comparing the lease to a lease with no services or to a standalone service contract).

29. This approach is consistent with current guidance on separating payments for the lease from other payments. The existing guidance in Topic 840 and in IFRIC 4 *Determining whether an Arrangement contains a Lease* states that:

> In some cases, separating the payments for the lease from payments for other elements in the arrangement will require the purchaser to use an estimation technique. For example, a purchaser may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements, or by estimating the payments for the other elements in the arrangement by reference to comparable agreements and then deducting these payments from the total payments under the arrangement.

30. However, as noted above it is inconsistent with the revenue recognition guidance because it requires separation when service and lease components are not distinct.

Approach (d) – Recognising a liability for the costs of future services

31. Under Approach (d), the following entries would result at lease inception under the partial derecognition approach:

Dr Lease receivable (PV of cash flows expected to be collected under a lease)

Cr Performance obligation – future services (estimated service costs plus margin on services)

Cr Revenue (plug)

Dr Cost of Sales (portion of underlying that represents the ROU)

Cr Underlying asset (portion of underlying that represents ROU)

As services are provided,

Dr Performance obligation

Cr Revenue

32. The staff do not recommend this approach to recognising a liability for the future service costs because it would not be consistent with the revenue recognition guidance because under the revenue recognition project, revenue is allocated to all of the performance obligations in the contract.

Staff recommendation

33. The staff think that the lessor would be able to separate services from leases even when service and lease components are not distinct by estimating costs (and a margin) of providing services for the purpose of allocating the lease payments. Consequently, the staff recommend approach (c).

Question 1
The staff recommend that the lessor should separate services from leases even when services and leases are not distinct by estimating costs (and a margin) of providing services for the purpose of allocating the lease payments.

Do the boards agree?

Is property tax payment a separate performance obligation?

34. Payment of a property tax (that is not yet due) for future periods would not be considered a separate performance obligation because it would not meet the definition of a liability. The lessor can avoid payment of the future property tax if it decides to sell the asset during the lease term (ie the lessor does not have an unconditional obligation to pay the tax).

35. Some are concerned that unless the lessor continues to pay the tax, it may not be able to provide the right to use the asset for the whole term of the lease (ie the tax authority would repossess the asset). The staff think that this would be very unlikely because the tax authority would look to recover cash from the lessor rather than the leased asset. Even if the tax authority seeks to take possession of the asset, it is unlikely that they would be able to remove the right-of-use from the lessee.