Project **Leases**

Topic **Lessor Accounting—Lessor Performance Obligation**

Purpose

1. At the April 2010 joint Board meeting, the Boards discussed whether, under the performance obligation approach to lessor accounting, a lessor should ever be permitted to recognize revenue at lease commencement. This is a significant issue for manufacturer/dealers who use leasing as an alternative means of marketing their products.

2. At that joint Board meeting the Boards also instructed the staff to identify the performance obligation(s) that arise in a lease contract and when they are satisfied under the performance obligation approach (revenue recognition). This paper provides that additional analysis.

3. Based upon the analysis in this paper, the staff thinks that the lessor has one performance obligation—to allow the lessee to use the leased asset over the term of the lease. The staff also thinks that the performance obligation is satisfied and, therefore, revenue is recognized, over the lease term under the performance obligation approach.

4. The structure of this paper is as follows:

    (a) Background

    (b) Staff Analysis and Recommendation

    (c) Other Revenue Recognition Considerations.

5. The appendix to this paper describes the activities approach to revenue recognition that was considered at one point in the revenue recognition project.

Background

6. At the joint Board meeting in April 2010, the staff presented Agenda Paper 2F/FASB Memo 87, which discusses lessor accounting for performance obligations. At that meeting, the Boards tentatively decided that the performance obligation should be satisfied and that revenue should be recognized, in a systematic and rational manner based on the pattern of use of the underlying asset by the lessee (for example, over time, based on hours of use, etc.).

7. In addition, the Boards instructed the staff to provide additional analysis on whether (and if so, how) revenue should ever be recognized upon lease commencement. To provide that analysis, the staff has considered the identification of a lessor's performance obligation(s) under a lease. Some Board members questioned whether a performance obligation is satisfied when the leased asset is made available for use (delivery) and, if so, whether the entire performance obligation, or only some of the performance obligation, is satisfied at that time. In addition, some Board members noted the potential difficulties of measuring the satisfaction of a portion of the performance obligation upon delivery.

Staff Analysis

Identification of Performance Obligation(s)

8. Under the performance obligation approach to lessor accounting, the lessor has promised to permit the lessee to use its economic resource (the leased asset) over the lease term in exchange for a right to receive rentals from the lessee.

9. The current draft of the proposed Exposure Draft on revenue recognition states the following:

> When an entity transfers promised goods or services to a customer at the same time, it need not account for each performance obligation separately. The entity has, in effect, a single performance obligation for those goods and services.
>
> If an entity transfers the promised goods or services at different times the 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. Otherwise, an entity shall combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct.

10. The proposed Exposure Draft also states that a good or service (or bundle of goods or services) is distinct if either:

> (a) The entity, or another entity, sells an identical or similar good or service separately in the market in which the entity typically sells its goods or services; or
>
> (b) The entity could sell the good or service separately in that market because the good or service meets both of the following conditions:
>
>> (i) It has a distinct function—that is, the good or service provides utility either on its own or together with other goods or services available in the marketplace; and
>>
>> (ii) It has a distinct profit margin—that is, the entity can separately identify the costs of providing the good or service.

11. Based on the Board's approach to lease accounting and revenue recognition, the promised good or service (the promised asset) under a performance obligation approach to lessor accounting is the lessor permitting the lessee to use the leased asset over the lease term. Consequently, the lessor transfers the promised asset at different times (the lessor does not provide the asset at one point in time but provides the asset continuously over the lease term). This transfer begins with the delivery of the leased asset and continues over the lease term as the lessor continues to allow the lessee to use the leased asset.

12. Because the lessor allows the lessee to use the leased asset continuously over the lease term, under the proposed revenue recognition requirements, the lessee receives (in concept) a series of incremental rights over the lease term. In other words, each day of the lease term represents a transfer of an asset (that is, an

incremental use of the leased asset) to the lessee. The lessor must consider whether each increment of the continuous transfer of the promised asset should be accounted for as a separate performance obligation. That would be the case only if each increment of the promised asset is distinct from each other as discussed in paragraph 10.

13. As noted in paragraph 9, an entity would account for each promised asset as a separate performance obligation only if the promised asset is distinct from other goods or services promised in the contract (that is, each increment of the promised asset would need to be distinct to be accounted for as separate performance obligations). Otherwise, an entity would combine that good or service with other promised assets as a single performance obligation.

14. Delivery of the leased asset is the first activity in a lease arrangement that begins the period of time over which the promised asset is transferred Each period of time that the lessor permits the lessee to use the leased asset is an additional increment of the promised asset.

15. To conclude that delivery of the leased asset should be accounted for as a separate performance obligation, the delivery of the leased asset must represent a transfer of the promised asset.

16. Because the definition of the promised asset under the performance obligation approach is a continuous transfer over time, delivery of the leased asset without permitting the lessee to use the leased asset over time is not a separate performance obligation.

17. Based on the Boards' tentative decisions under the performance obligation approach to lessor accounting analyzed under the proposed revenue recognition guidance, the staff thinks that each increment of the promised asset is not distinct because it does not have a distinct function or margin. That is, each incremental period of time that the lessor permits the lessee to use the leased asset is not distinct from each other. Therefore, the lessor should combine each increment of the promised asset and account for the continuous transfer of the promise to permit the lessee to use the leased asset as a single performance obligation.

Satisfaction of the Performance Obligation

18. Under the proposed revenue recognition requirements, for continuous transfer of goods or services when the promised goods or services underlying a separate performance obligation are transferred to a customer continuously, an entity should apply a single revenue recognition method that depicts the transfer of goods or services to the customer.

19. Under the proposed revenue recognition guidance, acceptable methods of recognizing revenue to depict the continuous transfer of goods or services to the customer include:

    (a) Output methods that recognize revenue on the basis of units produces, units delivered, contract milestones, or surveys of goods or services transferred to date relative to the total goods or services to be transferred

    (b) Input methods that recognize revenue on the basis of efforts expended (for example, costs incurred, labor hours expended, and machine hours used) to date relative to total efforts expected to be expended

    (c) Methods based on the passage of time.

20. In other words, once the promised asset has been identified (permitting the lessee to use the leased asset continuously over the lease term), it is necessary to pick a single method to recognize revenue (from the methods described in paragraph 19) that best depicts the transfer of the promised asset over time. It is important to maintain consistency with the identification and satisfaction of the performance obligation. That is, because the identification of the performance obligation is *over time*, the satisfaction of the performance obligation should also be *over time*.

21. As such, the staff notes that the Boards' tentative conclusion at the April 2010 joint meeting that the satisfaction of the performance obligation should be performed in a systematic and rational manner based on the pattern of use of the underlying asset by the lessee (for example, over time, based on hours of use, etc.) is consistent with the proposed revenue recognition guidance in paragraph 19.

22. Under the performance obligation approach to lessor accounting, the staff also notes that the lessor has not transferred control of the underlying asset. Since the underlying asset has not been sold, it seems appropriate and consistent with the performance obligation model that no profit or loss would be recognized at lease commencement

23. The final section of this paper discusses other alternatives for revenue recognition.

Arrangements with service components

24. The Boards have also tentatively decided that for arrangements containing both service components and lease components, lessors 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.

25. 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 part of the 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.

26. If the service component is distinct but the lessor is unable to allocate the total payments among the service and lease components of an arrangement, the entire arrangement should be considered and accounted for as a lease.

27. The performance obligation approach to recognizing revenue over the lease term would ensure that revenue is not being recognized immediately for services yet to be provided to the lessee.

Staff Recommendation

28. Under the performance obligation approach the promised asset in a lease contract is a promise to permit the lessee to use the leased asset over the lease

term (a continuous transfer). Each increment of the promised asset is not distinct and therefore there would be one performance obligation that is satisfied over the lease term.

Question 1
Under a performance obligation approach the lessor has a single performance obligation to continue to permit the lessee to use the leased asset over the lease term. That performance obligation would be satisfied, and revenue recognized, continuously over the lease term. Do the Boards agree?

Other Revenue Recognition Considerations

29. If the Boards are uncomfortable with no profit/loss recognition upon lease commencement (specifically for manufacturer/dealers), the staff has considered alternative approaches.

30. At the April 2010 joint meeting, the staff recommended that there should be no profit/loss recognition at lease commencement under a performance obligation model for lessors (consistent with the staff recommendation in Question 1). However, also at the meeting, the Boards were split on whether there should be profit/loss recognition at lease commencement.

31. Some argue that some lessors have leases with the same economics as sales of the underlying asset and that therefore profit should be recognized to reflect those same economics. For example, some may think it is appropriate for a manufacturer or dealer that uses leasing as a means of marketing their products to recognize profit upon delivery of the leased asset.

32. In addition, some members are uncomfortable with no profit/loss recognition for self-constructed assets. For example, if a car manufacturer/lessor builds a car for a cost of $35,000 with a $50,000 selling price, the lease payments will be based on a $50,000 car. However, under the staff recommendation in this memo, that manufacturer/lessor would not recognize any profit at lease commencement.

33. Because the Boards were split on whether there should be any profit recognition at lease commencement under a performance obligation approach to lessor accounting at the joint meeting, the staff considered the following approaches:

    (a) Change the promised asset in a lease arrangement and, consequently, recognize profit/loss at lease commencement, under the proposed revenue recognition guidance

    (b) Apply a different revenue recognition model rather than the proposed revenue recognition model.

Approach A: Change the Promised Asset

34. The staff notes that the promised asset under a performance obligation approach to lessor accounting is a promise to permit the lessee to use the leased asset over the lease term (a continuous transfer).

35. Approach A would change the promised asset in a lease arrangement from a promise over the lease term to a promise to give the lessee a right-of-use asset at lease commencement (delivery).

36. Because the lessor transfers the promised asset (the right-of-use asset) at one time (the delivery date), the lessor has a single performance obligation.

37. In accordance with the proposed revenue recognition guidance, the lessor should recognize revenue when it satisfies its performance obligation by transferring the promised asset to the customer.

38. Under Approach A, the performance obligation would be satisfied completely upon delivery of the leased asset. The delivery date would represent the date in which the transfer of the promised asset occurred. The entire promised asset transferred on that delivery date, rather than being transferred continuously over the lease term.

39. Consequently, that would result in all revenue that is not attributable to the financing component of the lease arrangement to be recognized upon delivery. This approach infers that there is no continuing obligation for the lessor to perform over the lease term.

40. Additionally, because of the tentative decisions made on service components discussed in paragraph 24-26, if the lessor were unable to allocate the total payments among the service and lease components of an arrangement, the entire arrangement would be considered and accounted for as a lease. As such, under Approach A, profit/loss for service components would be *recognized* upon lease commencement.

41. The staff notes that satisfaction of the performance obligation at lease commencement would be more in line with the derecognition approach to lessor accounting, which will be discussed in another memo. Satisfaction of the performance obligation at lease commencement would not be consistent with the performance obligation approach.

42. If the Boards support Approach A, the Boards would have to determine if they want to change the promised asset for all lessors, or just for manufacturer/dealer lessors.

43. Under current lease guidance, only manufacturers and dealers are permitted to recognize profit/loss in a lease contract under both U.S. generally accepted accounting principles and International Financial Reporting Standards. In addition, the lease must transfer substantially all of the risks and rewards of the underlying from the lessor to the lessee. The amount to be recognized as profit is based on the difference between the carrying amount of the underlying asset and the fair value of the underlying asset. As the Boards discussed in April 2010, under a right-of-use model, the cost and fair value of the underlying asset is not as significant in a lease contract. Therefore, it is not ideal to consider the underlying asset when determining whether some of the consideration should be allocated to profit at lease commencement. The Boards asked the staff to consider other methods to recognize profit.

44. If the Boards decide to change the promised asset for manufacturer/dealer lessors only, Approach A would be similar to the dual model approach to lessor accounting discussed in October 2009 (Agenda Paper 10C/FASB Memo 43). That approach recommended a derecognition approach for manufacturer/dealer lessors and a performance obligation approach for all other lessors.

45. However, if a dual-model approach were adopted, criteria would need to be developed to define manufacturer/dealers, which is one of the criticisms of existing lease guidance.

Approach B: Apply a Different Revenue Recognition Model

46. Approach B would apply a different revenue recognition model than the current proposed revenue recognition model.

47. For example, Approach B could use an activity-based revenue recognition model to allocate consideration in a lease arrangement to profit/loss.

48. Under an activity-based revenue recognition model, as discussed in Agenda Paper 14B/FASB Memo 119B in July 2009 for the revenue recognition project (see Appendix A to this memo), an entity recognizes revenue on the basis of an entity's activities, regardless of whether those activities transfer goods and services to a customer when performed. The asset giving rise to revenue in an activities model is inventory. As an entity's activities enhance the value of its inventory, it recognizes revenue.

49. However, the activity-based revenue recognition model was rejected in the proposed revenue recognition guidance. Appendix A of this memo, which was originally distributed to the Boards in July 2009, is the revenue recognition project's description of consequences of an activity-based revenue recognition model.

50. The staff notes that creating a new method of recognizing revenue for lessors would create complexity and decrease comparability between lessors and other entities.

Staff Recommendation

51. Although the staff has recommended that, under the performance obligation model for lessor accounting, the promised asset in a lease contract is a promise to permit the lessee to use the leased asset over the lease term (continuous transfer), if the Boards were uncomfortable with no profit/loss recognition upon lease commencement for manufacturers/dealers, then the staff would

recommend Approach A; that is, provide a derecognition approach for manufacturer/dealer lessors and a performance obligation approach for all other lessors.

Question 2
Question 2 – The staff recommends Approach A; that is, provide a derecognition approach for manufacturer/dealer lessors and a performance obligation approach for all other lessors. Do the Boards agree?

Appendix A: Consequences of an activities model

Note: This appendix is a replica of the appendix in Agenda Paper 14B/FASB Memo 119B provided to the Boards in July 2009 for the revenue recognition project. All references within reference the revenue recognition project.

A1. The purpose of this appendix is (a) to illustrate how the activities model differs conceptually from the transfer model proposed in the Discussion Paper and (b) to highlight some revenue consequences of an activities model.

A2. Consider the following example.

> On 1 January Homebuilder enters into a contract with a customer for the sale of House 1 on a new development for CU1m. At that time, Homebuilder has not started building the house. Under the terms of the contract, the customer is required to pay a 10 per cent deposit with the balance due when it obtains ownership of the house (and related land), expected to be 30 June. The customer is able to select some of the fixtures and fittings in the property from a limited range of options, but cannot specify any major structural changes. In this particular jurisdiction, the customer obtains no rights to the underlying real estate until it obtains ownership of the house.
>
> Assume that the cost of the land is CU175,000 and the costs of labour and materials, incurred evenly over the construction period, are CU450,000. The customer obtains ownership of the house on 30 June.

A3. The accounting would be as follows:

	Activities model		*Transfer model*	
	31 Mar	30 Jun	31 Mar	30 Jun
WIP	640 [(a)]	-	400	-
Cash	(300)	375	(300)	375
Contract liability	(100) [(b)]	-	(100)	
Revenue	640	360	-	1,000
Expenses	(400)	(225)	-	(625)
Margin	240	135	-	375

(a) the CU400,000 costs incurred to 31 March (land of CU175,000 and labour and materials of CU225,000) plus a margin of CU240,000. For simplicity, the margin is assumed to accrue in

proportion to costs, so the CU240,000 margin in the period to 31 March is CU375,000 expected total margin × (CU400,000 actual costs ÷ CU625,000 expected total costs)
(b) remaining rights of CU900,000 less performance obligations of CU1,000,000

A4. The obvious difference between the two models is that revenue is recognised throughout the contract in the activities model but only on 30 June in the transfer model. Revenue in the activities model arises from the increase in the WIP asset throughout the contract, i.e. as Homebuilder creates value. In the transfer model revenue is recognised when the performance obligation is satisfied on 30 June. Note that there is no difference in the accounting for the *contract* in both models: the performance obligation is satisfied in both cases on 30 June. In particular, the performance obligation in the activities model is *not* satisfied as the house is constructed because there is no transfer of assets to the customer. The different pattern of revenue recognition arises because the activities model accounts for a broader set of assets and liabilities.

A5. In the staff's view, conceptually there is no reason why a contract is required for revenue recognition in the activities model. The revenue arises from the activities (or value creation) of the entity which are independent of a contract with a customer. However, other than perhaps for biological assets and readily marketable commodities, most would not recognise revenue in the absence of a contract, because of uncertainties about whether an increase in an asset has in fact occurred and the amount of that increase. In other words, in an activities model, the contract typically is a recognition criterion.

A6. But if activities have been undertaken before the entity obtains a contract, then revenue would arise at contract inception in an activities model for those activities. Consider again the example above.

> Suppose that Homebuilder starts building another similar house, House 2, on 1 January without a contract and construction of House 2 progresses in parallel with House 1 so that at 31 March the two houses are at the same stage of completion. Further suppose Homebuilder enters into a contract with a customer on 31 March for the sale of House 2 with exactly the same terms as for the sale of House 1.

A7. In that case, Homebuilder would recognise revenue and margin of CU640,000 and CU240,000 respectively on 31 March with respect to House 2—for the activities undertaken between 1 January and 31 March. That is, Homebuilder would recognize revenue at contract inception on a cumulative catch-up basis. Its WIP and contract liabilities with respect to the two contracts are then measured at the same amounts. Homebuilder then recognises revenue continuously over the remainder of the contracts.

A8. Conceptually that means that the activities model results in a very different pattern of revenue recognition for the sale of goods compared with existing standards. Consider the following example:

> WidgetCo manufactures widgets for inventory. On 1 January it enters into a contract for the sale of a widget for CU9,500, for delivery on 31 January. The cost of manufacturing each widget is CU5,000. Customer also purchases optional delivery services for CU500 and prepays in full on 1 January.

A9. In the activities model, WidgetCo would recognise revenue of CU9,500 and margin of CU4,500 on 1 January on obtaining the contract. That revenue conceptually arises from manufacturing the widget but it is not recognised until a contract is obtained. The widget would continue to be recognised on WidgetCo's statement of financial position at CU9,500 until the performance obligation is satisfied on 31 January. (Although on 1 January customer has a right to receive a widget on 31 January, it has no present rights to a widget itself.) The remaining revenue of CU500 would be recognised on 31 January when the delivery services are provided.

A10. Of course, an activities model could be supported by additional recognition criteria to deal with contracts such as the above in which the benefits to users of recognising revenues as they arise would probably not justify the costs.