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Project **Leases**

Topic **Derecognition model - Accounting for arrangements with service and lease components**

Purpose

1. The purpose of this paper is to address issues in the accounting for arrangements that contain both service components and lease components under a derecognition approach to lessor accounting.

2. The Appendix to this paper includes an example of a lease with a service component under a derecognition approach to lessor accounting.

3. The staff recommend that if there are situations in which the lessor could not determine specific costs attributable to services provided to a specific lessee for the purpose of allocating the lease payments, the lessor should be required to estimate the costs attributable to the services.

Background

4. At the March 2010 joint meeting, the boards discussed how to account for arrangements that contain both service components and lease components. 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 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.

(c) If the lessor or lessee 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. The boards noted that this situation should be rare for the lessor because they are able to estimate and allocate in most situations. In contrast, the lessee may have difficulty in very rare circumstances.

5. 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 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.

Staff analysis and recommendation

6. The staff think that situations in which the lease and service element would not be distinct would be rare for lessors. This view is supported by comments received from constituents:

> 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].

7. Although it would be very rare that the lessor could not bifurcate, there may be some situations where it might be difficult to separate the lease element of the contract from the service element. For example, property leases where security or maintenance services are shared among tenants.

8. Therefore, the staff have considered three possible approaches that the boards could adopt if the lessor is unable to separate payments between lease and service components:

   (a) treating all payments as lease payments;

   (b) treating all payments as payments for services; and

   (c) requiring allocation on a reasonable basis.

9. Treating the entire arrangement as a lease is consistent with the boards' tentative decision in April 2010. However, under a derecognition approach, this approach would result in recognition of revenue for all service components at lease commencement.

10. Treating the entire arrangement as a service would avoid the recognition of the up front revenue, resulting in revenue recognised over the lease term. This approach may also encourage the lessors to bifurcate.

11. Based on discussions with constituents, the staff think that even in very rare situations where the lessor could not bifurcate, it would be possible for the lessor to estimate the split between the leases and services by allocating the cost of

providing the services on a reasonable basis (for example, by allocating based upon square footage occupied or some other reasonable basis in property leases shared among lessees).

12. Therefore, the staff recommend that if there are situations in which the lessor could not determine specific costs attributable to services provided to a specific lessee for the purpose of allocating the lease payments, the lessor should be required to estimate the costs attributable to the services. This could be done by comparing the lease to a lease with no services or to a standalone service contract.

Question 1
The staff recommend that if there are situations in which the lessor could not determine specific costs attributable to services provided to a specific lessee for the purpose of allocating the lease payments, the lessor should be required to estimate the costs attributable to the services. Do the boards agree?

Appendix – Lease example with service component under a derecognition model

Operating lease with maintenance services example

A1. In the example below, the lessor provides maintenance services on the leased car.

A car's original cost is CU21,776
Estimated value at the end of lease is CU15,000
Estimated useful life is 10 years
A car is leased for a fixed term of 2 years
Annual payments due in arrears in total is CU6,000
The lessor promises that it will provide the lessee with maintenance service during the lease term. Maintenance services are provided evenly over the lease term
The lessor estimates that the total annual payment of CU6,000 is made up of CU5,000 related to lease element and CU1,000 related to maintenance services
The lessor estimates that annual maintenance service costs would be CU800. Assume that the estimate equals the actual expenses incurred for purpose of this example.
Interest rate the lessor is charging the lessee is 8%
The present value of the lease payments is CU8,916
Interest component of the lease payments is CU1,084
Present value of estimated value at the end of lease is CU 12,860

Full derecognition approach

Year	Statement of financial position			Statement of comprehensive income			
	Receivable at the end of the year	Annual payment	Carrying amount of car	Revenue	Interest revenue	Service income	Maintenance expense
Before leasing	-	-	21,776				
0	8,916	-	12,860	-			
1	4,630	5,000			714	1,000	800
2	0	5,000			370	1,000	800
Total	-	10,000		21,776	1,014	2,000	1,600

A2. The journal effects are as follows:

<u>Year 0</u>

DR	Receivable	8,916	
DR	Residual Value Asset	12,860	
DR	Cost of sales	21,776	
CR	Underlying asset		21,776
CR	Revenue		21,776

No day 1 profit

To derecognize the car and recognize a receivable and a residual value asset, and to recognize cost of sales and sales revenue

A3. Journals from <u>Year 1 to Year 2</u> are below:

	Year 1	Year 2
DR Cash CR Receivable *To recognise receipt of rental payment*	5,000 5,000	5,000 5,000
DR Receivable CR Interest revenue *To recognise interest on receivable*	714 714	370 370
DR Cash CR Service revenue *To recognise service revenue*	1,000 1,000	1,000 1,000
Dr Maintenance expense CR Cash *To recognise service cost*	800 800	800 800

Partial derecognition approach

Year	Statement of financial position			Statement of comprehensive income			
	Receivable at the end of the year	Annual payment	Carrying amount of car	Sales revenue Day 1	Interest revenue	Service income	Maintenance expense
Before leasing	-	-	21,776				
0	8,916	-	12,860	-			
1	4,630	5,000			714	1,000	800
2	0	5,000			370	1,000	800
Total	-	10,000		8,916	1,014	2,000	1,600

A4. The journal effects are as follows:

Year 0

DR	Receivable	8,916	
DR	Cost of sales	8,916	
CR	Underlying asset		8,916
CR	Revenue		8,916

No day 1 profit

To remeasure the leased asset as a result of the transfer of a right of use to the lessee and to recognise a receivable, sales revenue and cost of sales

A5. Journals from Year 1 to Year 2 are below:

	Year 1	Year 2
DR Cash	5,000	5,000
CR Receivable	5,000	5,000
To recognise receipt of rental payment		
DR Receivable	714	370
CR Interest revenue	714	370
To recognise interest on receivable		
DR Cash	1,000	1,000
CR Service revenue	1,000	1,000
To recognise service revenue		
Dr Maintenance expense	800	800
CR Cash	800	800
To recognise service cost		