Staff Paper

Project: **Leases**

Topic: **Contracts that contain a lease - which components to separate**

Purpose

1. The purpose of this paper is to discuss how to separate a lease, service, and other components within contracts that contain a lease.
2. This paper does not discuss how to allocate consideration in the contract between the lease, service, and other components within contracts that contain a lease. This is discussed in IASB Agenda Paper 11J/FASB Memo 154.
3. This paper does not discuss the definition of a lease. This was discussed in IASB Agenda Papers 5C, 5D and 5E/FASB Memos 131,132 and 133, and the staff are currently conducting targeted outreach on this topic. Instead, this paper deals with contracts once they have met the definition of a lease (see Appendix A).

Structure of this paper

4. This paper is organised into the following sections:
   (a) Summary of staff recommendation
   (b) Background
   (c) Summary of proposals in the leases exposure draft
   (d) Feedback received (from outreach and comment letter respondents)
   (e) Staff analysis

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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(f) Appendix A— chart showing assessment of a multiple element contract.

Summary of Staff recommendation

5. The staff recommend that, in contracts that contain a lease but also include non-lease components, entities should be required to account separately for the non-lease components, including services and executory costs.

Background

6. Multiple element contracts are common. They can combine sales of goods with the provision of services, for example, a car can be sold with a number of years of maintenance. Or, they can combine a lease with the provision of services, for example a car can be leased with maintenance included for the duration of the lease term.

7. Current guidance for the accounting for multiple element lease contracts is included in IFRIC 4 *Determining Whether an Arrangement Contains a Lease* and EITF 01-8 *Determining Whether an Contract Contains a Lease* (now Topic 840 *Leases* in the *FASB Accounting Standards Codification*®). This guidance helps identify whether an arrangement is or contains a lease and, if it does, it requires lease components and non-lease components to be accounted for separately.

8. IFRIC 4 says the following:

> 12 If an arrangement contains a lease, the parties to the arrangement shall **apply the requirements of IAS 17 to the lease element** of the arrangement, unless exempted from those requirements in accordance with paragraph 2 of IAS 17. Accordingly, if an arrangement contains a lease, that lease shall be classified as a finance lease or an operating lease in accordance with paragraphs 7–19 of IAS 17. **Other elements of the arrangement** not within the scope of IAS 17 shall be **accounted for in accordance with other Standards**. (emphasis added)

9. Topic 840 says the following:

> If an arrangement contains a lease and related executory costs, as well as other nonlease elements, the classification, recognition, measurement and disclosure requirements of this Topic shall be **applied by both the purchaser and the supplier to the lease element of the arrangement**.
>
> Other elements of the contract not within the scope of this Topic shall be accounted for in accordance with other generally accepted accounting principles (GAAP). (emphasis added) [paragraphs 17 and 18 of ASC 840-10-15, formerly EITF 01-8]

10. The staff understands that there have not been many problems reported in applying this guidance in current practice. Sometimes operating lease payments are reported in disclosures with non-lease elements included (eg services associated with a property lease). This is consistent with current guidance which says the non-service component does not have to be separated if impracticable. As present accounting for operating leases and services is similar - any inconsistency of the split of lease components and non-lease components is currently only a presentation, and not a recognition, issue. However, the proposal in the leases Exposure Draft (ED) that requires most lease contracts to be capitalised makes the separation of non-lease components more significant.

Executory costs

11. Both IFRS and US GAAP exclude executory costs from measurement of lease assets and liabilities.

    (a) US GAAP treats them as a lease payment but specifies that these costs are excluded from the measurement of a capital lease asset and a capital lease obligation:

    > The lessee shall measure a capital lease asset and capital lease obligation initially at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term **excluding that portion of the payments representing executory costs** (such as insurance,

maintenance, and taxes to be paid by the lessor) including any profit thereon. [emphasis added] [ASC 840-30-30-1]

(b) IFRS excludes these costs from the definition of minimum lease payments:

> Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, **costs for services and taxes to be paid by and reimbursed to the lessor**…[emphasis added] [IAS 17, *Leases*]

Summary of the proposals in the ED

12. The ED proposes that, once an entity has identified a lease in a multiple element contract, the lessee and lessor should apply revenue recognition guidance to a distinct service component of a contract that contains both service components and lease components. If the service component in a contract that contains service components and lease components is not distinct:

    (a) The FASB proposed the lessee and lessor should apply the lease accounting requirements to the combined contract.

    (b) The IASB proposed that:

        (i) A lessee should apply the lease accounting requirements to the combined contract.

        (ii) A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

        (iii) A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service components in accordance with revenue recognition guidance.

13. The ED specifies that a service is distinct if:

    > (a) the entity, or another entity, sells an identical or similar service separately; or

> (b) the entity could sell the service separately because the service meets both of the following conditions:
>
> > (i) It has a distinct function—a service has a distinct function if it has a utility either (1) on its own or (2) together with other non-leasing goods and services that the lessee has acquired from the lessor or is provided separately by the lessor or by another entity; and
> >
> > (ii) it has a distinct profit margin—a 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 service.

14. The ED further specifies that an entity shall determine whether a service component is distinct at the date of inception of the lease, considering all concurrently negotiated contracts with another party.

Feedback Received

Comment letter feedback received

15. Many respondents commented on the importance of the FASB and the IASB reaching the same conclusions for the final standard because, in the ED, the boards had different proposals on the accounting for non-distinct service components of a lease contract for lessors that apply the derecognition approach.

Lessees

16. Almost all respondents agreed that lessees should separate distinct service components from the lease components of a contract. However, more than half of the respondents disagreed with the proposals for lessees to account for non-distinct service components together with the lease.

17. Most of the respondents who disagreed with the ED proposals suggested that entities should always separate between lease components and non-lease components, regardless of whether non-lease components are distinct services or non-distinct services, for the following reasons:

(a) There should be no liability or expense recognised in relation to services that are yet to be provided.

(b) The accounting for services should be the same, regardless of whether an entity purchases, or leases, an asset in a contract which includes services.

(c) Lessees should not be penalised (by having to recognise a higher right-of-use asset and liability, and thus higher interest expense or amortisation expense) for lessors not having provided information to enable the lessee to identify the distinct non-lease components of a contract.

18. Many respondents were concerned about the treatment of property-related executory costs, such as maintenance, insurance, property tax, landscaping and utilities. In particular, they were concerned that these executory costs would not be considered distinct and would therefore be capitalised as part of a right-of-use asset for the lessee. Almost all respondents who mentioned property-related costs in their responses asked the boards to exclude those costs from the measurement of the right-of-use asset and of the liability to make lease payments. For example:

> 'Executory costs' in today's lease accounting guidance includes insurance, maintenance and taxes. In practice, this term is often extended also to apply to other common cost allocations including common area maintenance, utilities, snow ploughing, security, landscaping and other similar shared operating costs…It is unclear if these common real estate service/executory costs would meet the distinct service definition. For example, **it would be difficult to say that real estate tax reimbursement meets the definition** or that a tenant in multi-tenant building paying a pro rata portion of landscaping or snow removal meets the definition…. We believe the boards should clarify explicitly that executory/common operating costs are also considered distinct for purposes of applying the proposed standard. We believe this is consistent with the boards view that leasing is a form of financing and that the outcome of owning and leasing should be similar.' [emphasis added] (Comment letter 63)

19. Some of the respondents who disagree with the ED proposal suggest that the accounting should be determined based on which component of the contract was predominant or incidental. The contract would then be treated in its entirety as either a service, or a lease, based on the predominant portion of the contract. These respondents were concerned that contracts in which the underlying asset is incidental to the entire contract would be accounted for as leases. For example:

> '….retailers may enter into service agreements as part of their business (i.e., alarm systems, logistics providers, delivery trucks, and landscaping). A strict reading of the Exposure Draft might suggest the equipment component of this type of service agreement be treated as an operating lease. We do not agree. We believe the leased equipment is incidental to the service and therefore recommend the costs associated with these types of agreements should be treated as period costs, outside the scope of the Exposure Draft.' (Comment letter 269)

20. Some respondents agreed with the proposals for lessees because:

    (a) It is perceived to be consistent with proposals in the revenue recognition project.

    (b) The cost of separating lease and non-distinct service components may exceed the benefits.

    (c) It may not be possible to reliably bifurcate the contract if the service is not distinct.

    (d) It is relatively simple to apply in practice.

    (e) There is no need to add additional complexity for something that rarely occurs in practice (ie there will rarely be non-distinct service component in a lease).

    (f) Non-distinct services are generally integral to the contract and should be accounted for as one unit of account, together with the lease components. This provides users with better information on committed future cash flows.

21. Overall, many respondents did not think it was clear what 'distinct' meant and suggested that further guidance should be provided. In addition to the treatment of property-related costs mentioned above, there were issues relating to the criterion of distinct profit margin, eg why would distinct profit margin matter, especially when it is not applicable in some cases (eg not for profit entities).

22. Some also questioned the applicability of the 'distinct' notion to the lessees, for example:

> '.. we question whether the notion of distinct services can be applied to lessees. Indeed, **this concept has been developed in the context of the revenue recognition guidance for entities entering into contracts to provide goods or services, not for entities acquiring such contracts**. Therefore, we consider that the Boards should define specific guidance for lessees. We suggest that lessees should estimate service components. This could be done for instance by comparing the lease to a lease with no services or to a stand-alone service contract. [emphasis added] (CL 449)

Lessors

23. Almost all respondents agreed that lessors should separate distinct service components from the lease components of a contract. Respondents were mostly in favour of separating non-distinct components in all situations (albeit it was a small majority).

24. However, respondents were less concerned with the separation of non-distinct services for lessors applying the performance obligation approach than for those applying the derecognition approach, because accounting under the performance obligation approach is more similar to accounting for services from a profit and loss recognition perspective.

25. Many respondents thought that lessors would always have information to separate non-lease components from lease components of a contract because this information is used in pricing of the contracts.

26. Other reasons given for supporting the separation of both distinct and non-distinct services from lease contracts in all cases were similar to those provided for lessees, with additional emphasis on two points:

    (a) The appropriate pattern of profit or loss recognition is important; ie recognising revenue from services when those services are rendered and not in advance.

    (b) Separation eliminates structuring opportunities.

27. Respondents who supported the proposal for lessors to not separate non-distinct services, but instead to account for them as a part of the lease, gave reasons similar to those for lessees. In particular, some respondents thought that it would in any case be very rare for a lessor to be unable to separate the non-lease and lease components of a contract. Consequently, the disadvantage of recognising revenue before services are rendered would not be very significant.

28. A few respondents commented that it is not logical to apply the derecognition approach to lessor accounting if there are non-distinct service elements in the contract.

    > 'As other correspondents have pointed out, this position is illogical - if there are no distinct lease and service components then this approach (*derecognition*) cannot possibly be followed'. (CL 199)

User feedback received

29. The users gave similar feedback, calling for a consistent approach to be agreed upon by the boards. They asked for specific disclosures if the ED proposals were to become the standard. They also expressed support for requiring contracts with inseparable components to be recognised as a lease in their entirety, noting that the proposals in the ED would provide them with more useful information on the future committed cash flows relating to the contract.

Private company feedback received

30. Similar feedback to what is summarised in paragraphs 17 – 28 was given with respect to private companies, with additional emphasis on cost benefit, such as in this comment letter:

> …the PCFRC recommends that for leases that include minor service components, such service components should be bundled with the lease for accounting and financial reporting purposes and not be separately identified and accounted for. Identifying and separating minor service components will add cost and complexity to financial statement preparers without providing benefit to the users of those financial statements. This is especially true in situations where the service component is an obligatory, non-optional part of the lease, such as cleaning/maintenance service included with the lease of office space, or oil changes included with the lease of an automobile. Bundling the service component with the lease will not only serve as a practical expediency in reducing the burden on financial statement preparers and practitioners, it will also serve to further the goal of presenting the complete lease liability in the financial statements. Since many of these service components are not optional, the lessee is obligated to pay for them. By bundling the service component with the lease, financial statement users would benefit from knowing the total amount a company is committed to pay on the lease in the future. [CL#686]

Staff analysis

31. Based on the feedback received, the staff has considered the following approaches on when to separate the non-lease components within a contract that contains a lease:

    (a) Separate non-lease components consistent with the proposals in the ED, ie assess if non-lease components are distinct and separate if they are distinct.

    (b) Separate the non-lease components of a contract containing a lease if the lease component is distinct; otherwise treat the entire contract as a service.

(c) Do not separate lease components from non-lease components, but instead account for the entire contract using a predominant component approach.

(d) Separate the lease component from all non lease components.

Approach A: Retain proposals in the ED

32. Revenue recognition is a key issue in lessor accounting. It therefore seems logical to refer to Revenue recognition in the leases standard, in particular when there are multiple element contracts, which, if not within the scope of leases standard, would be within the scope of Revenue recognition. Consistency with Revenue recognition and providing a simple approach to separation were some of the main reasons for the proposal to use the distinct notion when separating non-lease components from the lease components of a contract.

33. However, the way the approach is applied in the ED is not consistent with Revenue recognition nor does it always simplify the accounting.

34. There is a key inconsistency with Revenue recognition: namely, Revenue recognition would assess whether the component delivered first under the contract is distinct, and, if not, related income would not be recognised until the other components are delivered. In the lease contracts, it is usually the right of use asset that is delivered first and as such should be assessed (control of the right of use is delivered to the lessee on inception whilst services are usually provided over time). Instead, the proposal in the leases ED was to assess if the service is distinct, and, if not, to recognise related assets and liabilities before the service is provided. Whilst the revenue proposal serves to faithfully depict the transfer of economic benefits, the leases ED application of distinct seems to show an accelerated transfer of economic benefits, thus providing misleading information.

35. Once the notion of distinct is correctly interpreted, it seems clear that it does not always provide the simplest answer:

(a) some think anything that is separable is distinct. However, as many respondents observed, separable components, such as maintenance separately charged in a real estate lease contract, might be non-distinct. Capitalising maintenance costs for a leased asset even though they are priced separately might seem counter-intuitive for some. However, separate pricing does not mean there is a separate obligation, and single price does not mean there is only one obligation.

(b) some think any services that a lessee <u>must</u> purchase as a part of the lease contract are not distinct. Again, this is not relevant to the determination of whether something is distinct or not in accordance with the Revenue recognition project. Instead, the assessment would be based on whether the leased asset has a function without those services.

36. There are also two key issues related specifically to lessee accounting:

(a) this approach would result in inconsistency between accounting for services contracted as a part of a lease of the underlying asset and those contracted as a part of the purchase of the underlying asset. If future services contracted with a purchase of asset do not meet definition of an asset it is unclear why they would be assets when contracted with a lease.

(b) capitalising services as a part of an asset called a right of use that is presented together with property, plant and equipment seems counterintuitive. In an extreme case, a lessee who enters in a long-term lease of a property where common area maintenance is provided by a lessor might end up recognising a right of use which would be higher than if the lessee purchased the same property. However, for some this is not an issue as they view these services as a part of the specification of the right of use.

37. Finally, the interpretation of the right of use model might have consequences on how this approach would be applied, which is discussed in the following paragraphs.

38. In the redeliberations on the Revenue recognition project, the boards have tentatively decided:

    An entity should account for a promised good or service as a separate performance obligation if:

    - the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and

    - the good or service has a distinct function.

39. According to the right of use model, the right of use is delivered on inception and services are usually provided over the lease term. Therefore, some think this is consistent with the view that the first criterion would be met.

40. Whilst there is a general agreement on this conclusion for leases that would fall under the derecognition approach by lessors, some view that a lessor under the performance obligation approach is satisfying its performance obligation for the lease continuously, which may result in the conclusion that the pattern of transfer for the lease is same as for the service component, thus resulting in lease and services under the performance obligation approach being a single performance obligation, regardless of whether the distinct function criterion is met.

41. Finally, treatment of other executory costs (eg property tax and insurance) would have to be clarified. These costs are merely reimbursement for lessor's costs, and not something which provides a benefit to a lessee and are not a good or a service. As the distinct notion only applies to goods and services these executory costs would have to be addressed separately.

42. If the boards decide in favour of this approach, the staff would recommend to include in the final standard application guidance an example of how it would be applied to a lease under performance obligation approach, eg a property lease with services included.

Approach B: Distinct lease component

43. Some have suggested that, as this project is concerned with leases, not services, the focus should be on considering whether the lease component of the contract is distinct and not whether services are distinct.

44. This approach would be consistent with Revenue recognition as analysed in paragraph 34 above.

45. Similar to approach A, the decision on pattern of transfer of benefits might be different depending on whether a lessor applies a derecognition approach or a performance obligation approach. Therefore, the staff think that interpretation guidance would be needed.

46. Under this approach, if the lease component is not considered distinct, the lease would not be recognised until services are provided, ie the accounting would be the same as today's operating lease accounting.

47. Whilst some may not have problems with this result for lessors, it seems counter-intuitive for lessees, who would not be recognising assets and liabilities relating to a right of use which meets the definition of a lease (see paragraph 3).

48. Instead of using this approach, the staff have worked to address this issue in the definition of a lease by specifying that rights of use that are incidental to the provision of a service are not leases.

49. In some staff's view, exclusion of incidental leases from the definition of a lease in effect applies the notions of separate performance obligation and distinct to leases. The staff are continuing to work on improvements to the definition of a lease.

Approach C: Predominant component approach

50. Some have suggested that lease and non-lease components should not be separated but instead should be accounted for either entirely as a lease or entirely as a service based on the predominant component.

51. For example, if total consideration in the contract was CU100, and of this CU95 relates to the non-lease components of the contract and CU5 to the lease component of the contract, the entire contract would be accounted for as a non-lease.

52. However, this allocation approach is less intuitive in other situations. For example, if total consideration in the contract was CU100, and of this CU55 relates to the non-lease components of the contract and CU45 to the lease component of the contract, the entire contract would be accounted for as a non-lease, despite a significant amount of value being assigned to the lease component.

53. Whilst this would simplify accounting, it would be inconsistent with the objective of faithful presentation of the transfer of benefits.

54. In addition, this approach could create structuring opportunities. For example, additional services could be artificially added to the lease contract so the service element becomes predominant, thus achieving off-balance sheet accounting for the lease.

Approach D: Always separate lease components from all non-lease components

55. Under this approach, only the right of use of the underlying asset would be accounted for as a lease. All other non-lease components, including services and other executory costs, would be separated and accounted for in accordance with applicable guidance.

56. This approach is arguably most consistent with the right of use model in which the lessee obtains control of the right-of-use of the underlying asset and recognises it as an asset at contract inception. Whilst the lessee's contract may also give the lessee the right to receive services from lessor, that right does not meet the definition of an asset at contract inception. Those rights to services are therefore not a part of the right of use asset.

57. Similarly, the lessor recognises a receivable at contract inception for that right-of-use delivered to the lessee. The lessor does not have a receivable for any

services to be provided under the contract until those services are delivered to the lessee.

58. In addition, by separating non-lease components the boards would not have to deal with questions about which discount rate to use in accounting for a lease including a service and how to test the right of use (that includes services) for impairment.

59. The opponents of this approach cite three arguments against it:

  (a) Feasibility. Sometimes it is difficult to separate, especially for lessees. Instead of not requiring separation in principle, the issue can also be dealt with by considering cost-benefit implications in the guidance on how to separate. So, for example, when lessees have no reliable information about the price of components they would be permitted not to separate. (Note the guidance on how to separate is included in a follow on paper).

  (b) Consistency with two types of leases for both lessees and lessors. The boards have tentatively decided to introduce another type of lease for lessees, called other than financing, with straight-lined pattern of expense recognition. One indicator that a lease would fall into this category is the existence of a significant service element in a contract. Some view this as an indication that there are bundled leases which should not be separately accounted for. In their view, any lease with significant service would fall into this category of ‘performance obligation accounting’ where the lessor has not performed on day one because there are significant integral services to be provided in relation to the lease.

  However, even though the profit or loss profile would be the same if these services are accounted for as a lease or separately, the statement of financial position would not. Treating them as a lease would capitalise the service element under the right of use presented with

tangible assets and recognise an obligation which on its own would need meet the definition of a liability

(c) Information about committed cash flows. Some users want to see capitalizing of all committed cash flows as liabilities, regardless of whether they are payments for a right of use of the underlying asset or for services. Not capitalising services committed to as a part of the lease would be against that objective. However, no other committed cash flows in relation to services are recognized as liabilities on contract inception, so capitalising only some might just create comparability concerns with the accounting for other executory costs.

60. In addition, some argue that when a lessee only makes one payment for both service and lease components, they become liable for the entire amount so the whole payment should be included in measurement of the lease liability. However, if the lessor does not perform under its obligation for service for a period of time, the lessee would normally be entitled to reduction for estimated service portion from payments required.

Staff recommendation

61. The right-of-use model and related accounting was developed to account for the rights to use the underlying assets, which are different from purchases and sales of goods or services. This is why the boards have decided to have separate accounting guidance for lease transactions, for both lessees and lessors.

62. The boards' main objective of splitting lease components from service components is proper identification and accounting for the leased asset. In addition, the proposals in the ED were considered to be a simplification of the current leases requirements and consistent with Revenue recognition project. But the analysis above shows these objectives are not met.

63. The staff recommends Approach D for both lessors and lessees . The staff think that, where a multiple element contract contains a lease, all non-lease elements should be separated from the lease, without further consideration as to whether

any of the components are distinct or not. The staff thinks that this approach results in the most appropriate accounting for both the service components and the lease components. This process is illustrated in the diagram in Appendix A.

64. In addition, there are practical considerations on how to separate the price between lease and non-lease elements, which are discussed in IASB Agenda Paper 11J/FASB Memo 154.

Question 1: Which components to separate
The staff recommend that, in multiple element contracts that include both lease components as well as non-lease components, entities should be required to identify and separately account for the non-lease components of the contract. Do the boards agree with the staff recommendation? Why or why not?

Appendix A – Separation of multi-element contracts