Staff Paper

Project: **Leases**

Topic: **Contracts that contain a lease – how to allocate between components**

Purpose

1. IASB Agenda Reference 11I/FASB Agenda Reference 153 discusses the separation of non-lease components within contracts that meet the definition of a lease. In that paper, the staff recommends that entities should be required to separately account for the non-lease components in contracts that contain a lease.
2. The purpose of this paper is to discuss how to allocate payments between the lease components and non-lease components of a contract that contains a lease.
3. The boards will not need to consider this paper if they tentatively decide not to separate lease and non-lease components, but instead decide to account for the contract based on the predominant component (Approach C in IASB Agenda Reference 11I/FASB Agenda Reference 153).

Structure of this paper

4. This paper is organised into the following sections:
   (a) Summary of staff recommendations
   (b) Background
   (c) Summary of proposals in the leases Exposure Draft
   (d) Feedback received (from outreach and comment letter respondents)

(e) Staff analysis

   (i) Lessors

   (ii) Lessees

(f) Appendix with proposed draft wording.

Summary of staff recommendations

5. In this paper, the staff recommends that when allocating payments between the separate components of a contract that contain a lease:

   (a) lessors should allocate payments required by the contract between lease components and non-lease components in accordance with revenue recognition guidance; and

   (b) lessees should allocate payments required by the contract between lease components and non-lease components as follows:

      (i) if the purchase price of each component is observable, based on relative purchase prices of individual components;

      (ii) if the purchase price of one or more, but not all, of the components is observable, based on a residual method; or

      (iii) if there are no observable purchase prices, all payments required by the contract would be accounted for as a lease.

Summary of proposals in the *Leases* exposure draft

6. The *Leases* exposure draft (ED) refers to the allocation of 'payments under the contract' to separate lease components and service components in an contract that meets the definition of a lease:

> If the service component is distinct (see paragraphs B6 and B7), the entity allocates the **payments required by the contract** between the service components and lease components using the principles proposed in paragraphs 50–52 of *Revenue from Contracts with Customers*. (para B5 a))

7. The ED referred to the guidance in the revenue recognition ED, which states the following:

> 50 An entity shall allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception (ie on a relative stand-alone selling price basis).
>
> 51 The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately. A contractually stated price or a list price for a good or service shall not be presumed to represent the stand-alone selling price of that good or service. If a stand-alone selling price is not directly observable, an entity shall estimate it.
>
> 52 When estimating stand-alone selling prices, an entity shall maximise the use of observable inputs and shall apply estimation methods consistently for goods or services and customers with similar characteristics. Suitable estimation methods include the following:
>
> (a) expected cost plus a margin approach—an entity could forecast its expected costs of satisfying a performance obligation and then add the margin that the entity would require for that good or service; and
>
> (b) adjusted market assessment approach—an entity could evaluate the market in which it sells goods or services and estimate the price that customers in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

Feedback received

8. The ED did not ask a specific question on this issue and only a handful of respondents discussed the subject. The respondents who commented mainly said that the relative fair values or selling price approaches should be used to allocate payments required by the contract between lease and non-lease components. For example:

> As lessees and lessors should have the information and are capable of distinguishing between the lease and service components of their own contracts, we believe the guidance regarding separating service and leases components should focus on allocating the total arrangement consideration to each component (e.g. on a relative fair value/selling price basis as is currently required by IFRIC 4, ASC paragraph 840-10-15-19 and ASC Subtopic 605-25 Revenue Recognition Multiple-Element Arrangements and IFRIC 12 Service Concession Arrangements. We also suggest that the standard require separation of executory costs (taxes, maintenance and insurance) and other non-lease goods and services in all cases on the basis of relative fair values or, if relative fair values are not readily determinable, using a reasonable allocation methodology for the particular circumstances. (CL 367)

9. Some respondents also requested more guidance for lessees that may not have the same information available as lessors and consequently may, in some circumstances, find it difficult to allocate payments required by the contract.

10. A few respondents also requested clarification on whether the term ‘payments required by the contract’ is the same, or different, to the term ‘transaction price’ that is used in the Revenue recognition ED guidance on allocation. The term transaction price in the Revenue ED is described as:

> The probability-weighted amount of consideration that an entity expects to receive from a customer in exchange for transferring of goods or services (para 35 of the Revenue ED).

Workshop feedback received

11. Workshop participants observed that it would be difficult to allocate payments between the non-lease components and lease components in a contract for which there were no observable prices for individual components.

12. In particular, lessees reported issues in relation to contracts such as time-charter contracts for vessels (vessel charters where lessor provides vessel, crew and maintenance services) that may be determined to contain a lease. The rates for those charters are market-driven and not split between lease components and non-lease components. There are no market rates for these separate components (workshop participants said the same vessels were not available for hire without the services and that the services were not separately available). In the examples prepared for the workshops, participants prepared scenarios to illustrate significantly different results achieved arising out of small differences in allocation assumptions chosen. These differences arise because of the size of the payments required by the contract and the significant effect that market volatility has on the rates charged. This example is discussed further in paragraphs 40 –42 below.

13. Other examples of contracts presented at the workshops that may contain a lease and were used to illustrate difficulty in splitting lease components and non-lease components for lessees included:

    (a) aircraft wet leases in which the contract provided the aircraft as well as the crew and maintenance;

    (b) triple net leases (property leases common in the U.S. which include maintenance, insurance and property tax but, in contrast to gross property leases, do not separately specify how payments are allocated between components of the contract);

    (c) drilling rig contracts; particularly when lessors assist with maintenance and drilling as well as contracts in which the lessors provide the drilling crew;

    (d) photocopiers provided with maintenance services; and

    (e) leases of advertising billboards when lessors are responsible for maintenance.

14. Most lessors participating in the workshops did not think it would be difficult for them to separate service components from lease components of a contract.

User feedback

15. Users supported the proposals in the ED that, if a lessee is unable to allocate the payments required by the contract between leases and non-lease components, the payments would all be accounted for as a lease. This is because they thought that recognition of a liability to make lease payments for these amounts, even though the liability would include payments relating to non-lease components, would provide them with more useful information on the future committee cash flows of the lessee. Users all supported requiring disclosures relating to contracts that contain lease and non-lease components.

Private Company Feedback

16. Feedback from private companies was consistent with the feedback from other parties. This included support for allocating payments required by the contract between lease and non-lease components in a rational manner, but concerns with complexities relating to an approach that would always require an allocation. Instead, feedback from some private companies indicated that sometimes the cost of allocating payments between lease and non-lease components may exceed the benefits, even if this lead to all payments being allocated to the lease component of the contract.

Staff analysis

17. Contracts including lease and non-lease components often explicitly state separate pricing for the different components, which would be the same or similar to when components are purchased/sold independently. In those cases, allocating payments required by the contract between lease components and non-lease components would be relatively straightforward.

18. There are also contracts with a single price for all components. Or, the lease and non-lease components can be priced separately, but at different amounts from the amounts if the components of the contract were purchased separately in an arms-length transaction. In these instances, there has to be a reasonable allocation between the lease and non-lease components of the contract.

19. Until ASU 2009-13 amended US GAAP guidance, both IFRIC 4 *Determining whether an Arrangement contains a Lease* and EITF 01-8 *Determining Whether an Arrangement Contains a Lease* (required an entity to allocate payments between the lease and non-lease components on a 'relative fair value basis'. IFRIC 4 says the following:

> 13 For the purpose of applying the requirements of IAS 17, payments and other consideration required by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into those for the lease and those for other elements **on the basis of their relative fair values**. The minimum lease payments as defined in paragraph 4 of IAS 17 include only payments for the lease (ie the right to use the asset) and exclude payments for other elements in the arrangement (eg for services and the cost of inputs).
>
> 14 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. (emphasis added)

20. EITF 01-8 refers to revenue guidance for allocation, and ASU 2009-13 amended revenue guidance in the U.S. GAAP to:

> 'replace the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant'

21. The staff have decided to analyse the accounting for lessees and lessors separately, noting that information available to the two parties will be different.

22. For the purpose of this paper, the staff have not analysed:

    (a) whether the term transaction price, as used in the revenue recognition project and the term payments required by the contract, as used in the ED are the same or different. The staff will provide an analysis of this issue in a future meeting once the boards have completed further redeliberations on these terms in the separate projects.

(b) how changes in payments required by the contract should be allocated between the lease and non-lease components of a contract. The staff will provide an analysis of this issue in a future meeting once the boards have determined the approach to the initial allocation of these payments.

Lessors

23. Lessors have indicated they would be able to allocate the payments between different components of a lease contract based on relative selling prices.

24. However, lessors noted the following issues with the guidance in ED on allocating payments between the lease components and non-lease components:

    (a) Should discount given for a multi-element contract always be allocated proportionally between the lease components and non-lease components?

    (b) When would a residual method be acceptable?

    (c) Is proportionate allocation appropriate for variable element included in the payments?

25. The staff thinks that these issues are not unique to lessors but also common to vendors and providers of services that account for transactions in accordance with the revenue recognition project. The staff notes that many of these issues are being addressed in redeliberations on the revenue recognition project.

26. Therefore, the staff does not think the guidance for lessors on the allocation of payments required by the contract between lease components and non-lease components should be different from the revenue recognition guidance.

Staff recommendation

27. The staff recommends that the boards do not develop separate guidance for the allocation of payments required by a contract that contains a lease between the lease components and the non-lease components for lessors. Instead, the staff recommends that, consistently with the ED, the leases standard should refer to the guidance on allocation between separate performance obligations being developed in the revenue recognition project.

Question 1: Lessors
The staff recommends that, in contracts that contain lease components and non-lease components, lessors should be required to allocate payments required by a contract between lease components and non-lease components consistent with the allocation method in the revenue recognition project. Do the boards agree with the staff recommendation? Why or why not?

Lessees

28. The staff think that there are three issues for the boards to discuss with respect to allocation of the payments between the lease and non-lease components by a lessee:

    (a) Most relevant value to use as a basis for allocation.

    (b) Allocation when there are observable prices for some but not all the components.

    (c) Allocation when there are no observable prices for any of the components.

Most relevant basis for allocation

29. In allocating the payments required by a contract between the lease and non-lease components, it seems more appropriate for a lessee to refer to individual transaction prices rather than fair values. This is reflected in the proposed guidance in the ED which refers to relative selling prices and not fair values.

30. As lessees are buyers in lease transactions, it may seem inappropriate to refer them to lessor's selling price when allocating payments. A transaction or

purchase price might be more relevant. In a lease transaction, lessor's selling price is the lessee's purchase price so, if prices are observable, the terminology used does not matter.

31. However, if the prices the lessor is charging the lessee or other market participants for the separate components of a contract are not observable, it would be very difficult for the lessee to estimate the lessor's selling price. The feedback received on the ED was that the estimation methods in the Revenue recognition ED do not work very well for lessees. Those estimation techniques involve taking market assumptions and adjusting them for lessor's business model, which is something lessees would not know. For example, they would not have the information about lessor's costs or the margins the lessors would charge them. Or, the lessees would not know what adjustments to make to prices of similar components in the market in order to arrive at what the lessor would charge the lessee for that component.

32. However, observable prices that other marketplace participants would charge the lessee for the individual components of the contract may be available to the lessee. This would reflect an estimated purchase price. For example, a lessee might enter in a lease of a vehicle with maintenance included. The lessor only specifies a combined total monthly payment for the contract, without splitting the payments into the vehicle and maintenance components. The lessee obtains separate quotes from other marketplace participants for a lease of the car without maintenance and for the maintenance; both for the same duration as the lease term, and may be able to use theses prices in allocating the price of the contract between the vehicle and maintenance components.

Staff recommendation

33. The staff thinks purchase price is the most relevant basis for the allocation by lessees of payments required by the contract between the lease and non-lease components. The staff thinks that observable lessor-specific standalone purchase price provide the best basis for determining lessee's purchase price, followed by observable purchase prices that other marketplace participants would charge for similar components.

Question 2: Lessees: general approach
The staff recommends that, in contracts that contain lease components and non-lease components, lessees should be required to allocate between lease components and non-lease components based on their relative standalone purchase prices. Do the boards agree with the staff recommendation? Why or why not?

Allocation when not all prices are observable

34. Although the staff thinks that relative purchase prices provide the best basis for allocation, for some contracts observable inputs, either directly from the contract or by reference to other marketplace transactions, may be unavailable for some components of the contract. For example, in a lease of an aircraft which includes maintenance and crew, it may not be possible to buy services of the crew provided by the lessor separately from the lease of the aircraft. However, a customer may be able to lease a similar type of aircraft for a similar term without the maintenance and crew. In this situation, using the price for leasing an aircraft without crew and maintenance may be a good proxy for the price of the lease component of the contract, with any remaining payments in the contract being allocated to the maintenance and crew components.

35. This approach is referred to as residual method (or more precisely reverse residual method because the residual (crew and services in this example) is the component that is not yet delivered), and is included as one of the methods of allocation between lease and non-lease components in IFRIC 4. It has however been removed from the guidance in US GAAP for the following reason:

> …eliminating the residual method of allocation will improve financial reporting because the relative selling price method spreads any discount in an arrangement across all of the deliverables in that arrangement rather than allocating the entire discount to the delivered items (ASU 2009 – 13, not codified)

36. Discounts are often granted in multiple element contracts, including leases, so this reason for eliminating the residual method is relevant. If the residual method was prohibited for lessees for this reason, the staff have identified three other ways of allocating the contract price between the lease and non-lease components:

(a) Require lessees to estimate the price of the component for which there are no observable prices;

(b) Allocate all of the payments required by the contract to the lease components; or

(c) Allocate all of the payments required by the contract to the non-lease components.

37. The staff are concerned that the costs for a lessee of estimating the price of a component for which there is no observable price in order to proportionately allocate a discount between lease and non-lease components may exceed the benefits of doing so. In addition, the proportionate allocation of a discount achieved by using relative standalone prices for each of the components prices may not necessarily reflect the economic substance of transaction when the discount relates to one specific component of a arrangement as if often the case.

38. The staff are also concerned that allocating all of the payments required by the contract to either the lease, or the non-lease components even though there is observable price for one component, is counter-intuitive. The existence of an observable price for either the lease or the non-lease component suggests entities can enter into a contract for that component only which would either be a lease or a service. Treating the entire contract as a lease or a service would impair comparability between those transactions and not result in faithful presentation.

39. It would therefore seem appropriate, for cost benefit reasons, to allow lessees to use the residual method when prices for some, but not all components of a contract are observable. The staff note this is currently permitted in IFRSs.

Question 3: Lessees: some observable prices

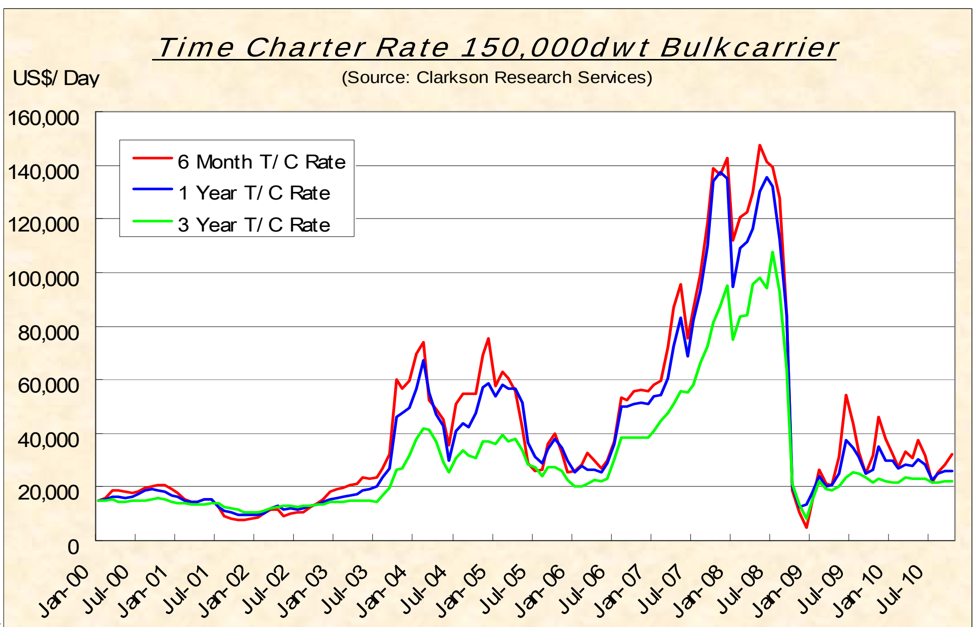
The staff recommends that if the purchase price of one component in a contract that contains a lease is observable, a lessee can use the residual method to allocate the price to the component for which there are no observable purchase prices.

Do the boards agree with the staff recommendation? Why or why not?

Allocation when there are no observable prices

40. In some lease contracts there will be no observable purchase prices for any of the components. This can be the case in some 'full service' leases where the lessor provides and operates the asset. In these situations, the staff thinks that the allocation by lessees of payments required by these contracts to lease and non-lease components for such contracts can be quite difficult.

41. This can be further complicated by very volatile pricing of some of these contracts (for example for vessel time charters which are determined to contain a lease – contracts which include provision of a vessel and captain and the crew as well as maintenance). Pricing volatility for such contract is illustrated in the below diagram (adapted from a presentation from a preparer workshop participant):



42. In one of the time charter examples discussed during preparer workshops, an estimate of the lease component was made using the fair value of the underlying asset (based on observable market prices), in proportion to the lease term,

discounted using the lessee's incremental borrowing rate. An estimate of the service component was made by breaking it down into relevant parts, such as manning, repair, lubricant oils, and other and estimating standalone prices. The workshop preparer was an expert in the field with a good idea of individual prices but still came up with relative proportions of lease and non-lease components which varied from 40:60 to 60:40. The variation in this example was material when taking into account the annual total cost of the contract was USD 8 million.

43. In another preparer workshop, a participant who had a similar time charter example commented they would not need to estimate prices as they were already separately identified in invoices from lessors because the lease components and non-lease components of the time charter contract had different tax rates.

44. This example suggests that once something is required, a practice will develop for lessors to disclose standalone prices for lease and non-lease components, ie make them observable.

45. In the meantime, three approaches are considered:

    (a) Require lessees to estimate the standalone prices for each of the components;

    (b) Estimate the predominant component and allocate accordingly; or

    (c) Allocate all of the payments required by the contract to the lease components.

46. The staff think that requiring lessees to use complicated estimation techniques when observable prices of the lease and non-lease components are unavailable may lead to allocations that are neither comparable nor reliable and consequently would not provide useful information to users. By allocating prices to individual components, users will be led to think that these are reliable estimates when in effect they may not be.

47. The second approach would be to treat the contract according to the predominant component, as suggested in some comment letters:

> In addition to this, T. does not support the proposal that if the contract includes both lease and non-distinct service components, lease accounting should be applied to the whole contract. We

> believe that when a contract includes both, lease and non-distinct services, entities should rather depict the economic substance of the transaction, assessing what the predominant component is, and then treating the whole contract accordingly. Identifying the predominant component requires a lesser degree of precision than identifying the relative fair values of each component, and lessees should be able to achieve it in most cases. (CL 440)

48. However, the staff think that, once the contract is determined to contain a lease that does not meet the definition of a short-term lease, not recognising assets and liabilities created by the contract would be misleading. In addition, this could create structuring opportunities to achieve off-balance sheet accounting, which is something the boards are working to avoid. The staff also think that concerns raised by respondents, specifically preparers, to the ED that this approach leads to recognition of an excessive lease liability are to an extent offset by:

    (a) other simplifications reflected in recent board redeliberations (eg relating to contingent lease payments and the lease term definition); and

    (b) the staff recommendations to move away from requiring lessees to apply the revenue recognition guidance to separate lease and non-lease components of a contract.

49. Therefore, the staff proposes to treat the entire contract as a lease, with disclosure of details of the contract in the notes to the financial statements (these disclosures would be addressed in a separate paper).

50. The staff did not analyse the option of treating the entire contract as a service as this is the question of lease definition. If a contract contains a lease, that lease should be recognised.

51. As this approach is potentially disadvantageous to lessees, specifically because they would recognise a liability to make lease payments that would include all payments required by the contract, the staff thinks that there will be significant pressure on lessors to disclose prices for the different components of a contract, leading to less services being accounted for as leases.

Staff recommendation

52. If there are no observable standalone purchase price of a lease or non-lease component of a contract, the staff recommend that the lessee accounts for the

whole contract as a lease. The staff think this is the most practical approach as lessees are not likely to have information available to estimate standalone purchase prices of individual components.

Question 4: Lessees: no observable prices
The staff recommend that lessees should treat the entire contract as a lease when there are no observable prices for any of the components. Do the boards agree with the staff recommendation? Why or why not?

APPENDIX A

Proposed Amendments to ED

The preliminary draft wording included in this appendix has been prepared by the staff to help the boards in reaching decisions regarding the accounting for multiple element contracts including a lease.

The preliminary draft wording starts with the wording used in Scope section of the ED and Appendix A and 'marks-up' changes to that wording to reflect the staff recommendations in paragraph xx of AP xx/Memo xx and paragraph xx of AP xx/Memo xx.
The Boards have not yet reached decisions about the views expressed under the staff recommendations, and in this appendix, and therefore the wording is subject to change.

Scope

6 An entity shall apply this [draft] IFRS to a lease component of a contract that contains ~~service components and~~ lease components and non-lease components (see paragraphs B5–B8).~~, except as follows:~~

(a) ~~A lessee shall apply *Revenue from Contracts with Customers* to a service component of a contract that contains service components and lease components if the service component is distinct and the lessee is able to do so.~~

(b) ~~A lessor shall apply *Revenue from Contracts with Customers* to a service component of a contract that contains service components and lease components if the service component is distinct and the lessor is able to do so.~~

(c) ~~When a lessor applies the derecognition approach (see paragraphs 28 and 29), it shall apply *Revenue from Contracts with Customers* to a service component of a contract that contains service components and lease components, even if that service component is not distinct~~.

Appendix A

Contracts that contain both ~~service components and~~ lease components and non-lease components (paragraph 6)

B5 If an entity determines that a contract contains both a lease component (see paragraphs xx) and a non-lease component, the entity shall allocate payments required by the contract between lease and non-lease component as follows:

(a) The lessor shall allocate the payments required by the contract between the lease component and the non-lease components of the contract using the allocation guidance in paragraphs xx–xx of *Revenue from Contracts with Customers.*

(b) The lessee shall allocate the payments required by the contract between the lease component and the non-lease components of the contract:

(b) if there are observable purchase prices for all of the components of the contract, on the basis of the relative standalone purchase price of each component;

(b) if there are observable purchase prices for one or more, but not all, of the components of the contract, the lessee shall deduct those observable standalone prices from the total payments required by the contract to estimate the payments for the component for which there are no observable prices; or

(b) if there are no observable purchase prices for any of the components of the contract, the lessee shall apply this IFRS to the whole contract.

~~B5 An entity shall apply the proposals in the boards' exposure draft *Revenue from Contracts with Customers* to identify separate performance obligations within a contract that contains both service components and lease components. An entity shall account for each component as follows:~~

(a) ~~If the service component is distinct (see paragraphs B6 and B7), the entity allocates the payments required by the contract between the service components and lease components using the principles proposed in paragraphs 50–52 of *Revenue from Contracts with Customers*. However, if a lessee or a lessor that applies the performance obligation approach is unable to allocate the payments, the lessee or lessor applies this [draft] IFRS to the whole contract.~~

(b) ~~If the service component is not distinct, a lessee and a lessor that applies the performance obligation approach shall account for the whole contract as a lease.~~

(c) ~~If a service component is not distinct and a lessor applies the derecognition approach, the lessor shall allocate the payments between service components and lease components on a reasonable basis, eg based on the stand-alone selling price of the service. The lessor recognises a receivable for the lease component only and recognises the service component in accordance with the principles proposed in paragraphs 50–52 of *Revenue from Contracts with Customers*.~~

~~B6 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.~~

~~B7 A service component is distinct if either:~~

(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.~~

(ii) ~~It has a distinct profit margin—a service has a distinct profit margin if it is subject to distinct risks and the lessor can separately identify the resources needed to provide the service.~~

To be addressed in a later paper:

B8 If the payments required by a contract that contains both lease and service components change after the commencement of the lease, an entity shall determine the change attributable to the lease and service components. If the amount of the change attributable to each component cannot be determined, the entity shall allocate the change to the service components and lease components in the same proportion as determined at the date of commencement of the contract.