

STAFF PAPER

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Project	Leases		
Paper topic	Separating Lease and Nonlease Components		
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Introduction

- The purpose of this paper is to provide the Boards with information and analysis related to separating lease and nonlease components and allocating consideration in a contract to those components, each of which arise only after an entity has concluded that a contract contains a lease. The definition of a lease is addressed in Agenda Paper 3A/FASB Memo 282, “Definition of a Lease.”
- This paper discusses the following two topics:
 - Separating lease components* – This discussion asks the Boards to consider the lowest appropriate unit of account for application of the final leases standard (for example, should an entity be permitted in all circumstances to apply the final leases guidance to a single leased asset when it is leased together with other underlying assets?).
 - Separating and allocating consideration to lease and nonlease components* – This discussion asks the Boards to consider when lease components should be separated from nonlease components and how to allocate the consideration in the contract between the separate components.

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3. The discussion of each topic contains the following sections:
 - (a) Background
 - (b) Summary of feedback on the 2013 Exposure Draft, *Leases*
 - (c) Staff analysis
 - (d) Staff recommendation.
4. In addition, Appendix A to this paper includes the proposed changes to the 2013 ED that would result from the staff recommendations in this paper.

Summary of staff recommendations

5. The staff recommend the following:
 - (a) To retain guidance similar to that proposed in the 2013 ED on identifying separate lease components for both lessees and lessors.
 - (b) To retain guidance similar to that proposed in the 2013 ED for lessors with respect to separating lease and nonlease components, and allocating consideration in the contract to those components. That is, a lessor should apply the guidance in the forthcoming revenue recognition standard relating to allocating the transaction price to separate performance obligations. In addition, the staff recommend clarifying that a lessor should reallocate the consideration in a contract when there is a contract modification that is not accounted for as a separate, new contract.
 - (c) To change the proposals in the 2013 ED for lessees with respect to separating lease components from nonlease components and allocating consideration in a contract to those components as follows:
 - (i) A lessee should always separate lease components from nonlease components, unless it applies the practical expedient discussed in (iv) below.
 - (ii) A lessee should allocate the consideration in a contract to the lease and nonlease components on a relative standalone price

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basis. Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. A lessee also should reallocate the consideration in a contract when (1) there is a reassessment of either the lease term or a lessee's purchase option or (2) there is a contract modification that is not accounted for as a separate, new contract.

- (iii) A lessee should use observable standalone prices, if available, and otherwise it would use estimates of the standalone price of lease and nonlease components (maximizing the use of observable information).
- (d) In addition, *some* staff recommend that a lessee be permitted, as an accounting policy election by class of underlying asset, to not separate lease components from nonlease components. Instead, a lessee would account for lease and nonlease components together as a single lease component. Other staff do not recommend including this practical expedient.

Separating lease components

Background

- 6. Some contracts convey the right to use not just a single asset, but a bundle of assets. For example, a lease of a port (incorporating land, warehouses, and equipment), a lease of a farm (incorporating a farmhouse, a farmyard and buildings, farming land, and equipment), and a lease of a manufacturing plant (incorporating the building, the land on which the building is situated, and equipment installed in the plant) all involve bundles of assets.
- 7. The 2009 Discussion Paper (2009 DP) and the 2010 Exposure Draft (2010 ED) did not contain explicit guidance on identifying the unit of account at which to apply the leases proposals. In addition, existing U.S. GAAP and IFRS leases guidance does not contain explicit guidance in this regard, other than on separating land and building elements; both existing U.S. GAAP and IFRS contain guidance on whether and when an entity should separate a land component from other real estate components (for

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example, buildings or, under U.S. GAAP, integral equipment). However, in practice, we understand that U.S. GAAP and IFRS preparers often consider multiple pieces of equipment together for purposes of lease classification when, as a result of their functional interdependence, they are part of an overall process or facility.

8. The 2013 ED proposed that, after determining that a contract contains a lease, an entity should identify each separate lease component within the contract. An entity should consider the right to use an underlying asset to be a separate lease component if both of the following criteria, which were derived from the separation guidance established at that time in the joint revenue recognition project, are met:
 - (a) The lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and
 - (b) The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.
9. In the Basis for Conclusions of the 2013 ED, the Boards explained their view that the identification of separate lease components in a lease contract is similar to the identification of separate performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer or a lessee (in the case of leases) is contracting for a number of separate deliverables or contracting for one deliverable that may incorporate a number of different assets. Accordingly, the Boards decided that providing requirements on the identification of separate lease components, similar to the requirements in the joint revenue recognition proposals for identifying separate performance obligations, would work well in this respect within the leases proposals.
10. Each separate lease component was the unit of account in the 2013 ED. An entity could not disaggregate below that unit of account. For example, if an entity leased a gas turbine plant that includes the turbine, a building, and the land upon which the building was situated, and concluded that the lease of these assets was a single lease

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component, the entity would *not* be permitted to apply the proposals to each individual asset. This guidance was deemed necessary to accurately and consistently apply the other proposals in the 2013 ED, particularly those on lease classification that distinguished between property leases and all other leases.

Effect of recent decisions reached

11. At the March 2014 joint meeting, the Boards decided that the final leases guidance can be applied at a portfolio level such that an entity may account for multiple lease components as a single unit of account if it reasonably expects that the financial statement effects of doing so would not differ materially from applying the final leases guidance to each lease component. Consequently, the discussion in this section is not intended to revisit that previous decision. The staff think that the separate lease components guidance serves only to establish the “floor” below which an entity should not disaggregate when applying the final leases guidance.
12. Also at the March 2014 joint meeting, the Boards decided the following regarding lease classification:
 - (a) Not to retain the distinction between leases of property and all other leases as proposed in the 2013 ED, but, instead, retain lease classification guidance similar to that in IAS 17 for lessors (and, for the FASB, also for lessees).
 - (b) Lessors (and, for the FASB, also lessees) should separately account for the land element in a lease that includes other components whenever necessary to classify and account for the contract, unless clearly immaterial.
13. The staff do not intend to revisit those lease classification decisions as part of this discussion.

Summary of feedback received on the 2013 ED

14. The Boards received limited feedback on the 2013 ED guidance for identifying separate lease components *other than* on separating land and other real estate components. The staff note that most constituents that commented on the 2013 ED on this topic expressed the view that land components in a lease should be accounted for

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separately from the other components in the lease. The staff think that the decisions reached by the Boards in March 2014 substantially address this feedback.

Staff analysis

15. The main reason that the Boards included the guidance on separating lease components in the 2013 ED was to address requests for such guidance in applying the lease classification guidance in the 2013 ED. Because the 2013 ED included different lease classification guidance for property leases than for all other leases (and because a contract could include the right to use property and non-property assets), it was important to identify each lease component and determine the nature of the primary underlying asset in each lease component. Some would suggest that this guidance is no longer needed because of the changes to the lessee and lessor accounting models. Where lease classification is retained (for lessors and, in U.S. GAAP, also for lessees), the Boards have decided to fundamentally retain the existing lease classification requirements in IAS 17 and Topic 840. There is no guidance on separating lease components in existing U.S. GAAP or IFRS and the staff are not aware that any significant issues exist in practice in determining when and how to separate lease components currently. Those supporting this view would suggest that there is no longer a reason to include the guidance on separating lease components, which has the potential to make the separation guidance more complicated than they would view as necessary for lessees.
16. Nonetheless, the staff think that the Boards should retain separate lease components guidance, similar to that in the 2013 ED, in the final leases standard. Despite the changes to the lessee and lessor accounting models adopted by the Boards during the 2014 redeliberations, the staff think that separate lease components guidance would be helpful for the following reasons:
 - (a) Whether applicable to all entities or solely to lessors, the Boards have decided that the final leases standard will include a lease classification test that is similar to existing lease classification requirements under both U.S. GAAP and IFRS. Some staff think that including separate lease components guidance in the final leases standard similar to that proposed in the 2013 ED would represent an improvement compared with existing U.S.

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GAAP and IFRS. Existing U.S. GAAP and IFRS do not contain specific guidance on how to identify the appropriate unit of account for determining lease classification. However, the fact that practice has developed interpretive guidance specifically in this respect demonstrates that guidance would be useful in this area and that different answers *can*, in fact, result from how the unit of account is determined.

- (b) The IASB tentatively decided not to require that lessees apply the recognition and measurement requirements to leases of “small” assets. Guidance on identifying the appropriate unit of account at which to apply the leases requirements may mitigate the risk that some lessees would attempt to inappropriately “componentize” leases (for example, convert a lease of one asset into a lease of the asset’s component parts) to qualify for the “small asset” lease exemption.
 - (c) Identifying the appropriate components would result in a more accurate allocation of contract consideration between lease and nonlease components. This is because the standalone price (observable or otherwise) for a bundled offering (for example, the lease of a data center) may be substantially different from the sum of the standalone prices for the items within a bundled offering (for example, the lease of each asset in the data center). Given the substantially different accounting for lease and nonlease components in the final leases standard, the accuracy of the allocation of contract consideration carries additional importance as compared to existing U.S. GAAP and IFRS.
17. The staff also think that substantially aligning the separate lease components guidance to the separate performance obligations guidance in the forthcoming revenue recognition standard continues to make sense for the same reasons as were summarized in paragraph BC116(b) of the Basis for Conclusions of the 2013 ED (and set out earlier in this paper).

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Staff recommendation

18. The staff recommend that the final leases standard include guidance on identifying separate lease components similar to that included in paragraph 20 (IASB) / paragraph 842-10-15-17 (FASB) of the 2013 ED.

Question 1: Separating lease components

Do the Boards agree with the staff recommendation to retain separate lease components guidance in the final leases standard similar to that included in paragraph 20 (IASB) / paragraph 842-10-15-17 (FASB) of the 2013 ED? If not, what do the Boards prefer?

Separating and allocating consideration to lease and nonlease components

Background

Existing U.S. GAAP and IFRS

19. Existing U.S. GAAP and IFRS are similar with respect to separating lease and nonlease components and allocating consideration in the contract to the separate components.
20. In general, both existing U.S. GAAP and IFRS require that an entity (lessee or lessor):
- (a) Apply the leases guidance (Topic 840, Leases, or IAS 17 *Leases*) to any lease elements in an arrangement.
 - (b) Account for any elements outside the scope of the leases guidance in accordance with other applicable guidance.
 - (c) Separate, on a relative basis, payments and other consideration called for by the arrangement into:
 - (i) Those for the lease element(s), including the related executory costs; and
 - (ii) Those for other services.
21. Both existing U.S. GAAP and IFRS require entities to use an estimation technique in determining the allocation of payments and other consideration between lease and

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nonlease components for some contracts. Topic 840 does not address a scenario for which the lessee (or the lessor) cannot reasonably separate the payments or other consideration in the contract between the lease and nonlease elements. However, IFRIC 4 *Determining whether an Arrangement contains a Lease*, provides guidance to the effect that if it is impracticable for a lessee to separate the payments or other consideration reliably that the lessee should:

- (a) For a finance lease, allocate to the lease element an amount equal to the fair value of the underlying asset (and, therefore, allocate the residual to any nonlease elements).
 - (b) For an operating lease, treat all payments or other consideration as lease payments for purposes of complying with the disclosure requirements in IAS 17.
22. Under existing guidance, for most leases, the separation of lease and nonlease components is not a substantial accounting issue or concern. This is largely because the accounting for operating leases and services is similar. Consequently, any allocation issues typically have little effect on the recognized amounts. However, the proposals in the 2013 ED would require lessees to capitalize most leases and that makes the separation of nonlease components much more consequential to the accounting.

Proposals in the 2013 ED

23. The 2013 ED proposed the following regarding the separation of lease and nonlease components:
- (a) *Lessors* should separate lease components from nonlease components in all cases and allocate the consideration in the contract in accordance with the allocation of the transaction price guidance in the forthcoming revenue recognition standard.
 - (b) *Lessees* should separate lease components from nonlease components only on the basis of observable *standalone prices*, which would mean that:

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- (i) Where there are observable standalone prices for all of the components (lease and nonlease) in the contract, the lessee should separate the components and allocate consideration on a relative standalone price basis.
 - (ii) Where there are observable standalone prices for one or more (but not all) of the components in the contract, the lessee should separately account for those components on the basis of each component's observable standalone price. The residual amount of consideration would be allocated to the remainder of the components as a bundle. If at least one of those remaining components is a lease component, the entire bundle would be accounted for as a single lease component.
 - (iii) Where there are no components with observable standalone prices, the lessee should combine those components into a single lease component for accounting purposes.
24. The 2013 ED proposals required lessors to separate lease components from nonlease components of a contract in all cases. In the Boards' view, a lessor should always be able to separate payments made for lease and nonlease components because it would need to have information about the value of each component, or a reasonable estimate of it, when pricing the contract. The Boards decided to require a lessor to allocate the consideration in a contract to lease and nonlease components in accordance with the revenue recognition proposals to ensure consistency for entities that are both lessors and sellers of goods or services in the same contract. The Boards concluded that the approach applied by a lessor should be no different from how a seller would allocate consideration in a revenue contract with separate performance obligations.
25. The Boards proposed a hierarchy of requirements that a lessee would follow when allocating consideration to different components of a contract. In setting a threshold that must be met to separate lease components from nonlease components (that is, having observable standalone prices to separately account for a component), the Boards did not wish the threshold to be so high that a lessee would find it too difficult, or could choose whether to separate lease and nonlease components. Accordingly,

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observable standalone prices was not limited to being lessor specific, and obtaining the price of *similar* leases, goods, or services would be sufficient (rather than *identical* leases, goods, or services). The Boards concluded that it would not be appropriate to always require a lessee to separate lease components from nonlease components, largely because the cost of obtaining the information required to separate nonlease components that do not have observable prices could outweigh the benefit for the lessee.

Summary of feedback on the 2013 ED

Support

26. The majority of constituents who commented on separating lease and nonlease components said that they agree, in principle, with allocating the contract consideration between those components. These constituents agree that the accounting for the service component of a contract should be the same, regardless of whether the contract is only for services or includes the purchase or lease of an asset as well as services. Additionally, many constituents think that the separation of significant components would provide beneficial information to users.
27. Constituents also support the proposals that a lessor should use the guidance in the forthcoming revenue recognition standard to allocate contract consideration to lease and nonlease components. These constituents think that the proposals in the 2013 ED for separating lease and nonlease components are much improved compared with the proposals in the 2010 ED.

Concerns

Lessees

28. Many constituents disagree with the proposed guidance. The most pervasive concern relates to the requirement for a lessee to combine nonlease components with lease components when the lessee is unable to obtain observable standalone prices for all components of the contract. The majority of constituents said that including nonlease components within a single lease component would not be appropriate.
29. These constituents assert that including services or other nonlease components in the measurement of the ROU asset and the lease liability would overstate a lessee's assets

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and liabilities and inappropriately “gross up” its balance sheet. These constituents think that a service component does not create an asset at lease commencement because it is not a resource controlled by an entity as a result of past events.

Additionally, many constituents think that including nonlease components in a single lease component introduces inconsistency in financial reporting among lessees, solely on the basis of the availability of observable standalone prices.

30. Some constituents assert that the absence of an observable standalone price for a lease component should result in the reassessment of whether that contract includes a lease. These constituents think that it is counterintuitive to account for the entire contract as a lease if the component for which the lessee cannot obtain an observable standalone price is the lease component itself. These constituents also think that the absence of such a price for the lease component indicates that the entire contract is a service contract.

Lessors

31. Many lessors disagreed with the *lessee* requirements proposed in the 2013 ED to separate lease and nonlease components. This is because they think that the proposals would result in them having to communicate proprietary information to customers about how they price contracts.
32. Regarding the lessor proposals, property lessors said that separation of lease and nonlease components would reduce the comparability of their reported rents and tenant reimbursements because the presentation of their rental revenues would be split between lease revenue and tenant reimbursement revenue. These lessors would prefer to account for the entire contract as a lease.
33. Some nonproperty lessors further expressed the view that the separation of lease components from nonlease components would often be operationally difficult, if not impossible, because their contracts almost always include significant service components. These lessors questioned whether they would always be able to determine standalone prices for payments made for lease and nonlease components because their agreements are priced largely on the basis of supply and demand at

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contract inception. Generally, drilling rig and shipping lessors would prefer to account for the entire contract as a service.

We agree that consideration should be allocated to lease and non-lease components, however only when observable, standalone prices can be observed **by both the lessor and lessee**. [*Emphasis added.*]

In the energy industry, arrangements may often involve the use of unique assets with non-standard service elements for which there are no observable, standalone prices. Because each arrangement may involve a unique asset and varying provision of services, there may be no reasonable basis to allocate consideration between the lease and non-lease components. In addition, due to the complexity in allocating consideration in these unique situations, allocation principles may not be applied consistently. (CL #208, *Energy Transportation Company*)

Other Concerns

34. Although it is clear that some costs, such as maintenance, would be classified as nonlease components, some constituents note that it is less clear whether other costs, such as taxes and insurance, would be considered to be nonlease components under the 2013 ED. These constituents note that executory costs are specifically excluded from *minimum lease payments* under existing guidance. However, in allocating contract consideration, the portion of total payments that are attributable to the lease, including related executory costs, must be separated from the payments that are attributable to the nonlease components. These constituents further note that in some leases it is common practice for one party to the contract to pay particular costs directly to a third-party, although the counterparty to the contract is principally liable to make those payments (for example, a lessee may make property tax payments directly to the taxing authority although the lessor is principally liable for those payments).
35. Additionally, some constituents note that the 2013 ED did not address whether, or how, lessees would allocate changes in consideration related to nonlease components

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after lease commencement. It is unclear whether a lessee would allocate subsequent changes on the same basis as they were at contract commencement. These constituents note that the forthcoming revenue recognition standard allows changes in the *transaction price* to be allocated solely to one or some of the performance obligations in the contract under specified circumstances, while the 2013 ED does not. Therefore, these constituents question whether the lease liability would need to be remeasured upon a change in the consideration related to a nonlease component.

Alternative suggestions

36. Most constituents who expressed concern about the recognition of a single lease component in the absence of observable standalone prices suggest that lessees be permitted to use reasonable estimates to separate lease components from nonlease components. Many of these constituents note that lessees and lessors use estimates to separate lease components from nonlease components under existing IFRS and U.S. GAAP. Some constituents added that the forthcoming revenue recognition standard requires entities to estimate the standalone selling price of a good or service if the standalone selling price is not observable. Consequently, such a requirement should not create additional complexity when compared to existing guidance.

When a contract contains both service and lease components and the service component is not distinct, we agree that the service component should be quantified and excluded from the lease based on the observable standalone price for such service. In the absence of an observable, standalone price, companies should be able to allocate the value of the contract between the lease and service components based on information provided by the lessor or management's best estimate, rather than simply combining such components into a single lease component as prescribed in the current exposure draft. Including the service component with the lease component would overstate both assets and liabilities.

(CL #114 – *A Large Preparer*)

37. Other constituents who disagree with the proposed separation of lease components from nonlease components suggest, instead, that lessees be required to determine

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whether the primary component of the contract is a lease component or a service component and to account for the entire contract accordingly. To operationalize this suggestion, some constituents suggested providing a threshold below which the separation of components would not be required.

...we are of the view that, in the cases mentioned in paragraph 23(b)(ii) or 23(c) of the IASB's revised ED, the lessee should account for the components as a single lease component or a single service component based on whether the primary component in the contract is a lease component or a service component, rather than accounting for them as a single lease component in all cases. The primary component would be the component which represents the predominant rights the customer (lessee) obtains from the contract, normally the component which accounts for the majority of the total consideration in the contract. We think that it is practicable to objectively identify the primary component, even if there are no observable stand-alone prices for any component within a contract. (CL #438, *National Accounting Standard Setter*)

38. Some constituents suggest permitting a lessee to elect not to separate lease components from nonlease components for particular classes of underlying assets and instead to account for those contracts entirely as leases. This would allow lessees to separate nonlease components on material classes of underlying assets, but would not require lessees to incur the costs to do so for less material contracts (for example, contracts that contain leases of smaller office equipment).

We agree with the Boards' proposal that entities should separate lease components of a contract from non-lease components and the provisions of the PASU [proposed Accounting Standards Update] should only apply to the lease components. Further, we agree with the Boards' criteria for allocating arrangement consideration on the basis of observable standalone selling prices. As the Boards have noted, it is common in many industries for lease arrangements

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to include some level of non-lease components such as maintenance, taxes or insurance. In many instances these non-lease components represent a significant component of the arrangement as may be the case in servicing of highly specialized equipment. In other instances, the service component is not significant to the overall contract and is included as a matter of convenience. We suggest the Boards include a practical expedient to allow entities to disregard the separation of criteria proposed in 842-10-15-17 and instead account for the entire arrangement as a lease if the non-lease component represents an insignificant portion of the total arrangement fee. We believe that the assessment of insignificance may be qualitative or quantitative based upon the facts and circumstances of the arrangement and should be a matter of a reporting entity's accounting policy, accompanied by appropriate disclosure in the financial statements. – (CL #200, *Large Preparer Industry Group*)

39. Some others suggest that lessees should not separate lease components from nonlease components because it will be costly to do so, with little added benefit to users.

As many of these leases are often accompanied by a service component, we further believe that lessees should not be required to separate the service component of such leases. Instead, such costs should be treated as a lease payment, since, in most cases, it would be impractical for the lessees to separately contract for these services with a party other than the lessors of the assets. The costs to obtain the information required to separate lease and non-lease components based on observable prices and apply a residual allocation method as proposed in the Exposure Draft would outweigh the benefit for the lessee. (CL #271, *Large Preparer*)

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Staff analysis

Separating and allocating consideration to lease and nonlease components—lessor

40. The staff continue to think that lessors should separate lease components from nonlease components and allocate consideration to those components, in accordance with relevant guidance within the forthcoming revenue recognition standard. Leasing transactions are fundamentally a revenue-generating activity for most lessors (even if the principal revenue stream is interest income) in which they transfer the right to use an underlying asset to the lessee. Accordingly, it is appropriate for a lessor to:
 - (a) Separate and allocate consideration to lease and nonlease components as a seller allocates the transaction price to performance obligations in a revenue contract; and
 - (b) Not to allocate consideration to administrative tasks (or cost reimbursements) that do not transfer a good or service to the lessee (that is, these are not *components*).
41. In addition, in any contract that contains both lease and nonlease components, the entity transferring goods and/or services is likely to be both a lessor (relating to the lease components) and a seller (relating to the nonlease components). That is, the contract would both contain a lease and be a revenue contract, subject to the requirements within the forthcoming revenue recognition standard. Retaining the proposals in the 2013 ED to separate and allocate consideration to lease and nonlease components in accordance with the revenue recognition guidance would ensure consistency for such entities that are both a lessor and a seller of goods or services in the same contract. The requirement for a lessor to separate lease components from nonlease components also is consistent with existing guidance.
42. The staff also recommend clarifying in the final leases standard that a lessor should reallocate the consideration in a contract when the contract is modified and the modification is not a separate, new contract.

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Separating lease components from nonlease components—lessee

43. The staff think that lessees also should separate lease components from nonlease components in a contract. This is because leases create assets and liabilities for a lessee by virtue of the lessor's performance at lease commencement—the lessee obtains the right to use the underlying asset at lease commencement and has an obligation to pay for that right—while service components that require continued performance by the lessor throughout the lease term do not. Consequently, requiring lessees in some cases to capitalize service components would result in lessees overstating ROU assets and lease liabilities. It also could result in different accounting for services, solely depending on whether the service is included together with a lease in one contract or is written as a standalone contract.

Practical expedient

44. Nonetheless, as a practical expedient, the staff think that the Boards *could* decide that a lessee should be *permitted*, as an accounting policy election by class of underlying asset, to *not* separate lease components from nonlease components. Instead, a lessee would account for lease and nonlease components together as a single lease component.
45. The staff considered whether this would lead to comparability issues for financial statement users. On the basis of discussions with lessees during outreach on the 2013 ED, the staff think that lessees would typically elect this practical expedient only when the nonlease component is *not* significant. If the nonlease component is significant, the staff think that a lessee would not elect the practical expedient because it would significantly increase its lease liabilities. By way of example, the staff spoke to two airlines in this regard. Both airlines expressed the view that they would be unlikely to apply this expedient to any aircraft leases that have significant service components. However, they would be inclined to potentially use this practical expedient for their high-volume, small-ticket leases of assets such as office equipment. Such leases generally have less significant service components. Thus, the administrative burden of allocating consideration in these contracts to separate components may not outweigh the benefit of more accurately reflecting only the right-

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of-use asset, rather than the right-of-use asset and the service component, in the lease liability.

46. The staff think that this practical expedient has the potential to provide significant cost relief to many lessees without significantly reducing comparability between similar lessees.

Allocating the consideration in a contract—lessee

47. The staff think that a lessee should allocate the consideration in a contract to the lease and nonlease *components* on a relative standalone price basis, consistent with existing guidance.
48. In determining the standalone price of lease and nonlease components in the contract, the staff also think that a lessee should use the best information available to it but, when necessary, should use estimates. This would be a change from the proposals in the 2013 ED, which would have required a lessee to obtain observable standalone prices to separate lease components from nonlease components.
49. Under such an approach, a lessee would use observable standalone prices, if available, before using an estimated standalone price. In estimating the standalone price of lease or nonlease components, a lessee would be required to maximize the use of observable inputs and apply estimation methods consistently in similar circumstances. This would include the ability to use a residual approach to estimate the standalone price, subject to the requirement to maximize the use of observable inputs in estimating the standalone price. This approach would be similar to the guidance in the forthcoming revenue recognition standard regarding the allocation of the transaction price to separate performance obligations.
50. The use of estimated standalone prices by a lessee (if observable prices are not available) in determining the allocation of contract consideration would address the most significant concerns raised in response to the proposals in the 2013 ED from both lessors and lessees. Lessors have indicated concerns about providing proprietary pricing information, which would potentially have been requested frequently by lessees under the proposals in the 2013 ED; the use of estimated standalone prices by a lessee would be likely to largely address this concern. The staff also think that this

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would help address the concerns of lessees that indicated that obtaining observable standalone pricing data (that is not readily available) could be onerous and costly.

51. The staff recommendation that lessees should use estimated standalone prices (if observable prices are not available) and allocate the consideration in the contract between lease and nonlease components on a relative basis would, in effect, retain current practice in both respects. The staff note that existing U.S. GAAP and IFRS both:

- (a) Require lessees to use estimates in determining the selling price of either (or both) the lease and/or nonlease components in the contract for some contracts; and
- (b) Require lessees to allocate the consideration in the contract between lease and nonlease components on a relative selling price basis.

The staff are not aware of any significant issues with applying existing U.S. GAAP and IFRS in these respects.

52. The staff recommendation may differ from existing IFRS in that a lessee would be explicitly required to (a) use observable prices, if available, and (b) maximize the use of observable inputs when estimating standalone prices. IFRIC 4 does not provide such explicit guidance. Existing U.S. GAAP, however, explicitly refers lessees to the multiple-element arrangement revenue guidance in ASC Subtopic 605-25. Because of the significant difference in the accounting for lease and nonlease components that would result from a final leases standard, the staff think it is important for a lessee to use the best information available when allocating the consideration in the contract to separate components and that explicit guidance to that effect is warranted. In saying that, the staff think that a lessee should not be required to search endlessly for observable prices; it should simply use the best information available to it.
53. Consistently with existing guidance, the staff also think that a lessee should reallocate the consideration in the contract, upon either:
- (a) A reassessment of the lease term or whether a lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset; or

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- (b) A contract modification that is not accounted for as a separate, new contract.

Identifying the components in the contract

54. The staff think that the final leases guidance should be clarified with respect to separating lease and nonlease components by stating that administrative activities or other costs of a lessor for which the lessee does not obtain a good or service would not be considered to be a component of the contract and, therefore, should not receive a separate allocation of the consideration in the contract. This is similar to the requirements within the forthcoming revenue recognition standard.
55. The staff think that an activity should be considered a *component* only when that activity transfers a good (including the right to use an underlying asset) or service to the lessee. The staff think the following are examples of activities that would be components in a contract that contains a lease because each activity provides the lessee with a good or a service:
- (a) The right to use an underlying asset that meets the definition of a lease would be a lease component.
 - (b) A promise by the lessor to provide maintenance services (including common area maintenance (CAM) services) with respect to a leased asset would be a nonlease component.
 - (c) A promise by the lessor to provide a service of operating the underlying asset (for example, the service of operating a shipping vessel or an aircraft) would be a nonlease component.
 - (d) Electricity or other utilities consumed by the lessee but paid for by the lessor (for example, where the lessee pays a gross rental amount to the lessor each month that includes its use of electricity) would be a nonlease component. In this case, the lessee obtains utility services that it would otherwise have to contract for separately.
56. Conversely, the staff think that activities or costs of the lessor for which the lessee does not obtain a good or service should not be considered components. For

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example, assume that a lease contract specifies that the consideration in the contract of CU2,000 to be paid by the lessee each month comprises: CU1,400 relating to interest the lessor pays on borrowings to fund the purchase of the underlying asset, CU200 relating to the lessor's administrative costs, and CU400 as the rent payment. In the staff's view, the entire CU2,000 would relate to the right to use the asset because that is the only good transferred to the lessee (that is, the only *component*) under the contract. Accordingly, CU2,000 would be considered to be lease payments. It would not be appropriate to consider CU1,400 relating to the lessor's financing costs or CU200 relating to the lessor's administrative costs to be nonlease components of the contract. Therefore, no consideration would be allocated to those items.

Staff recommendation

57. In summary, the staff recommend the following:

- (a) To retain guidance similar to that proposed in the 2013 ED for lessors with respect to separating lease components from nonlease components and allocating consideration in the contract to those components. Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. In summary, a lessor should apply the guidance in the forthcoming revenue recognition standard relating to allocating the transaction price to separate performance obligations when separating lease and nonlease components. In addition, the staff recommend clarifying that a lessor should reallocate the consideration in a contract when there is a contract modification that is not accounted for as a separate, new contract.
- (b) To change the proposals in the 2013 ED for lessees with respect to separating lease and nonlease components as follows:
 - (i) A lessee should separate lease components from nonlease components in a contract (or in a single transaction that reflects the combining of two or more contracts).
 - (ii) A lessee should allocate the consideration in a contract to the lease and nonlease components on a relative standalone price

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basis. Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract.

- (iii) A lessee should reallocate the consideration in a contract when (1) there is a reassessment of either the lease term or a lessee's purchase option; or (2) there is a contract modification that is not accounted for as a separate, new contract.
- (iv) A lessee should use observable standalone prices if available, and otherwise would use estimates of the standalone price of lease and nonlease components (maximizing the use of observable information).

58. The staff are split as to whether a lessee should be permitted to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components. Instead, the lessee would account for the combined component as a single lease component. Some staff think this would reduce costs and complexity for many lessees, while not creating significant issues of comparability. This is because, in general, the staff think that a lessee would not adopt the practical expedient for leases with significant service components because it would increase the lessee's lease liabilities. The staff who support this practical expedient think that lessees are likely to adopt this principally for high-volume, "small-ticket" leases, which would not be very material with or without a service component.
59. Conversely, other staff disagree with introducing an option in this regard. They think it is inappropriate for a lessee to have an unfettered choice on how it accounts for nonlease components within a contract that contains a lease. Such a choice could reduce comparability between lessees. If the Boards agree with the staff recommendation to require the use of estimates when separating lease components from nonlease components (if observable prices are not available), those staff would recommend not providing any practical relief in this respect. However, if practical relief is considered necessary in this regard, they would recommend carrying forward the guidance within IFRIC 4 that permits a lessee to combine lease and nonlease

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components when it is impracticable to separate the consideration in the contract reliably.

Questions 2-4: Separating and allocating consideration to lease and nonlease components

Question 2 – Do the Boards agree with the separation and allocation proposals for lessors outlined in the staff recommendation above?

Question 3 – Do the Boards agree with the separation and allocation proposals for lessees outlined in the staff recommendation above?

Question 4 – Do the Boards wish to permit lessees to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract (or single transaction if combining two or more contracts) as a single lease component?

Appendix A – Proposed changes to the 2013 ED

- A1. The following table lists the proposed guidance in the 2013 ED that relates to separating lease and nonlease components and demonstrates which proposals would change as a result of the staff recommendations in this paper:

Proposals in the 2013 ED	Proposed Changes
<p>Separating components of a contract</p> <p>20. After determining that a contract contains a lease in accordance with paragraphs 6–19, an entity shall identify each separate lease component within the contract. An entity shall consider the right to use an asset to be a separate lease component if both of the following criteria are met:</p> <p>(a) the lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and</p> <p>(b) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.</p>	<p>No material change anticipated; final wording would take into account the wording in the final revenue recognition guidance.</p>
20A. [NOT USED]	20A. The above paragraph notwithstanding, whenever necessary to classify and account for a lease of land and other assets, an entity shall account for the right to use land as a lease component separate from the other lease components.
20B. [NOT USED]	20B. Lease or nonlease components do not include activities and related costs that do not transfer a good or service to the lessee. For example, a lessor may need to perform various administrative tasks and incur various costs in its role as lessor that do not transfer a good or service to the lessee.
<p>21. An entity shall account for each lease component as a separate lease, separately from nonlease components of a contract, except as described in paragraphs 23(b)(ii) and 23(c). An entity shall allocate the consideration in the contract to each separate lease component that has been identified in accordance with paragraphs 22–24.</p>	<p>No material changes anticipated; some minor changes expected to conform with changes to paragraph 23.</p>

<p>Lessor</p> <p>22 After identifying the lease components in a contract in accordance with paragraph 20, a lessor shall allocate the consideration in the contract using the requirements in paragraphs 70–76 of proposed Accounting Standards Update, <i>Revenue Recognition (Topic 605): Revenue from Contracts with Customers</i> {[draft] IFRS X <i>Revenue from Contracts with Customers</i>}.</p>	<p>No material changes anticipated, except to clarify that a lessor should do both of the following:</p> <ul style="list-style-type: none"> (a) Reallocate the consideration in the contract at the effective date of a contract modification that is not accounted for as a separate, new contract (b) Allocate consideration in the contract only to lease and nonlease components.
<p>Lessee</p> <p>23. After identifying the lease components in a contract in accordance with paragraph 20, a lessee shall allocate the consideration in the contract as follows:</p> <ul style="list-style-type: none"> (a) if there are observable stand-alone prices for each component of the contract, a lessee shall allocate the consideration to each component on the basis of the relative stand-alone price of each component. (b) if there are observable stand-alone prices for one or more, but not all, of the components of the contract, a lessee shall allocate both of the following: <ul style="list-style-type: none"> (i) the stand-alone price of each component to the components of the contract with observable prices; and (ii) the remaining consideration in the contract to the components of the contract without observable prices. If one or more of the components without observable prices is a lease component, the lessee shall combine those components and account for them as a single lease component. (c) if there are no observable stand-alone prices for any components of the contract, a lessee shall combine the components and account for them as a single lease component. 	<p>23. A lessee shall allocate the consideration in the contract to the lease and nonlease components as follows:</p> <ul style="list-style-type: none"> (a) The lessee shall determine the standalone price of lease and nonlease components on the basis of their observable standalone prices. The lessee shall estimate the standalone price of lease and nonlease components (maximizing the use of observable information) if observable standalone prices are not available. (b) The lessee shall allocate the consideration in the contract on a relative standalone price basis to the lease and nonlease components in the contract.
<p>23A. [NOT USED]</p>	<p>23A. As a practical expedient, a lessee may elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract as a single lease component.</p>
<p>23B. [NOT USED]</p>	<p>23B. A lessee shall reallocate the consideration in the contract upon either of the following:</p> <ul style="list-style-type: none"> (a) A reassessment of the lease term or

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	<p>whether a lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset; or</p> <p>(b) A contract modification that is not a separate, new contract.</p>
24. A price is observable if it is the price that either the lessor or similar suppliers charge for similar lease, good or service components on a stand-alone basis.	No material change anticipated.