

Purpose

1. The purpose of this paper is to address the accounting for arrangements that contain both service components and lease components.
2. In this paper, the staff recommend that lessors under the derecognition approach to lessor accounting should be required to bifurcate between service and lease components in a lease arrangement for both distinct and non-distinct service components. Additionally, lessors under the derecognition approach to lessor accounting should be required to bifurcate between service and lease components based on the proposed revenue recognition requirements. That is, allocation should be done relative to the standalone selling prices of the service for both distinct and non-distinct services.
3. In regards to the service component of a lease arrangement, staff members recommend a lessor account for the lease component of the lease arrangement under the proposed lease requirements. However, some staff members recommend that any service component would be accounted for under the proposed revenue recognition requirements for lessors under the derecognition approach to lessor accounting. Other staff members recommend that a lessor under the derecognition approach to lessor accounting would recognize a separate performance obligation for the service component.

4. This paper is structured as follows:
 - (a) Background
 - (b) Staff analysis
 - (c) Staff recommendations.

Background

5. At the March 2010 joint meeting, the Boards held discussions on the accounting for arrangements that contain both service components and lease components for both lessees and lessors under the performance obligation approach to lessor accounting.
6. At that meeting, the Boards tentatively decided that:
 - (a) Lessors under the performance obligation approach to lessor accounting and lessees would be required to evaluate whether the lease payments should be allocated between service and lease components, considering all concurrently negotiated contracts with a third party.
 - (b) A lessor under the performance obligation approach to lessor accounting would be subject to the revenue recognition requirements regarding the identification of separate performance obligations within an arrangement. That is, if the service component is not considered distinct, total payments under the arrangement should be accounted for as a lease. If the service component is considered distinct, total payments under the arrangement should be allocated between the service and lease components using the same principles as those proposed in the revenue recognition project.
 - (c) The lessee's identification of distinct components within an arrangement and measurement of the allocation between service and lease components within an arrangement would be based on the same principles used by the lessor. The Boards noted that if the proposed revenue recognition guidance is incorporated into the proposed new leases guidance, some language changes would be necessary.

- (d) If the lessor under the performance obligation approach to lessor accounting or the lessee is unable to allocate the total payments among the service and lease components of an arrangement, the entire arrangement should be considered and accounted for as a lease.
7. At both the May and June 2010 joint meetings, the Boards held discussions on the accounting for arrangements that contain both service components and lease components for lessors under the derecognition approach to lessor accounting. At these meetings, the Boards noted their concerns with recognizing revenue before services had been completed and how lessors would separate services from leases when the services are not distinct. The Boards asked the staff to provide examples of how to apply two different approaches (discussed below in paragraphs 20-35) to separating the lease components from the service components of a contract for a lessee and for a lessor under both approaches to lessor accounting. However, no decisions were made.

Proposed revenue recognition requirements

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

If an entity promises to transfer more than one good or service, the entity shall account for each promised good or service as a separate performance obligation only if it is distinct. If a good or service is not distinct, an entity shall combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the goods or services promised in the contract as a single performance obligation.

A good or service, or a bundle of goods or services, is distinct if either:

- a. The entity, or another entity, sells an identical or similar good or service separately; or
- b. The entity could sell the good or service separately because the good or service meets both of the following conditions:
 - i. It has a distinct function—a good or service has a distinct function if it has utility either on its own or together with other goods or services that the

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customer has acquired from the entity or are sold separately by the entity or by another entity; and

- ii. It has a distinct profit margin—a good or service has a distinct profit market if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service.

When an entity transfers promised goods or services to a customer at the same time, it is not necessary to apply the proposed recognition and measurement requirements to each performance obligation separately if accounting for those performance obligations together would result in the same amount and timing of revenue recognition as if they were accounted for separately. For example, if an entity transfers two distinct services to a customer over the same time period, it could account for the promises to transfer those services as a single performance obligation if applying the same revenue recognition method to both services would faithfully depict the transfer of services to the customer.

9. As such, an entity would account for each promised asset as a separate performance obligation only if the promised asset is distinct from other goods or services promised in the contract (that is, each increment of the promised asset would need to be distinct to be accounted for as separate performance obligation). Otherwise, an entity would combine that good or service with other promised assets.
10. Additionally, indicators that the customer has obtained control of a good or service within the current draft of the proposed Exposure Draft on revenue recognition include the following:
 - (a) The customer has an unconditional obligation to pay
 - (b) The customer has legal title
 - (c) The customer has physical possession
 - (d) The design or function of the good or service is customer specific.
11. However, in most circumstances, payment would be conditional on providing those goods or services.
12. Under the performance obligation approach to lessor accounting, the lessor has a single performance obligation to continue to permit the lessee to use the leased asset over the lease term and that performance obligation would be satisfied, and

revenue recognized, continuously over the lease term. The risk that a lessor is unable to accurately bifurcate the lease and service components of an arrangement is mitigated by the fact that no revenue is recognized upon lease commencement under the performance obligation approach to lessor accounting.

13. The staff note that Agenda Paper 2A/Memo 112 recommends that the leases Exposure Draft state that leases that include material non-distinct service elements may expose the lessor to significant risks and benefits associated with the underlying assets. Consequently, the derecognition approach may not apply to most leases of this type.

Staff Analysis

Bifurcation of the service and lease components of a lease arrangement under the derecognition approach to lessor accounting

14. Based on the revenue recognition proposed requirements, it may be questionable in certain lease arrangements whether the attached service components are distinct. That is, it is questionable whether a lessor would provide a right-of-use asset without certain services (for example, providing office space without electricity).
15. However, based on discussions with constituents and because of concerns with revenue recognition upon lease commencement for services, the staff think that lessors under the derecognition approach to lessor accounting would be able to estimate the split between the lease and service components within a lease arrangement and should, therefore, recognize separate performance obligations.
16. The staff think that lessors under the derecognition approach to lessor accounting will be able to develop a reasonable methodology to determine specific costs attributable to services for the purpose of allocating a lease arrangement between service and lease components. This allocation should be done relative to the standalone selling prices of the service.
17. Bifurcating the service components and lease components of a lease arrangement is also consistent with current guidance on separating payments for the lease from

other payments. The existing guidance in leasing guidance in Topic 840 of the *FASB Accounting Standards Codification*TM and in IFRIC 4 Determining whether an arrangement contains a lease states that:

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.

Staff Recommendation

18. The staff recommend lessors under the derecognition approach to lessor accounting should be required to bifurcate both distinct and non-distinct service and lease components in a lease arrangement. The staff are aware that this is inconsistent with the proposed revenue recognition requirements for recording non-distinct services as a single performance obligation.
19. Additionally, the staff recommend that lessors under a derecognition approach to lessor accounting should be required to bifurcate service and lease components in a lease arrangement based on a reasonable allocation basis consistent with the proposed revenue recognition requirements. That is, allocation should be done relative to the standalone selling prices of the service for both distinct and non-distinct services.

Question 1

Do the Boards agree that lessors under the derecognition approach to lessor accounting should be required to bifurcate service and lease components in a lease arrangement for both distinct and non-distinct service components? If not, why not?

Question 2

The staff think that a lessor under the derecognition approach to lessor accounting should be required to bifurcate service and lease components based on the proposed revenue recognition requirements. That is, allocation should be done relative to the standalone selling prices of the service for both distinct and non-distinct services. Do the Boards agree? If not, why not?

Accounting for the service component of a lease arrangement under the derecognition approach to lessor accounting

20. Based on the staff recommendation in paragraphs 18-19, the staff have considered the following approaches for the accounting of the service component of a lease arrangement because the staff think that both the lessee and lessor under a derecognition approach to lessor accounting should be required to bifurcate the contract between the lease and service component of a lease arrangement:
- (a) Approach A: Account for the lease component of the leasing arrangement under the proposed lease requirements. Any service component would be accounted for under the proposed revenue recognition requirements for lessors under the derecognition approach to lessor accounting.
 - (b) Approach B: Account for the lease component of the leasing arrangement under the proposed lease requirements. A lessor under the derecognition approach to lessor accounting would recognize a separate performance obligation for the service components.
21. These approaches are illustrated in Appendix A to this paper.
22. The staff notes that both of the approaches are inconsistent with the proposed revenue recognition requirements because the approaches account for non-distinct

services of a contract as if they were distinct services. However, both approaches would not result in revenue recognition under the derecognition approach to lessor accounting until services have been provided.

Approach A: Account for the lease component of the lease arrangement under the proposed lease requirements. Any service component would be accounted for under the proposed revenue recognition requirements.

23. Under Approach A, the service component of a lease arrangement would be accounted for in accordance with the current draft of the proposed Exposure Draft on revenue recognition, separate from the accounting for the right-of-use asset. This service component would include any of the services that are not part of the right to use the underlying asset. The lessor would record a receivable for the lease component only and would account for the service component under the proposed revenue recognition requirements. The staff have included an illustrative example of Approach A in Appendix A.
24. As such, the current draft of the proposed Exposure Draft on revenue recognition states that an entity shall recognize revenue when it satisfies a performance obligation identified by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service.
25. In addition, the current draft of the proposed Exposure Draft on revenue recognition states the following:

A customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. Control includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

The customer's ability to direct the use of a good or service (that is, an asset) refers to the present right to use the asset for its remaining economic life or to consume the asset in the customer's activities. The customer's ability to receive the benefit from an asset refers to its present right to obtain substantially all of the potential cash flows from that asset (either an increase in cash inflows or a decrease in cash outflows). The customer can obtain cash flows from an asset directly or indirectly in many ways such as by using, consuming, selling, exchanging, pledging, or holding the asset.

26. If the lessor had an unconditional right to receive cash, the lessor would present its obligation gross; if not, it would be recognized net of the receivable. However, in most circumstances, payment would be conditional on providing goods or services.
27. Therefore, under Approach A, the statement of financial position (SFP) would not likely reflect the right to receive cash for services not yet provided or the liability to provide these services. The income statement would reflect income for these services as the services were provided.
28. Approach A would not reflect assets or liabilities for services that have not yet been provided by the lessor. The service component of a lease arrangement would be accounted for in accordance with the proposed Exposure Draft on revenue recognition. That is, although it can be argued that the service component is not distinct of the lease component, the lessee would not recognize assets or liabilities for services that have not been performed, as is the case under Approach B.
29. Approach A could also be considered consistent with the current treatment of executory contracts. That is, assets and liabilities would not be reflected on the SFP and expenses would be reflected as incurred.
30. However, because under Approach A the lessor would not recognize assets or liabilities for these services, there is a possibility that material assets and liabilities would not be presented. However, some staff members would argue that service components are not assets or liabilities until the service has been provided.
31. Additionally, the service component of a lease arrangement that may not be distinct from the lease component would not be presented under Approach A. Users may prefer to see that these components are related.

Approach B: Account for the lease component of the lease arrangement under the proposed lease requirements. A lessor under the derecognition approach to lessor accounting would recognize a separate performance obligation for the service component.

32. Under Approach B, the service component of a lease arrangement would be accounted for separate from the accounting for the right-of-use asset. However, the accounting for the service component would be specified within the proposed

lease requirements. This service component would include any of the services that are not part of the right to use the underlying asset. The lessor would record a receivable for the full amount of payments, including expected services, and would record a separate liability for the service component of the lease arrangement. The staff have included an illustrative example of Approach B in Appendix A.

33. Under Approach B, a lessor under the derecognition approach to lessor accounting would present an asset for its right to receive cash for services not yet provided and a performance obligation to provide those services. The income statement would reflect income for these services as the services were provided consistent with the continuous transfer of goods under the proposed Exposure Draft on revenue recognition.
34. Approach B would reflect assets and liabilities for the service component of a lease arrangement. Some would argue that because it is primarily part of the lease arrangement, the service component should be reflected and that these assets and liabilities could possibly be material.
35. Approach B is also not consistent with the current treatment of executory contracts. Although expenses would be recorded as incurred, the lessor would present assets and liabilities gross on their SFP before services were rendered. However, some do not view service contracts related to a lease arrangement as executor contracts.

Staff Recommendation

36. Some staff members recommend Approach A. That is, a lessor would account for the lease component of the lease arrangement under the proposed lease requirements. Any service component would be accounted for under the proposed revenue recognition requirements for lessors under the derecognition approach to lessor accounting.
37. Other staff members recommend Approach B. That is, a lessor would account for the lease component of the lease arrangement under the proposed lease

requirements. A lessor under the derecognition approach to lessor accounting would recognize a separate performance obligation for the service component.

Question 3

Which approach do the Boards prefer?