FASB Emerging Issues Task Force

Issue No. 08-2

Title: Lessor Revenue Recognition for Maintenance Services

Document: Issue Summary No. 1*

Date prepared: March 3, 2008

FASB Staff: Leverenz (ext. 258)/Nickell (ext. 282)

EITF Liaison: Jay Hanson

Date previously discussed: None

Previously distributed EITF materials: None

References:

FASB Statement No. 13, *Accounting for Leases* (FAS 13)

FASB Statement No. 29, *Determining Contingent Rentals* (FAS 29)

FASB Statement No. 154, *Accounting Changes and error Corrections* (FAS 154)

FASB Technical Bulletin No. 90-1, "Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts" (FTB 90-1)

FASB Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (CON 5)

FASB Concept Statement No. 6, *Elements of Financial Statements* (CON 6)

APB Opinion No. 22, *Disclosure of Accounting Policies* (APB 22)

AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2)

AICPA Statement of Position 00-2, *Accounting for Producers or Distributors of Films* (SOP 00-2)

SEC Staff Accounting Bulletin Topic 13, *Revenue Recognition* (SAB Topic 13A)

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

International Accounting Standard 17, *Leases* (IAS 17)

International Financial Reporting Interpretations Committee Interpretation 4, "Determining whether an Arrangement contains a Lease" (IFRIC 4)

EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" (Issue 00-21)

EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (Issue 01-8)

Background

1. Certain leasing arrangements require the lessor to maintain the leased asset during the lease term. The maintenance services can range from janitorial services in an office space lease to planned major maintenance for an aircraft lease. Typically, the lessor is paid a contractually determined amount for these maintenance services. The timing of those payments may not coincide with the performance of the maintenance services. FAS 13 provides that executory costs such as maintenance, insurance, and taxes, together with any profit thereon, shall be excluded from minimum lease payments. However, FAS 13 provides no guidance on the accounting for executory costs, other than excluding them from the determination of minimum lease payments. At issue is how a lessor should account for payments it receives in connection with performing maintenance services to the leased item, in lease agreements or other arrangements accounted for as leases (hereinafter referred to as "maintenance services").

2. This Issue applies to arrangements identified as leases as well as arrangements that convey the right to use property, plant, or equipment, and are accounted for as leases based on the guidance in Issue 01-8. Power purchase agreements, airline capacity purchase arrangements, and take-or-pay contracts are common examples (but not an exhaustive list) of arrangements that may contain a lease under Issue 01-8. However, this Issue does not apply to maintenance services that are provided under a separate arrangement that are within the scope of FTB 90-1 or that are not associated with a related leased asset.

3. The issue exists in the airline, utility, and real estate industries; however, it may exist in other industries as well. The staff understands that lessors bill for maintenance services in various ways. For example, in a "gross lease" of office space, maintenance is included in the base rent billed to the lessee. In other situations, maintenance is billed separately as a common area maintenance (CAM) charge based on an agreed upon fixed rate per square foot. In some situations maintenance is invoiced by the lessor to the lessee as services are performed by the lessor. The accounting for maintenance services varies among lessors. For example, some lessors recognize revenue from maintenance service on a straight-line basis as part of the related rental income. Others record maintenance income as it is billed (which may or may not coincide with the performance of the maintenance services). The staff notes that the issue is more likely

to have a significant impact when maintenance is incurred on an irregular basis, such as a planned major maintenance event, than when maintenance is incurred on a routine basis. The staff believes that any guidance on this Issue will need to be sufficiently broad to allow for application by a diverse cross section of industries and arrangements within those industries.

Summary of Existing Accounting Literature

FAS 13

4. FAS 13 refers to maintenance, insurance, and taxes as examples of executory costs. However, FAS 13 provides no specific guidance as to the accounting treatment for executory costs, other than excluding them from the determination of minimum lease payments. If the portion of the lease payments representing executory costs, including profit thereon, is not determinable from the provisions of the lease, FAS 13 requires an estimate of the amount to be made.

Issue 00-21

5. Issue 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. Paragraph 4(a)(ii) discusses higher-level literature that provides for separation of deliverables within the scope of that higher level literature from deliverables not within the scope of higher-level literature, but does not specify how to allocate arrangement consideration to each separate unit of accounting. Footnote 3 provides an example of how to apply that guidance to multiple deliverables in a lease transaction:

> For example, leased assets are required to be accounted for separately under the guidance of Statement 13. Consider an arrangement that includes the lease of equipment under an operating lease, **the maintenance of the leased equipment throughout the lease term (executory cost),** and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the Statement 13 deliverables and the non-Statement 13 deliverables on a relative fair value basis using the entity's best estimate of fair value of the Statement 13 and non-Statement 13 deliverables. **(Although Statement 13 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment**

> **and the related maintenance as Statement 13 deliverables.)** The guidance in Statement 13 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Issue would be applied to further separate any non-Statement 13 deliverables and to allocate the related arrangement consideration. [Emphasis added.]

Issue 01-8

6. Paragraph 15 of Issue 01-8 discusses multiple element arrangements that contain a lease. Paragraph 15 states that, for purposes of applying FAS 13, payments called for by the arrangement shall be separated into (a) those for the lease, including executory costs and profits thereon, and (b) those for other services on a relative fair value basis consistent with the guidance in paragraph 4(a) of Issue 00-21 (hereinafter referred to as "other services"). Once the lease elements (including executory costs) have been separated from the non-lease elements ("other services"), Issues 00-21 and 01-8 both refer to FAS 13 for the accounting for the lease elements (although FAS 13 provides no guidance on how to account for the executory costs other than to exclude them from minimum lease payments).

7. The analysis of the existing accounting literature illustrates that it is unclear how lessors should recognize revenue for maintenance services. Furthermore, the staff is aware that in certain instances, maintenance services may be so significant that some believe that those services should no longer be consider a lease-related executory cost but should be considered "other services" (that is, a non-Statement 13 deliverable). Some Task Force members might question whether this distinction affects the accounting. The staff notes two potential effects of this determination:

- If maintenance services are considered an executory cost (and, by extension, a "Statement 13 deliverable" under paragraph 4 of Issue 00-21), they would not effect the analysis of whether other non-Statement 13 deliverables represent a separate unit of accounting under Issue 00-21. For example, if the lessor did not have objective and reliable evidence of fair value for maintenance services under the lease arrangement, the lessor is still <u>required</u> to separate the maintenance services (along with the other Statement 13 deliverables) from the non-Statement 13 deliverables.[1]

- The amount allocated to the maintenance services could vary depending on whether the service is considered a Statement 13 deliverable (that is, an executory cost) or "other services" (non-Statement 13 deliverable). For example, if the maintenance is considered "other services," the amount allocated would most likely be the relative fair value of the maintenance services if that deliverable was determined to be a separate unit of accounting under Issue 00-21. However, if the maintenance service is a Statement 13 deliverable, although the total amount allocated to the Statement 13 deliverables would be based on the relative fair value of the total of those deliverables, the allocation to the maintenance element required by FAS 13 would require that an amount first be allocated to the maintenance element with the residual amount allocated to the minimum lease payments (in other words, the allocation required within FAS 13 is not a relative fair value allocation).

This Issue does not address allocation of total consideration of an arrangement to the lease and lease related components (including executory costs and the portion thereof for maintenance service) and the other services as described in Issue 01-8.

8. The staff has not prepared an analysis of when maintenance costs should or should not be considered lease-related executory costs. The staff has included an alternative view (View C of Issue 1) that, if supported by the Task Force, would result in the staff developing such an analysis. The staff believes that the outcome of such an approach would most likely result in a significant increase in the scope and time needed to resolve this Issue.

9. Furthermore, lessors may be performing a wide variety of maintenance services under the leasing arrangement (for example, periodic cleaning services and non-routine major maintenance); accordingly, some assert that an analysis should be performed to determine whether the different maintenance "deliverables" under the arrangement are separate units of accounting (regardless of whether the maintenance services are considered an executory cost

[1] Footnote 2 of Issue 00-21 states, "Solely for purposes of the allocation between deliverables within the scope of higher-level literature and deliverables not within the scope of higher-level literature, an entity's best estimate of fair value is not limited to vendor-specific objective evidence of fair value or third-party evidence of fair value, as those concepts are discussed in paragraph 16 of this Issue."

under FAS 13). There are two views in practice in which maintenance services could be a separate deliverable using the guidance in Issue 00-21 a) the maintenance services are considered a non-Statement 13 deliverable ("other services") or b) the maintenance services are considered a Statement 13 deliverable (executory costs) but because different maintenance services are provided by the lessor, Issue 00-21 is used to determine the unit of accounting for those services. This Issue does not address the determination of when the different maintenance services provided by a lessor would represent multiple deliverables under Issue 00-21.

Accounting Issues and Alternatives

Issue 1: Whether the scope of this Issue should include all payments for maintenance services in an arrangement accounted for as a lease.

View A: The scope of this Issue should include only maintenance services that are considered executory costs under FAS 13 in an arrangement accounted for as a lease.

10. Proponents of View A assert that FAS 13 clearly defines maintenance as an executory cost in a number of places. For instance, the definition of minimum lease payments in FAS 13 states, "executory costs such as insurance, maintenance, and taxes in connection with the leased property...." View A proponents believe that since maintenance costs are clearly listed as executory costs in that definition, this Issue should provide revenue recognition guidance for only those maintenance services within the scope of FAS 13. Proponents of View A are concerned that expanding the scope of this Issue to include maintenance services outside the scope of FAS 13 is a broader undertaking than was contemplated for this Issue. In particular, those proponents are concerned that if the scope of this Issue were expanded to include maintenance services that are separate units of accounting under Issue 00-21, for example, it would bring into question why this Issue is limited to maintenance services related to a leased asset.

11. Opponents of View A believe that executory costs are <u>not</u> clearly defined in FAS 13. Paragraph 5(j)(i) lists three examples of executory costs (insurance, maintenance, and taxes); however, neither FAS 13 nor its basis for conclusions provides a further description or definition

of executory costs. Opponents also cite paragraph B6 of the Background Material and Basis for Consensus of Issue 01-8, which states, in part, "The Task Force reached a consensus that substantial services provided by the lessor (for example, significant operating services) are not executory costs within the scope of Statement 13." Opponents of View A believe that judgment should be applied to determine when payments for maintenance services are executory costs (as that term is used in FAS 13). Opponents of View A believe that maintenance services can reflect other substantial services provided by the lessor; therefore, they are not always executory costs under FAS 13. Opponents are concerned that if this Issue is scoped in such a way that it only includes maintenance services that are considered executory costs, similar transactions would result in different accounting depending on one's interpretation of what is considered an executory cost under FAS 13.

View B: The scope of this Issue should include maintenance services that are considered executory costs under FAS 13 and those that are considered a separate unit of accounting under Issue 00-21.

12. View B proponents believe that the accounting for maintenance services should be similar whether the services are considered "other services" (and a separate unit of accounting under Issue 00-21) or executory costs under FAS 13. Accordingly, this Issue should provide guidance on revenue recognition for maintenance services in both situations. Proponents note that if the maintenance services are <u>not</u> considered a separate unit of accounting under Issue 00-21, then those arrangements would be outside the scope of this Issue. When two or more elements do not meet the condition for separation, they are considered to be a combined unit for revenue recognition purposes. If the maintenance services do not meet the conditions to be accounted for as a separate unit of accounting, then this Issue would be attempting to provide revenue recognition guidance for an infinite number of combinations of maintenance and non-maintenance elements.

13. Opponents of View B believe that if the scope of this Issue implies that maintenance can be either an executory cost or "other services," it would indicate that maintenance is sometimes something other than an executory cost even though FAS 13 specifically lists maintenance as an

example of an executory cost. Opponents of View B also note that the example (cited in paragraph 5 above) in paragraph 4(a)(ii) of Issue 00-21 specifically identifies "maintenance of the leased equipment" as an executory cost to be included in the Statement 13 deliverables. Opponents are also concerned that expanding the scope of this Issue to include maintenance services outside the scope of FAS 13 is a broader undertaking than should be contemplated by this Issue.

View C: This Issue should provide guidance to determine when maintenance services are executory costs under FAS 13 or other services under Issue 01-8.

14. Proponents of View C believe that Issue 01-8 and FAS 13 are not clear whether significant maintenance services should be considered an executory cost under FAS 13. Proponents believe that it is necessary to resolve this issue before establishing revenue recognition criteria for maintenance payments made to the lessor, otherwise, similar arrangements could be accounted for differently based on different interpretations of the term "executory cost."

15. Opponents of View C believe both Views A and B represent valid views, and an attempt to provide guidance on the exact definition of "executory cost" would represent an unnecessary extension of the scope and expansion of the timeframe of this project.

Issue 2: How a lessor should recognize revenue related to maintenance services.

16. Accounting guidance for revenue recognition for service arrangements is limited. Furthermore, guidance for revenue recognition of maintenance services associated with an arrangement that includes a lease is similarly limited. CON 6 includes a discussion of revenue but refers to CON 5 for recognition procedures. Paragraph 83 of CON 5 states that "recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration." Generally,[2]

[2] References to the four conditions can be found in a number of accounting pronouncements regarding revenue recognition including but not limited to: SAB Topic 13A1; SOP 97-2, paragraph 8; and SOP 00-2, paragraph 7.

revenue is considered both earned and realizable when each of the following four conditions is met:

a. Persuasive evidence of an arrangement exists
b. The arrangement fee is fixed or determinable
c. Delivery or performance has occurred
d. Collectibility is reasonably assured.

17. The alternative views on Issue 2 focus on Condition (c), when delivery or performance has occurred, for maintenance services. In some situations there may be a question about whether the arrangement fee is fixed or determinable or there may be questions about collectibility based on the credit worthiness of the counterparty to the maintenance arrangement. Those considerations are not included in the analysis below and may affect the recognition of revenue regardless of the view supported by the Task Force on this issue. This issue focuses solely on the recognition method that is consistent with delivery or performance of the services within the scope of this Issue and not on other considerations that are necessary to conclude that the revenue meets the factors listed above and is recognizable.

View A: Revenue related to maintenance services should be recognized into income over the lease term in proportion to the costs expected to be incurred in performing maintenance services under the contract. If that pattern cannot be reliably determined, maintenance services should be recognized into income on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the pattern in which the costs of performing maintenance services under the contract are incurred.

18. Proponents of View A believe that lessors should analogize to FTB 90-1 to determine how to recognize revenue related to maintenance services. Based on the guidance in paragraph 3 of FTB 90-1, revenue would be deferred and recognized on a straight-line basis over the lease term except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue would be recognized over the contract period in proportion to the costs

expected to be incurred in performing services under the contract. Proponents of View A assert that maintenance service arrangements within the scope of this Issue are economically similar to those considered by FTB 90-1 and, accordingly, the accounting should be similar. In circumstances in which a consistent level of maintenance services are performed evenly throughout the contract period (for example, daily janitorial services), the recognition of revenue on a straight-line basis might be appropriate under this view, which is consistent with FTB 90-1.

19. View A proponents note that the guidance in View A is consistent with the guidance in FTB 90-1 except for the addition of the concept of systematic and rational allocation basis in situations in which the pattern of costs incurred cannot be reliably determined (FTB 90-1 requires the use of a straight-line basis; however, View A also allows the use of a systematic and rational allocation basis). Under View A when the pattern of costs incurred cannot be reliably determined, maintenance services should be recognized into income on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the pattern in which the costs of performing services under the contract are incurred. Some observe that the use of the term straight-line implies allocation, based on the passage of time (and no other basis), of a fixed payment over the contractual term of the arrangement. View A proponents believe that an entity should not be limited to the straight-line method as there may be another systematic and rational allocation basis that more appropriately reflects when costs are incurred for maintenance services. For example, in situations in which costs incurred for maintenance services are linked to the level of utilization of the leased asset, it might be more appropriate to recognize revenue based on a measure of utilization of the leased asset rather than the passage of time. Accordingly, View A proponents believe that allowing for the use of a systematic and rational allocation basis (as opposed to requiring just the use of a straight-line basis) is more consistent with the principle of View A that revenue should be recognized over the contractual term based on the pattern in which the costs of performing maintenance services under the contract are incurred.

20. Opponents of View A believe that maintenance services would not be explicitly within the scope of FTB 90-1 as that guidance applies to "separately priced extended warranty and product maintenance contracts." FTB 90-1, paragraph 2, provides that "a contract is *separately priced* if

the customer has the option to purchase the services provided under the contract for an expressly stated amount separate from the price of the product." Therefore, opponents of View A believe that the definition of "separately priced" in FTB 90-1 implies that not only does the contract include a price for such services on a separate basis, but that the service could be independently obtained at the same price from the lessor or another provider (referred to as "independently priced"). Opponents of View A believe that many leases do not contain separate pricing for the individual components, including maintenance, and, therefore, maintenance would not be considered "separately priced." Furthermore, opponents of View A believe that in situations in which a lease specifies the individual amount for the maintenance activities, those arrangements would generally not meet the FTB 90-1 requirement that maintenance be "independently priced" from the other contract components. They point out that it would be rare for the individual contract components to be separately negotiated to achieve an adequate return for that individual component (that is, a return that would be required for the specific risks and rewards associated with that individual component if it were sold on a stand-alone basis). Therefore, opponents of View A believe that it would be inappropriate to analogize to guidance in FTB 90-1 to recognize revenue related to maintenance services in a lease.

21. Opponents of View A also believe that the lessor should not be limited to using cost incurred as the input-based measure to determine revenue recognition for maintenance services. Opponents note that in certain fact patterns there may be an alternative output or input-based measure that would more accurately reflect the pattern under which maintenance services have been performed and delivered.

View B: *Revenue related to maintenance services should be recognized into income as those services are performed utilizing a proportional performance method that is determined to be the most appropriate method under the circumstances.*

22. Proponents of View B assert that the customer (in this case, the lessee) receives value as the maintenance services are performed. Because maintenance services generally involve multiple acts that will be performed over a period of time, a lessor will need to utilize a proportional performance method to measure when delivery of the maintenance services has occurred. The

performance measure chosen would depend on the circumstances and could include input-based measures (for example, labor hours or another measure of efforts expended) or output-based measures (for example, the completion of a specific maintenance activity such as an engine overhaul). In circumstances in which a consistent level of maintenance services are performed evenly throughout the contract period (for example, daily janitorial services), the recognition of revenue on a straight-line basis may be appropriate under this view.

23. Proponents of View B believe that revenue for maintenance services should be recognized when the underlying maintenance services have been performed. Proponents of this view believe that revenue should not be considered earned until the maintenance has actually been performed and that recognizing revenue in any other manner would be inappropriate. Accordingly, under View B, revenue would be recognized into income in proportion to the maintenance services that have been performed. The method of measuring performance of those services should be based on the most appropriate method for the circumstance and is not limited to one particular input or output approach.

24. Proponents of View B point to paragraph 83(b) of CON 5, which states that

> revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, **rendering services**…revenues are considered to have been earned when the entity has **substantially accomplished what it must do to be entitled to the benefits represented by the revenues**. [Emphasis added and footnote reference omitted.]

Paragraph 84(a) of CON5 provides further guidance on recognizing revenues, stating that "the two conditions (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered or **services are rendered to customers**" (emphasis added).

25. As discussed in the background to this Issue, maintenance services required of lessors will often require the lessor to perform various maintenance activities over a specified period. Those maintenance activities, even within the same leasing arrangement, could vary from routine, recurring maintenance to significant overhauls of the leased asset. A leasing arrangement may not specify how often the maintenance activity would need to occur, and the arrangement could

provide for payment terms that do not necessarily mirror the performance of the maintenance services. Furthermore, in many fact patterns the lessor will be providing an unspecified number of individual maintenance activities over the lease term. Those facts may affect the entity's judgment regarding the most appropriate proportional performance method in the circumstances, but the objective of that method should be to reflect the pattern under which the maintenance services are performed.

26. In assessing a model that intends to reflect the performance pattern of the maintenance services, View B proponents believe that lessors need to adopt an accounting method that reflects how the services are being performed under the contract. Those proponents acknowledge that a systematic and rational basis over the contractual term of the maintenance services may be employed in circumstances under which the performance occurs consistently over the contract term or when more specific measures are unavailable. In support of that view, proponents cite Question 1 of SAB Topic 13-A.3(f), which states, in part,

> …the staff believes that upfront fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned[40].
>
> [40] A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

27. Proponents of View B acknowledge the application of a proportional performance method could result in a revenue recognition method that is similar to View A. For example, if a lessor concludes that costs incurred (an input-based measure) are the most appropriate measure of when maintenance services have occurred then View A and View B would result in the same revenue recognition method. However, proponents of View B believe View A inappropriately requires lessors to utilize one input-based measure (costs incurred) to determine revenue recognition for all fact patterns.

28. View B proponents observe that output-based measures may be the best measure of performance in circumstances in which a reliable measure of output can be established. For

example, it could be appropriate to recognize maintenance service revenue relating to periodic major overhauls of fixed assets when each overhaul is completed. However, those proponents acknowledge that output-based measures often cannot be established for maintenance services, so input-based measures would often be appropriate. For example, when maintenance services are performed continuously, it will often be difficult to measure performance using an output measure. In those circumstances, the use of input measures such as cost or labor hours may be the most appropriate methods of recognizing maintenance service revenue under View B.

29. This view provides an overarching principle to be applied when determining how to recognize revenue for maintenance services, but would not prescribe a particular method. Given the wide variety of leasing transactions and differing levels of maintenance activities in those transactions, judgment is necessary and prescribing a particular method may not reflect the economics in some situations. View B provides that overarching principle while still allowing for judgment to be applied to the individual circumstances being considered.

30. Opponents of View B assert that FTB 90-1 provides an existing model for revenue recognition of maintenance services and, accordingly, is the most appropriate analogy for the circumstances within the scope of this Issue. Those opponents challenge why the creation of a new model for similar services is necessary.

View C: The minimum maintenance payments over the lease term should be recognized into income over the lease term on a straight-line basis. Contingent maintenance payments should be recognized as they accrue.

31. Proponents of View C believe that even though FAS 13 does not provide guidance on how to account for executory costs it is proper to analogize to minimum lease payments and contingent rent as defined in FAS 13 to determine the accounting treatment for executory costs. Similar to paragraph 5(j) in FAS 13, which states, "minimum lease payments include the following: (a) The minimum rental payments called for by the lease over the lease term," proponents of View C believe that if a contract includes required minimum <u>maintenance</u> payments, those payments should be accounted for in the same manner as minimum <u>lease</u>

payments, which is generally on a straight-line basis. View C proponents believe that in the case of a building lease in which gross rents include a maintenance component, a lessee is leasing "maintained" space and a portion of the required minimum lease payment is intended to cover the lessor's maintenance costs; therefore, it is appropriate to recognize rent revenue and maintenance revenue on a similar straight-line basis.

32. However, proponents of View C believe that when the contract does not include required minimum maintenance payments, it is not proper to account for them on a straight-line basis but to analogize to contingent rent. View C proponents note that contingent rent is defined in FAS 29, paragraph 11, as

> The increase or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based…. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sale volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety.

Proponents believe that maintenance that is not based on a fixed contractual minimum is consistent with this definition as it is based on changes and activities occurring subsequent to the inception of the lease and depends on factors directly related to future use of the leased property. Therefore, these proponents believe that maintenance not tied to a contractual minimum should be accounted for in the same manner as contingent rent as stated in FAS 29, paragraph 13, "Contingent rentals shall be included in the determination of income as accruable."

33. Opponents of View C believe that it is not appropriate to analogize the accounting treatment of maintenance payments to the accounting treatment of minimum lease payments and contingent rent because FAS 13 specifically excludes executory costs from the determination of minimum lease payments. View C opponents believe that recognizing maintenance payments on a straight-line basis or as accrued would not always recognize maintenance revenue based on when maintenance services have been performed or in proportion to the costs incurred to provide the maintenance service. Both of these methods are believed by these proponents to be more accurate methods to recognize maintenance revenue. Opponents of View C also observe that it

may result in the service provider beginning to recognize maintenance revenue before any maintenance services are performed (for example, if maintenance services begin subsequent to the commencement of the lease term) and may also result in the service provider being required to defer revenues after the maintenance services have been completed (for example, if the maintenance services are completed before the end of the lease term).

International Convergence

34. IFRIC 4, paragraph 12, provides the following guidance related to separating payments for lease and non-lease elements in an arrangement that contains a lease:

> If the arrangement contains a lease, the parties to the arrangement shall apply the requirements of IAS 17 to the lease element of the arrangement…Other elements of the arrangement not within the scope of IAS 17 shall be accounted for in accordance with other Standards.

35. IFRC 4 would appear to be consistent with the requirements of Issue 01-8, except when the purchaser concludes that it is impracticable to separate the maintenance payment from the lease payment. In this situation, under an operating lease, the maintenance payment would be treated as part of the lease payment and recorded in accordance with IAS 17, paragraph 51, which states, that the lease income is recognized on a straight-line basis over the lease term. Other than that situation, there is currently no guidance specific to this Issue under IFRS. However, the FASB and IASB Boards are jointly working on a lease project and a revenue recognition project that may effect the conclusions reached in this Issue.

Effective Date and Transition

36. The staff recommends that the consensus on this Issue be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. The staff has identified the following transition alternatives for Task Force consideration:

Alternative A: Entities should recognize the effect of the change as a change in accounting principle through retrospective application to all prior periods for all arrangements that existed *during the periods for which the financial statements are presented. Entities should disclose the cumulative-effect of the change on retained earnings in the statement of financial position for the first period presented using the guidance in FAS 154.*

Alternative B: Entities should recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately.

Alternative C: Entities should recognize the effect of the change on a prospective basis to arrangements entered into after the effective date

37. The staff considers Alternative A to be consistent with paragraph 7 of FAS 154, which requires retrospective application to changes in accounting principles. In addition, retrospective application is the transition method that best achieves consistency of financial information between periods and facilitates comparability of accounting data. If it is impracticable to apply retrospective application, paragraph 9 of FAS 154 allows for the new accounting principle to be applied on a prospective basis. Alternative A would be the most costly to achieve from the preparer's perspective but the comparability that would result provides the most benefit to the financial statement user. The preparer would need to reassess all transactions under this Issue summary and, depending on the Task Force's decision, determine when specific maintenance activities were performed, or when costs were incurred, or when costs were invoiced to the lessee. Depending on a preparer's current practice and the number of transactions, that could be very costly and time consuming to complete. If the Task Force opted for Alternative A, it may need to reconsider the suggested effective date of fiscal years beginning after December 15, 2008.

38. Alternative B carries the benefit of consistency and comparability for the current year and future years without the burden of recasting prior years' amounts. Alternative B requires entities to evaluate only the arrangements in place at the effective date of this Issue. The staff

acknowledges that with the reduced costs and burdens of Alternative B comes less consistency and comparability for years prior to the year of adoption. In particular, Alternative B could result in some entities recognizing revenue under the same arrangement twice, that is, both in periods before the effective date and after the transition date.

39. Alternative C would eliminate the need to reassess a significant number of arrangements, an activity that may not be considered cost beneficial from the preparer's perspective. Opponents of Alternative C are concerned with the inconsistency of allowing service agreements for maintenance entered into prior to the effective date of this Issue to be accounted for in a manner inconsistent with the consensus reached. Alternative C would allow for an entity to have multiple policies for revenue recognition for some period of time (which could be significant for longer term lease arrangements) after this Issue is finalized, as arrangements entered into before its effective date would follow the entity's historic policy and arrangements entered into after the effective date would follow the guidance in this Issue.

Disclosure

40. The staff considered requiring disclosures and concluded not to recommend any incremental disclosure requirements beyond those already required by FAS 13, FAS 154, APB 22, and Issue 00-21.

<u>Exhibit 08-2A</u>

These examples are to illustrate the application of the principles in each view identified in this Issue Summary. These examples include the following exceptions and/or assumptions:

1. All revenue recognition criteria outside the scope of this Issue have been met (that is, persuasive evidence of an arrangement exists, the arrangement fee is fixed or determinable, and collectibility is reasonably assured). See paragraph 17 and 18 in the Issue Summary.
2. The contractual maintenance payments are equal to the fair value of the individual maintenance services.

Example 1—Airline Capacity Purchase Arrangement

Major Airline A (lessee) contracts with Regional Airline B (lessor) to provide connecting service into Major Airline A's hub over a five year period. The contract is structured as a capacity purchase arrangement under which Major Airline A purchases the use of Regional Airline B's aircraft and flight crews and other related services. Major Airline A is required to purchase all maintenance services from Regional Airline B. The aircraft is painted in the colors and logos of Major Airline A, and Major Airline A takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. Major Airline A is required to make payments to Regional Airline B on a per departure basis. After an analysis under Issue 01-8, Regional Airline B concludes that the capacity purchase agreement contains a lease. Included in the per departure basis payment to Regional Airline B is a payment for expected maintenance, which can be categorized into three categories:

a. *Line maintenance.* Consists of routine daily and weekly scheduled maintenance inspections and checks, including pre-flight checks, and any diagnostics and routine repairs.
b. *Component overhaul and repair.* Involves the repair of parts, such as engines and landing gears, and inspections or replacement of major parts, which the Federal Aviation Administration (FAA) requires at specific maximum periodic intervals to

recertify that the part is completely airworthy.

c. *Planned major maintenance.* Servicing of the aircraft that cannot be accomplished during an overnight visit. These occur at predetermined levels as set forth in an airline's maintenance program and can range in duration from a few days to a month, depending on the magnitude of the work prescribed.

Below is a hypothetical example that includes the original contract pricing information (assumes 6 percent mark-up on costs) and actual and revised total costs and maintenance reimbursements after the end of Year 1. The maintenance payments are nonrefundable regardless of the actual amount of maintenance performed by Regional Airline B. Regional Airline B concludes the line/component maintenance and planned major maintenance are separate units of accounting. This contract includes an annual minimum maintenance payment in the amount of $712,500 to be made to the lessor based on 1,500 departures.

Contract Pricing		Unit Rates ($)					Total Est $	Total Est $
Maintenance Activity	Unit	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Reimbursement	Cost
Line/Component Maintenance	Departures	225	225	225	225	225	2,317,500	2,186,321
Planned Major Maintenance	Departures	250	250	250	250	250	2,575,000	2,429,245
		475	475	475	475	475	4,892,500	4,615,566
Estimated Departures		1,600	2,200	2,300	2,000	2,200		
Minimum Maintenance Payments								
Line/Component Maintenance ($225 x 1,500)		337,500	337,500	337,500	337,500	337,500		
Planned Major Maintenance ($250 x $1,500)		375,000	375,000	375,000	375,000	375,000		

As of End of Year 1	Actual Yr 1	Estimated Cost Projections				Total Est $ Reimbursement	Total Est $ Cost
Line/Component Maintenance	345,000	417,713	433,575	454,725	454,725	2,232,082	2,105,738
Planned Major Maintenance	-	-	-	-	2,429,245	2,575,000	2,429,245
	345,000	417,713	433,575	454,725	2,883,970	4,807,081	4,534,983
Line/Component Payment ($225 x 1,700)	382,500						
Planned Major Payment ($250 x $1,700)	425,000						
Actual/Estimated Departures	1,700	1,975	2,050	2,150	2,150	10,025	

View A: *Revenue related to maintenance services should be recognized into income over the lease term in proportion to the costs expected to be incurred in performing maintenance services under the contract. If that pattern cannot be reliably determined, maintenance services should be recognized into income on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the pattern in which the costs of* *performing maintenance services under the contract are incurred.*

Regional Airline B incurred $345,000 of actual costs related to line/component maintenance in Year 1. Year 1 actual maintenance cost is 16 percent of total expected line/component maintenance costs ($2,105,738) to be incurred over the contract period based on the revised estimated departures. Accordingly, Regional Airline B would recognize $357,133 ($2,232,082 total estimated line/component maintenance revenue × 16%) in maintenance revenue and record a deferred liability in the amount of $25,367 ($382,500 line/component payment received − $357,133 revenue recognized) in Year 1.

Regional Airline B did not incur costs related to planned major maintenance in Year 1. Accordingly, Regional Airline B would not record revenue related to planned major maintenance and would record a deferred liability in the amount of $425,000 ($425,000 planned major maintenance payment received − $0 revenue recognized) in Year 1.

View B: *Revenue related to maintenance services should be recognized into income as those services are performed utilizing a proportional performance method that is determined to be the most appropriate method under the circumstances.*

Regional Airline B determined departures are the most appropriate input-based measure to determine when line/component maintenance services are performed as total line/component maintenance activities (pre-flight checks, diagnostics, routine and part repairs) have historically correlated directly to the number of departures. The percentage of services already provided is determined to be 17 percent (1,700 departures ÷ 10,025 total estimated departures). Accordingly, Regional Airline B would recognize $379,454 ($2,232,082 total line/component maintenance payments × 17%) in maintenance revenue and record a deferred liability in the amount of $3,046 ($382,500 payment received − $379,454 revenue recognized) in year 1.

Because the planned maintenance has not been performed, no revenue is recognized related to planned major maintenance. In this example, the planned major maintenance is expected to be performed in Year 5 based on FAA maintenance schedules. Accordingly, Regional Airline B would record a deferred liability in the amount of $425,000 ($425,000 planned major maintenance payment received − $0 revenue recognized) in Year 1.

View C: The minimum maintenance payments over the lease term should be recognized into income over the lease term on a straight-line basis. Contingent maintenance payments should be recognized as they accrue.

Regional Airline B would recognize $382,500 of line/component maintenance revenue in Year 1 based on the total of $337,500 (stated minimum maintenance payment in the contract) and $45,000 (contingent rent payment). The contingent rent payment is equal to the difference between the actual billing and the minimum maintenance payment.

Regional Airline B would recognize $425,000 of planned major maintenance revenue in Year 1 based on the total of $375,000 (stated minimum maintenance payment in the contract) and $50,000 (contingent rent payment). The contingent rent payment is equal to the difference between the actual billing and the minimum maintenance payment.

Example 2—Office Space Lease (Gross Lease - Maintenance included in Base Rent)

Company A leases office space to Company B in a building owned by Company A over a five year lease. Company A is responsible for all maintenance related to the building. Company A does not receive a payment specifically for maintenance but, rather, Company A bills Company B a fixed amount of rent on a monthly basis, which includes rent, maintenance, property taxes, and insurance. Below are the details of the annual rental payments Company B is contractually required to make and actual maintenance costs incurred. Note: The actual lease agreement and related invoice do not separately itemize the rental payments into its components. The example assumes that actual and estimated total maintenance costs are equal.

Contract Pricing						
Lease Component	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Rental Payment						
Rent	47,000	48,500	50,000	51,500	53,000	250,000
Maintenance	12,000	13,000	14,000	15,000	16,000	70,000
Taxes & Insurance	3,000	3,200	3,400	3,600	3,800	17,000
Total:	62,000	64,700	67,400	70,100	72,800	337,000
Actual Annual Maintenance Costs	7,000	8,000	28,000	11,000	12,000	66,000

Embedded in Company A's maintenance charges is an estimated 6 percent mark-up on all maintenance costs. Included in the $70,000 total maintenance rental payment is $15,000 for planned maintenance to the heating & air conditioning system in Year 3. Company A concludes the planned maintenance to the heating & air conditioning system and all other maintenance services are a single unit of accounting.

View A: Revenue related to maintenance services should be recognized into income over the lease term in proportion to the costs expected to be incurred in performing maintenance services under the contract. If that pattern cannot be reliably determined, maintenance services should be recognized into income on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the pattern in which the costs of performing maintenance services under the contract are incurred.

Company A incurred $7,000 of actual maintenance costs in Year 1. Year 1 actual maintenance costs is 11 percent ($7,000 ÷ $66,000) of total expected maintenance costs to be incurred over the contract period. Company A would recognize $7,700 ($70,000 total estimated maintenance revenue x 11%) in maintenance revenue and record a deferred liability in the amount of $4,300 ($12,000 maintenance payment received − $7,700 maintenance recognized as revenue) in Year 1. In Year 3 when the heating & air conditioning system planned maintenance costs are incurred, maintenance revenue will be considerably higher than in other years of the contract due to the substantial heating & air conditioning system maintenance costs incurred.

View B: *Revenue related to maintenance services should be recognized into income as those services are performed utilizing a proportional performance method that is determined to be the most appropriate method under the circumstances.*

Company A determined costs incurred is the most appropriate input-based measure to determine when maintenance services are performed since these maintenance activities have historically correlated to when the actual maintenances services have been performed. Therefore, under View B, the accounting results would be the same as in View A since cost incurred was the proportional performance model used.

View C: The minimum maintenance payments over the lease term should be recognized into income over the lease term on a straight line basis. Contingent maintenance payments should be recognized as they accrue.

Company B is contractually obligated to make the rental payment, which includes maintenance, based on the contractual provisions in the agreement. Therefore, Company B would record the maintenance payments into income over the lease term on a straight-line basis. Accordingly, Company B would record maintenance revenue of \$14,000 (\$70,000 total maintenance payments ÷ 5 years) and record an unbilled receivable in the amount of \$2,000 (\$14,000 maintenance revenue recorded − \$12,000 maintenance payment received) in Year 1.