

defining issuesTM

JUNE 2003 No. 03-12



IDENTIFYING A LEASE	1
COMPONENTS OF THE ARRANGEMENT	2
WHEN TO REASSESS AN ARRANGEMENT	2
REPORTING REVENUE	3
EFFECT ON PURCHASERS	3
TRANSITION	3

Lease Arrangements Have Broadened

New requirements on identifying leases could affect the operating results of companies that sell or purchase products or services through supply, commodity, transportation, and data-processing outsourcing contracts. Revenues formerly reported from sales of products or services might have to be treated as rental or leasing income, which could lead companies to reevaluate the way they describe their businesses to stakeholders or to restructure arrangements. Should capital-lease treatment be necessary, purchasers of the products or services in the arrangements would have to recognize new assets on their balance sheets. The new requirements, which could also affect the timing of revenue and expense recognition, are in an EITF Consensus that applies prospectively to new or modified arrangements beginning after May 28, 2003.¹

IDENTIFYING A LEASE IN AN ARRANGEMENT

The guidance in the Consensus is designed to mandate reporting revenue as rental or leasing income that otherwise would be reported as part of product sales or service revenue. It requires both parties to an arrangement to determine whether a service contract or similar arrangement is or includes a lease within the scope of FASB Statement 13, which means focusing on agreements conveying the right to use property, plant, or equipment.²

© 2001, 2002, 2003 KPMG LLP, the U.S. member firm of KPMG International, a Swiss nonoperating association. All rights reserved.

(1) EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*, as of May 15, 2003.
(2) FASB Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, November 1976.

An arrangement is a lease or contains an embedded lease if it conveys the right to control the use of property, plant, or equipment (collectively, the “property”), whether the property is explicitly or implicitly specified. The right is conveyed if the purchaser obtains physical or operational control of the property or takes substantially all of its output.

For purposes of the Consensus, a purchaser takes substantially all of the output from property if two conditions are met. First, there is only a remote chance that another party will take more than a minor amount of the output (in practice, more than a minor amount is typically defined as more than 10 percent). Second, the pricing indicates that the arrangement exposes the purchaser to some of the economic risks and rewards of the property producing the output. That risks and rewards determination is based on the product pricing. If the price per unit of output is neither fixed nor equal to the current market price per unit of output, the purchaser is deemed to be exposed to some of the economic risks and rewards of the property producing the output.

Assessing the likelihood that another party will take more than 10 percent of the output produced by property will make for challenging accounting assessments. For example, a purchaser that takes output equal to 81 percent of the capacity of a manufacturing facility would need to evaluate the likelihood that the manufacturer will be able to sell more than 9 percent of the facility’s output to others, in which case the total output of the plant would exceed 90 percent of its capacity. The Consensus does not provide much guidance on how to make that determination. It says that all evidence should be considered, including the arrangement’s pricing. It also implies through an example that pricing designed to recover the seller’s capital investment in property “may be” persuasive evidence that the purchaser will take substantially all of the output.

THE COMPONENTS OF THE ARRANGEMENT

The lease and non-lease components of a combined sales arrangement must be accounted for separately by the seller and purchaser. Sellers must record rental or leasing income and revenue from sales of products or services. Purchasers must

treat the arrangement as a lease, either capital or operating, and the purchase of products or services. The cash or other consideration in the arrangement should be allocated between the lease and non-lease deliverables based on their relative fair values. Obtaining fair value information for this purpose will be difficult whenever the components of the arrangements are not sold or delivered separately. For example, a satellite TV company that provides equipment (e.g., a satellite dish and receiver) only to customers who buy its satellite services may have difficulty determining the fair value of the equipment lease.

WHEN TO REASSESS AN ARRANGEMENT

Arrangements should be assessed at their inception based on all available facts and circumstances. Subsequent reassessments are required in any one of these circumstances:

- The contractual terms change;
- A renewal option is exercised or an extension is agreed to, if the option or extension is within the terms of the original arrangements;
- The seller’s obligations under the arrangement no longer depend on specified property; or
- The property is substantially changed physically.

The last two conditions will be difficult for purchasers to ascertain without physical or operational control of the property.

The EITF provided detailed guidance on how to account for an arrangement when reassessment leads to a different conclusion about whether there is a lease. Under that guidance, no gain or loss is generally recognized as a result of reassessing whether there is a lease. Loss recognition could occur from applying the impairment criteria in Statement 144.³ Gain recognition could occur when what had been considered a supply arrangement is reassessed as a sales-type lease, subject to the continuing involvement criteria in Statement 66.⁴

(3) FASB Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, August 2001.

(4) FASB Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, October 1982.



REPORTING REVENUE

The Consensus requires sellers to report the revenue from the leasing component of the arrangement as leasing or rental income rather than revenue from product sales or services. Reports of significant rental or leasing income by sellers of products or services may be inconsistent with their disclosures about the nature of their businesses, which could confuse investors. Depending on the level of operating results regularly reviewed by the chief operating decision maker, the leasing component of revenue might also need to be considered a reportable operating segment for purposes of financial statement disclosure.

The accounting requirements under the Consensus could affect the timing of revenue recognition. Lease accounting could result in immediate revenue recognition from a sale of equipment (i.e., sales-type leases) or straight-line recognition of revenue from the use of property and equipment (i.e., operating leases). These patterns of revenue recognition could differ from the patterns that occur when recognizing revenues as sales of services or products.

EFFECT ON PURCHASERS

Purchasers' arrangements that previously would have been considered service or supply contracts and are now considered leases could affect both the timing of their expense recognition and the assets and liabilities on their balance sheets. If the lease is a capital lease, purchasers will have to recognize assets and liabilities in connection with the property producing the goods or services. The timing of expense recognition could change to straight-line, which could present a recognition pattern different from recognizing expenses as goods or services are acquired.

TRANSITION

The Consensus should be applied prospectively to arrangements agreed to, modified, or acquired in business combinations in fiscal periods beginning after May 28, 2003. Previous arrangements that would be leases or would contain a lease according to the Consensus will continue to be accounted for as purchase or sales arrangements. The mix of arrangements, some accounted for using prior accounting guidance and some reported as leases under the Consensus, will diminish period-to-period comparability. It will not be fully restored until existing arrangements expire, are terminated, or are modified and thereby become subject to the new requirements.

The descriptive and summary statements in this presentation are not intended to substitute for the text of the EITF Consensus on Issue 01-8. All relevant facts and circumstances should be evaluated to arrive at accounting and disclosures that comply with the Consensus. Persons who apply the Consensus should consult the text of the requirements and their accounting and legal advisors.

Additional information on how to implement the Consensus is available from KPMG LLP.

This is a publication of
KPMG's Department of
Professional Practice.
The phone number is
(212) 909-5600

Contributing authors:
Shaileen M. Tracy
Kimber K. Bascom
Kayreen M. Handley

Copies are available at:
www.kpmg.com