KPMG

Hot Topic: ASC 842

Lessor accounting for a supply agreement that includes a ‘free’ lease of equipment

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Suppliers (lessors) providing ‘free’ use of their equipment to facilitate sales of goods generally will need to allocate a portion of the consideration for goods sales to the ‘free’ lease.

Applicability

This Hot Topic applies only to lessors. Customers (lessees) should not analogize to the guidance herein because much of it derives conceptually from the interaction between Topic 842 and Topic 606 for lessors.

Customers’ (lessees’) accounting will depend on factors beyond those discussed in this Hot Topic, such as whether an enforceable minimum is cumulative (i.e. applies to the entire contract period) or periodic (e.g. the customer must purchase a specified number of goods each month, quarter or year during the contract period), and it will generally never be appropriate for a customer (lessee) to allocate none of the consideration in the contract or variable payments to the equipment lease.

Key impacts

A supplier of goods will frequently provide customers with related equipment for use with its goods for no stated consideration – i.e. the contract does not stipulate a fixed or variable payment expressly for the right to use the equipment. Rather, the customer pays only a per unit price for the applicable goods.

In these arrangements, the supplier (lessor) will generally need to allocate the consideration in the contract and any variable payments among the goods (e.g. consumables) and the ‘free’ lease of equipment using one of two methods: (1) minimum purchase method or (2) total estimated purchases method. The supplier cannot use the lessor non-separation practical expedient if the goods are determined to be transferred at a point in time, rather than over time, under Topic 606. This is the case even if it is expected that the goods will be sold for use with the leased equipment throughout the lease term.[1]

[1] See Question 4.4.13 of KPMG’s Handbook, Leases.

We believe the total estimated purchases method is always acceptable, while facts and circumstances will dictate whether the minimum purchase method is also acceptable. In general, we believe the minimum purchase method is more likely to yield an acceptable result if the minimum purchase amount is a substantial portion of the total expected purchases of goods by the customer under the contract. However, in limited circumstances, the minimum purchase method may be acceptable even when this is not the case (including when there is no minimum purchase required by the contract). An entity should apply the same method to similar circumstances.

Background

The following are examples of arrangements described above.

— A supplier of chemicals or gases may provide its customers with the right to use storage tanks (or other containers) to store the chemicals or gases until their use by the customer for no stated consideration. The only consideration that will be paid by the customer is a per unit purchase price for the chemicals or gases.

— A supplier of medical devices and related consumables may provide its customers with the right to use a medical device, with which the customer may use only the supplier's consumables, for no stated consideration. The only consideration that will be paid by the customer is a per unit purchase price for the consumables.

Terms and conditions of the arrangement, and other facts and circumstances, can vary. The following are examples (not exhaustive).

— Some contracts include a minimum purchase requirement, while others do not. Additionally, the minimum may be significant or minor compared to the total expected purchases by the customer under the contract.

— The supplier may sell the goods and/or the equipment separately – e.g. the goods may be sold separately to customers that previously purchased the equipment, and/or the equipment may be sold separately by the supplier to authorized dealers or resellers (and by them, separately to end customers).

Contracts with mandatory minimum purchase volumes

If a contract includes an enforceable minimum purchase volume of the goods, there is 'consideration in the contract' equal to the minimum amount of consideration the customer will pay the supplier to fulfill the minimum. Purchases above the minimum are 'optional purchases'.[2]

The supplier must consider whether there is a material right[3] related to the option of the customer to make purchases above the enforceable minimum; if so, the material right is a non-lease component of the contract.

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[2] See Question 5.3.10 and related examples in KPMG's Handbook, Revenue recognition.
[3] Chapter 8 of KPMG's Handbook, Revenue recognition, discusses identifying and accounting for material rights.

However, there would generally not be a material right if the per unit price for the optional purchases is the same as or more than the per unit price for the units that comprise the minimum. The discussion that follows assumes there is not a material right in the contract.

Depending on the facts and circumstances, we believe the supplier (lessor) should apply one of two methods to account for the contract.

Minimum purchase method

— **Step 1.** The supplier allocates the consideration in the contract (e.g. $100,000, based on a 10,000 unit purchase minimum at $10/unit) to the lease and the minimum purchase quantity based on the stand-alone selling prices of each. The 'lease payments' equal the portion of the consideration in the contract allocated to the lease.

— **Step 2.** The supplier accounts for the lease, including recognition of lease revenue, in accordance with Subtopic 842-30,[4] and recognizes revenue related to the promised goods in accordance with Topic 606.

— **Step 3.** Customer orders for optional goods above the purchase minimum are accounted for separately from the initial contract including the lease and the purchase minimum. Consequently, the consideration for those orders is allocated entirely to the optional goods ordered – i.e. none of the consideration from those orders is allocated to the ongoing lease.

Under this method (unlike the total estimated purchases method), the supplier does not need to estimate total expected customer purchases under the contract, and there is no *variable* lease revenue earned by the supplier.

We do not believe this method is appropriate if the amount that would be allocated to the lease under this method is inconsistent with the Topic 606 allocation objective[5] – e.g. it is an uneconomical amount. In that case, the lessor should use the total estimated purchases method. See discussion below about using the minimum purchase method when the contract does not include a mandatory minimum purchase volume.

We believe the minimum purchase method is more likely to yield an acceptable result if the minimum purchase amount is a substantial (not minor) portion of the total expected purchases of goods by the customer under the contract.

Total estimated purchases method

— **Step 1.** The supplier allocates the consideration in the contract (calculated in the same way as under the minimum purchase method) to the lease and the total expected purchase quantity (rather than the minimum purchase quantity) based on the stand-alone selling prices of each. The 'lease payments' equal the portion of the consideration in the contract allocated to the lease, which will be less than what is allocated to the lease under the minimum purchase method, because the total expected purchase quantity generally will exceed the minimum purchase quantity.[6]

— **Step 2.** The supplier accounts for the lease, including recognition of lease revenue, in accordance with Subtopic 842-30,[4] and recognizes revenue related to the promised goods (i.e. the committed minimum) in accordance with Topic 606.

— **Step 3.** Customer orders for optional goods above the purchase minimum are not accounted for separately. Because the original allocation of the consideration in the contract contemplated customer orders above the purchase minimum, and therefore allocated less consideration to the

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[4] See Chapter 7 of KPMG's Handbook, Leases.
[5] See paragraph 4.4.190 of KPMG's Handbook, Leases.
[6] See Example 4.4.25 of KPMG's Handbook, Leases.

lease, the consideration from each order is allocated to the lease and the goods ordered on the same basis as the consideration in the contract was allocated originally.

— **Step 4.** Amounts allocated to the lease under the optional goods orders are accounted for as variable lease payments. The amount allocated to the goods in each order is the Topic 606 'transaction price' for those goods and is recognized in accordance with Topic 606.

We believe the total estimated purchases method is acceptable under any circumstance – i.e. regardless of whether the minimum is a substantial or minor portion of the customer's total expected purchases under the contract. In circumstances where use of the minimum purchase method would yield a result that is inconsistent with the Topic 606 allocation objective, we believe the total estimated purchases method must be used. See discussion below about using the minimum purchase method when the contract does not include a mandatory minimum purchase volume.

Contracts without mandatory minimum purchase volumes

Based on discussions with the FASB and SEC staffs about contracts of this nature, in general we believe that when the contract does not include a minimum purchase requirement, the supplier should use the total estimated purchases method.

Applying the total estimated purchases method to these contracts will differ from its application to contracts that include a minimum purchase requirement. This is because the contract will include no 'consideration in the contract'. Therefore, in effect, only Steps 3 and 4 of the total estimated purchases method will apply.

In limited circumstances, the minimum purchase method may be acceptable. Based on our discussions with the FASB and SEC staffs, this method, which would result in no allocation of payments stemming from the customer's orders for the supplier's goods to the lease, would be appropriate only when both:

a. the lease is insignificant in value, such that the customer would effectively view the lease as a 'convenience', rather than a valuable aspect of the contract; and

b. there is objective evidence that the price for the goods available for purchase under the contract is the stand-alone selling price for those goods. In other words, the price offered for the goods is the observable stand-alone selling price of the goods when sold separately to customers that are not leasing the supplier's equipment, such as customers that previously purchased the supplier's equipment or another vendor's equipment with which the supplier's goods can be used.

While not expressly stated by the staffs, it appears to be their view that when these criteria are met, allocating no consideration from the customer's goods orders to the lease would not be inconsistent with the Topic 606 allocation objective – i.e. it would not be an uneconomical reflection of the transaction.

Related to criterion (a), based on our discussions with the FASB and SEC staffs, we believe:

— This requirement would be met only if the underlying asset is inexpensive – i.e. has an insignificant fair value – such that the stand-alone selling price of the lease is insignificant. In other cases (e.g. if the asset is an expensive piece of medical equipment, for which the stand-alone selling price of a lease thereof would be more than insignificant), it would not be reasonable to ascribe no economic value to the lease, regardless of the price for the goods offered under the contract.

— Significance in the context of this criterion is not determined on a relative basis – i.e. the stand-alone selling price of the lease relative to the stand-alone selling price of the total expected consumable purchases. In other words, it is not relevant to the evaluation of this criterion whether the portion of the total expected payments that would be allocated to the lease is insignificant in relation to the customer's total expected payments under the contract.

Example

Supply agreement with no stated consideration for the lease

Supplier, a chemical manufacturer, enters into a supply agreement with Customer to sell chemicals (Chemical) over a five-year period.

As part of the agreement, Supplier provides a storage tank to Customer for storing and using Chemical during the same period. The contract stipulates that the storage tank is provided at no additional charge. Supplier retains title to the storage tank. At the end of the five years, the storage tank will be returned to Supplier.

Under the contract, Customer is required to make minimum purchases each year and must pay a penalty if its actual purchases do not meet the required minimum. There is not a material right in the contract because the unit pricing for Chemical is the same throughout the contract period.

The following additional facts are relevant.

Minimum purchase requirement:	22,500 units per year (112,500 total)
Expected purchases:	30,000 units per year (150,000 total)
Contract price of Chemical:	$2.50/unit
Penalty for failing to reach the minimum purchase requirement:	$0.20/unit of shortfall
Stand-alone selling price of the storage tank lease:	$18,000
Renewal options:	None
Storage tank purchase option:	None
Remaining economic life of the storage tank:	10 years
Fair value of the storage tank:	$22,500
Lessee or third-party residual value guarantees:	None

Supplier determines that the penalty is substantive, and therefore the minimum purchase requirement is deemed to be enforceable. In addition, Supplier concludes that $2.50/unit is the stand-alone selling price of Chemical in other contracts.

To account for the arrangement, Supplier must determine how to allocate the consideration in the contract and variable payments between the lease component (i.e. the right to use the storage tank) and the non-lease component (i.e. purchases of Chemical).

Approach 1: Minimum purchase method

Supplier determines that the minimum purchase method is acceptable because the total allocation to the lease is reasonable when considered against the Topic 606 allocation objective. That is, as illustrated below, the total lease revenue that will be recognized is in line with the stand-alone selling price for the lease.

Step 1

The consideration in the contract is based on the minimum purchase volume. This results in total consideration in the contract of $281,250 (112,500 units × $2.50/unit). This amount is allocated to the storage tank and the minimum purchase quantity of Chemical based on their stand-alone selling prices.

Component	Units	Stand-alone selling price	Total stand-alone selling price	Allocation	Calculation
Storage tank	1	$ 18,000	$ 18,000	$ 16,917	(18,000 / 299,250) × 281,250
Units of Chemical	112,500	$ 2.50	281,250	264,333	(281,250 / 299,250) × 281,250
			$ 299,250	**$ 281,250**	

Step 2

Supplier recognizes total lease revenue of $16,917 on a straight-line basis over the five-year lease term ($3,383 per year) because the lease is classified as an operating lease. Supplier recognizes product revenue by allocating a transaction price of $2.35 ($264,333 / 112,500 units) to each unit of Chemical as it is sold until the minimum purchase requirement is met.

Step 3

Once the minimum purchase requirement of 112,500 units is met, the consideration for additional orders is allocated entirely to the optional purchases of Chemical. Therefore, the transaction price for these optional purchases is $2.50 per unit. No variable lease revenue is recognized by Supplier.

Description	Allocation	Calculation
Straight-line operating lease revenue recognized over five years	$ 16,917	112,500 units × [(18,000 / 299,250) × $2.50]
Topic 606 revenue recognized for units of Chemical sold against the minimum purchase requirement	264,333	112,500 units × [(281,250 / 299,250) × $2.50]
Topic 606 revenue recognized on optional Chemical purchases above the minimum	93,750	37,500 units × $2.50
	$ 375,000	

Approach 2: Total estimated purchases method

Step 1

The consideration in the contract is still based on the minimum purchase requirement because those purchases represent the fixed payments in the contract. Therefore, the consideration in the contract is still $281,250 (112,500 units × $2.50/unit).

However, this consideration is allocated to the storage tank and the total expected purchase quantity (rather than the minimum purchase quantity) based on their stand-alone selling prices.

Component	Units	Stand-alone selling price	Total stand-alone selling price	Allocation	Calculation
Storage tank	1	$ 18,000	$ 18,000	$ 12,882	(18,000 / 393,000) × 281,250
Units of Chemical	150,000	$ 2.50	375,000	268,368	(375,000 / 393,000) × 281,250
			$ 393,000	**$ 281,250**	

Step 2

Supplier recognizes operating lease revenue of $12,882 on a straight-line basis over the five-year lease term ($2,576 per year) because the lease is classified as an operating lease. Supplier recognizes product revenue by allocating a transaction price of $2.39 ($268,368 / 112,500 units) to each unit of Chemical as it is sold.

Step 3

The original allocation of the consideration in the contract contemplated additional orders above the purchase minimum, and therefore allocated less consideration to the lease. As a result, the consideration from each order is allocated to the storage tank and purchases of Chemical on the same basis as the consideration in the contract was allocated originally – i.e. $2.39 to each unit of Chemical purchased and the remaining $0.11 to the storage tank.

Step 4

Amounts allocated to the lease from optional purchases of Chemical above the purchase minimum in Step 3 are accounted for as variable lease payments. The amount allocated to the units of Chemical in each such order is the Topic 606 'transaction price' for each unit of Chemical. Total amounts recognized for each component are as follows.

Description	Allocation	Calculation
Straight-line operating lease revenue recognized over five years	$ 12,882	112,500 units × [(18,000 / 393,000) × $2.50]
Topic 606 revenue recognized for units of Chemical sold against the minimum purchase requirement	268,368	112,500 units × [(375,000 / 393,000) × $2.50]
Topic 606 revenue recognized on optional Chemical purchases above the minimum	89,456	37,500 units × [(375,000 / 393,000) × $2.50]
Variable lease revenue arising from optional Chemical purchases above the minimum	4,294	37,500 units × [(18,000 / 393,000) × $2.50]
	$ 375,000	

For further information

For more information about the lessor allocation requirements in arrangements that include lease and non-lease components, refer to section 4.4 in KPMG's Handbook, Leases.

This document is part of a series to highlight implementation issues related to Topic 842.

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