Service components in real estate leases and the impact of IFRS 15

Lease contracts for real estate in Canada often contain more than just a right of use for a specified portion of a building (or land and building). It is common for a lease agreement to contain terms that require the landlord to provide certain services to the lessee. Examples include common area services, including security or janitorial services, and the provision of utilities for use in the leased space, such as lighting, heating and air-conditioning. The contract may also specify the landlord's obligations with respect to items such as maintenance of the common areas and elevators or escalators, as well as structural maintenance and so on. Some leases charge for these obligations separately on a cost recovery basis, for example, triple net leases which are common in commercial real estate. Other leases, such as gross leases, do not charge separately for these obligations and they are factored into the base rent. For example, many residential leases are gross leases.

Separating components of a lease contract

Under both existing IFRS (IFRIC 4) and future lease accounting standards (IFRS 16), a lessor is required to account for a lease element separately from other elements in the arrangements, such as services. The lease element is accounted for under the leasing guidance (i.e. IAS 17 or IFRS 16 as applicable). The accounting for the other elements depends on their nature, for example the revenue recognition standard is applied when the element is for the provision of services.

Prior to the adoption of the new revenue standard (IFRS 15), the pattern of revenue recognition of these “service elements” and the pattern of recognition under a lessor’s operating lease accounting was often not significantly different. Accordingly, many Canadian real estate entities did not distinguish revenues earned from providing services from those relating to use of the underlying assets.

What changes with the adoption of IFRS 15?

There are a number of impacts of IFRS 15 that warrant real estate entities taking a closer look at their accounting for services provided to tenants:

- IFRS 15 provides clarity that performance obligations are promises to transfer distinct goods or services to a customer and can provide additional guidance on separating components of arrangements into lease and non-lease components.
- IFRS 15 has a different model for the recognition of variable consideration than that which is expected to be applied by lessors under IAS 17/IFRS 16. In certain circumstances this could result in a different pattern of revenue recognition for service components compared to lease components.
- IFRS 15 has enhanced disclosure requirements that will need to be considered for elements that are in scope of IFRS 15. This includes disclosing revenue from services separately from lease revenue and providing information about unfulfilled performance obligations. These disclosure requirements apply to service components within both “gross” and “net” lease contracts.

The extent to which any company is affected will depend on the nature and materiality of their leasing and service arrangements.

Determining whether a promise is a service or part of the lease component

Under IFRS 15, lessor entities need to consider what non-lease performance obligations they are responsible for and allocate consideration to these distinct performance obligations. For example, some promises in the contract are clearly distinct services that transfer a good or service to the tenant that the tenant benefits from separately, such as the provision of building security, janitorial services, or utilities. These non-lease performance obligations need to be considered regardless of whether the lease is a “gross” or a “net” lease contract.

A landlord may not be providing a service to a tenant merely because the tenant is charged separately for it. If the lessee’s payment is in relation to activities and costs of the lessor that do not transfer a good or service to the lessee, these will not give rise to a separate component of the contract. Put another way, reimbursements of lessor costs that do not provide a distinct service to the lessee are not separate performance obligations. Examples of these reimbursements of lessor costs that are common in triple net leases are property taxes, landlord’s insurance (when the tenant does not benefit from the insurance services themselves) and other “owner operating cost” charges such as for the landlord’s cost of personnel involved in ownership, administration, and management of the property or auditing, accounting, legal and other consulting fees that relate to the building operations.

For some contractual terms, significant judgment may need to be applied to determine whether the landlord transfers a service to the lessee or whether the required actions of the landlord are to ensure the tenant's right-to-use and access a specified asset under the terms of the lease. For example, a promise to maintain the building elevators may be seen as a service to provide well maintained and functioning elevators. Elevators in a multi-tenant building are generally not a leased asset subject to a right-of-use, as they are shared by all tenants and all tenants benefit from the elevators, therefore access to elevators might be accounted for as a service component separately from the lease component. Alternatively, some may view the obligation to maintain elevators as a promise that the lessee can safely and appropriately access to the leased property, for example when the leased space is the 10th floor of a multi-story building. This ability to access the property safely may be viewed as not being distinct from the right-of-use of that office space and therefore would not be a separate non-lease component. Capital expenditure programs that are recoverable from tenants also need to be considered carefully. The cost of an asset (or betterment of an asset) that is recorded as part of the investment property is not a good that is transferred to a tenant. However, these may indicate that the landlord has an obligation to allow the tenant a right-to-use a resulting specific asset (which may be a separate lease component) or access to a resulting shared asset, such as a common area (which may be a distinct service).

Some leases also include other lease components, such as the right-to-use a parking lot or specific parking area. Generally, unless the promise is an integral (non-distinct) part of the right-to-use the specified asset for the lease term it should be separated from the lease and treated as a separate lease or non-lease component. In making these judgments management may have to consider the context of the contractual terms, the nature of the building, and the substance of the arrangements. When the landlord contracts with third parties to provide services to tenants, the landlord will also have to consider whether they are a principal or an agent in the transaction, which is determined by assessing whether the landlord controls the service prior to it being delivered to the tenant. Under IFRS 15, credit risk is not an indicator of control – rather landlords would look to whether they have the primary responsibility for fulfilling the service component obligations under the contract and whether they have 'inventory risk' (for example, paying the service provider for servicing vacant space).

Recognition implications

We expect that a consistent pattern of revenue recognition will still apply to lease revenue and service revenue in many situations. However, variable payments for the lease component may be recognized later than revenue for services in situations where:

- The landlord offers a "rent-free" period that also gives the tenant relief from payments of common area costs and other services for a period when the landlord is still required to provide those

EXAMPLE: FIT-OUT PERIOD SERVICES

RealCo provides a 6 month rent-free fit-out period to a new tenant as a tenant inducement for a 5-year lease, and does not charge common area maintenance or other recoverable costs to the tenant over this time. However, the lease contract obligates RealCo to provide certain services, such as building security services, over the entire lease term including the fit-out period. Building security services are determined to be a series of distinct services transferred to a customer in a consistent and consecutive pattern over time and therefore is one performance obligation.

RealCo is an experienced real estate landlord and can reasonably estimate the total cost of building security over the 5-year lease term – at least to the extent of the amount that is not subject to a significant risk of reversal.

As RealCo can estimate the total amount of revenue that will be earned by providing building security services over the term of the lease, RealCo should recognize revenue for those services over the fit-out period based on the estimated amount of consideration that relates to the services performed.

services to the tenant under the terms of the lease, **and**

- The payments for services are fixed or, when they are charged on a cost recovery basis, the costs of the services can be reliably estimated over the initial contract (lease) period, meaning that the revenue to be earned on the provision of the services can also be reliably estimated.

Under both IAS 17 and IFRS 16 a lessor's rental revenue from minimum lease payments is recognized on a straight-line basis over the term of the lease. Neither IAS 17 nor IFRS 16 deal specifically with recognition of contingent or variable lease payments that are not dependent on an index or rate from a lessor's perspective. There is guidance for lessees, however, who required to recognize an expense for such payments in the period in which the event or condition that triggers those payments occurs. This generally means that the expense is recognized in the period in which the lessor incurs costs that are recoverable under the lease agreement. We believe that most lessors will take a similar approach, consistent with current practice under IAS 17, in regards to the recognition of revenue relating to variable lease payments that are not dependent on an index or rate and recognize these in the period in which the event or condition that triggers the payment occurs. In other words, revenue from variable lease payments are generally recognized when the lessor can charge them, with no amounts recognized in respect of variable lease payments during the free rent period when, under the lease contract, the lessor cannot charge these costs to the tenant.

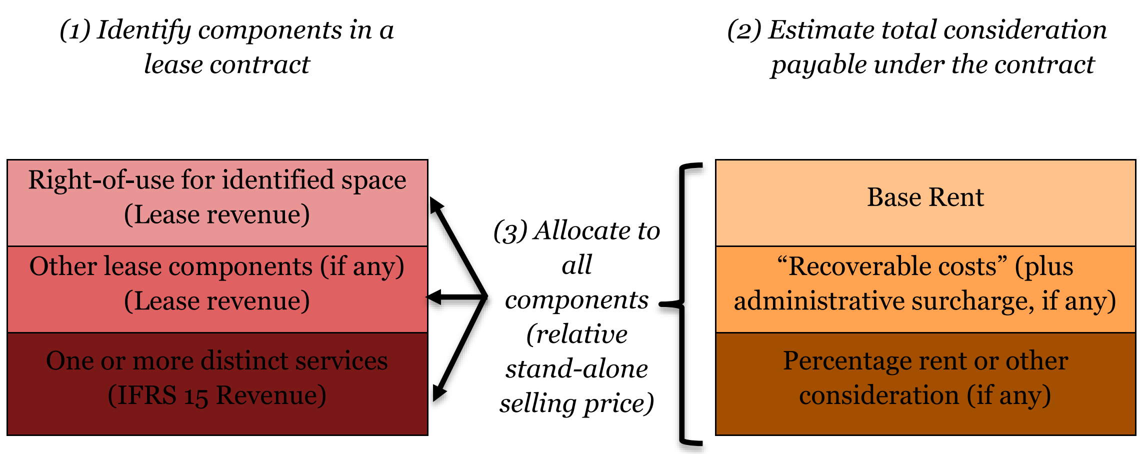
However, the revenue recognition concept for services – performance obligations recognized over time under IFRS 15 – is to recognize revenue as control of those services passed to the customer. This is generally as those services are delivered to and consumed by the tenant, even when the consideration received for those services is variable. Services delivered over time on a consistent basis are generally treated as one performance obligation under IFRS 15. An estimate of the consideration to be received under the contract is made and the total consideration must then be allocated to lease and non-lease components and revenue allocated to the service performance obligations that are recognized as services are provided. (Allocation is considered further below). The estimates of variable consideration are subject to a "constraint". The constraint means that revenue can only be recognized to the extent it is highly probable the cumulative revenue recognized on the contract will not be subject to a significant reversal. However, when the amount of revenue recognized under a contract is estimable and *not* highly probable of reversal, this amount *must* be recognized as those services are provided to the tenant. In other words, revenue would be recognized for services provided during the full service period including free rent periods. In these cases it may be important to determine whether a promise within a lease agreement is a service or part of the lease component. When recognizing revenue in these circumstances it is important to remember that the impact of the constraint might change over the life of a long-term contract, as the amount of cumulative revenue that can be recognized under the constraint must be re-estimated at each balance sheet date.

Impact on allocation of consideration between lease and service elements

Regardless of the reason for the payment by the tenant – base rent, percentage rent, recovery of the cost of services, recovery of capital costs, administrative surcharge and so on – all payments from the lessee under the lease contract are consideration for the right-of-use of the leased space and identified services and must be allocated between the lease and service components. Even when there is no difference in the timing of the recognition of lease and service revenue, allocation will affect the amounts to be disclosed for each type of revenue.

Under IFRIC 4 allocations of payments are made between lease and service elements on a relative fair value basis. In contrast, IFRS 16 requires the allocation of payments between lease and non-lease components to be made using the guidance in IFRS 15; that is, based on relative stand-alone selling prices. We believe that in most cases relative fair values and relative stand-alone selling prices would approximate each other in a typical real estate lease. Generally, variable consideration is allocated across all components in an arrangement, consistent with relative stand-alone selling prices. However, IFRS 15 also requires that variable consideration is allocated only to a specific performance obligation (rather than across all performance obligations) when the payment relates specifically to the satisfaction of that performance obligation and the result is consistent with the general objective of allocating consideration. Services priced on a cost-recovery basis that are billed to the tenant in the periods in which the landlord incurs those costs have variability that relates specifically to the satisfaction of delivering those specific services – the higher the cost of those services, the more is charged for them. Allocating revenue to each service performance obligation based on the amounts permitted to be invoiced for that performance obligation under the arrangement may reflect the allocation objective in IFRS 15, which is to depict the amount of consideration to which the entity expected to be entitled in exchange for transferring the services to the customer. If an entity is relying on this practical expedient, care should be taken to ensure that the arrangements with the customer do provide a right to invoice the tenant for the variable amount in the same period as the services are provided. For example, arrangements that provide for billing in estimated equal installments over a period with a “true-up” at the end of the period may not meet the requirements for this practical expedient if the installment amounts billed do not reflect the performance completed to that date.

Allocating consideration to lease and service components



Allocation objective:

Allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer (IFRS 15.73).

Impact of lease and service elements – Lessee perspective

Lessees may also account for the service components of a lease contract separately from the lease component. However, IFRS 16 provides a practical expedient for lessees to combine any service components with the lease component and treat the entire contract as a lease. This is a choice that a lessee makes by class of underlying asset (e.g. all building leases must be treated the same way). Lessors do not have the option to treat both the lease and service components of a lease arrangement as a single lease component.

Impact on disclosures

Revenue that is in scope of IFRS 15 is subject to additional disclosure requirements. Entities need to consider the level of detail necessary to satisfy the disclosure objective of IFRS 15 including how much emphasis to place on each of the various requirements. IFRS 15 requires an entity to disclose amounts for revenue recognized from contracts with customers separately from its other sources of revenue (i.e. separately from lease income). As IAS 1 does not require lease income to be presented separately from service revenue on the face of the income statement, entities have a choice as to whether to present these revenue streams separately on the face of the income statement or aggregate these for income statement presentation with additional disclosure of the breakdown between lease revenue and service revenue in the notes to the financial statements. In either case, the amounts of revenue earned from the service components within real estate leases should be evaluated and disclosed.

The following is a comparison of potentially relevant IFRS 15 disclosures compared to current IAS 18 disclosures, as well as a comparison of current IAS 17 disclosures compared to IFRS 16 disclosures relevant to the lessor's lease component.

IAS 18 disclosures relevant to services and variable consideration	IFRS 15 disclosures relevant to revenue recognized over time and variable consideration (selected disclosure requirements only)
Disclose the accounting policies adopted for the recognition of revenue, including the methods adopted to determining the stage of completion of transactions involving the rendering of services.	Disclose the significant judgments, and changes in the judgments, made in applying IFRS 15 to contracts with customers. In particular: (a) the timing of satisfaction of performance obligations; and (b) the transaction price and the amounts allocated to performance obligations.
Disclose the amount of each significant category of revenue recognized during the period including revenue arising from the rendering of services.	Disclose amounts for revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue. An entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment, if the entity applies IFRS 8, *Operating Segments.*
	Disclose: (a) the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed; (b) revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period; and (c) revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).
	An entity shall explain how the timing of satisfaction of its performance obligations relates to the typical timing of payment and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.
	An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information.
	An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following: (a) when the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered or upon completion of service), including when performance obligations are satisfied in a bill-and-hold arrangement; (b) the significant payment terms (for example, when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained); (c) the nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e. if the entity is acting as an agent); (d) …

IAS 18 disclosures relevant to services and variable consideration	*IFRS 15 disclosures relevant to revenue recognized over time and variable consideration (selected disclosure requirements only)*
	An entity shall disclose the following information about its remaining performance obligations: (a) the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period; and (b) an explanation of when the entity expects to recognize as revenue the amount disclosed in (a) above on either a qualitative or quantitative basis. This information need not be disclosed if either the performance obligation is part of a contract that has an original expected duration of one year or less or the entity recognizes revenue from the satisfaction of the performance obligation in accordance with the practical expedient to recognize revenue on the right to invoice (IFRS 15.B16)
	For performance obligations that an entity satisfies over time, an entity shall disclose both of the following: (a) the methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied); and (b) an explanation of why the methods used provide a faithful depiction of the transfer of goods or services.
	An entity shall disclose information about the methods, inputs and assumptions used for all of the following: (a) determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration; (b) assessing whether an estimate of variable consideration is constrained; (c) allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable); and, (d) measuring obligations for returns, refunds and other similar obligations.

Current disclosures for real estate lessors with operating leases	IFRS 16 disclosures for real estate lessors with operating leases
IAS 17 does not contain a disclosure objective.	Disclosure objective: The objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.
The disclosure requirements IAS 40 apply to lessors for assets provided under operating leases.	Same requirement.
Disclose the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods: (i) not later than one year; (ii) later than one year and not later than five years; (iii) later than five years.	A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.
Disclose total contingent rents recognized as income in the period.	Disclose amounts of lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate. Provide the disclosure in a tabular format, unless another format is more appropriate.
Disclose a general description of the lessor's leasing arrangements.	*To meet the disclosure objective*: Include information to help users assess the nature of the lessor's leasing activities.
	To meet the disclosure objective: Include information to help users assess how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor shall disclose its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk. Such means may include, for example, buy-back agreements, residual value guarantees or variable lease payments for use in excess of specified limits.