



Solution 124.6

Component	Automotive industry
Index	Tooling – asset and/or revenue
Short title	Does a tooling agreement contain a lease?

Attention: This guidance is based on the revised standards and interpretations that are mandatory for accounting periods commencing 1 January 2005. A company may early adopt an individual revised standard, but only in its entirety.

Issue

IFRIC 4 addresses the issues [\[IFRIC4.5\]](#):

- (a) how to determine whether an arrangement is, or contains, a lease as defined in IAS 17;
- (b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and
- (c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

When does a tooling contract contain a lease?

Background

Entity Y is a car parts supplier entering into an arrangement with entity X (vehicle manufacturer) to design, develop and manufacture a new generation of car seats for a new generation of vehicle.

The outlines of the arrangement are the following:

- To fulfil the arrangement entity Y shall develop and custom build the tooling, consequently the cost for the tooling is the sum of development costs and cost of material.
- Inventions and know-how embedded in the tooling are granted royalty free to entity X. Entity Y is responsible for repairs, maintenance and capital expenditure.
- Entity Y will recover the costs of the tooling as above defined (development costs and cost of materials) through a fixed price per component over the production period, according to guaranteed volumes. The invoice shows separately the component dedicated to the use of the tool and the one dedicated to manufacturing. In case entity X stops production of the new vehicle or decides to manufacture a number of vehicles lower than the



guaranteed volumes, entity X is committed to completely repay entity Y for the costs sustained (take or pay).

- The arrangement conveys to entity X the right to exercise a purchase option on the tooling at any time, this is to 1) safeguard against the stop of production in case of entity's Y default and 2) be free to move the production abroad to another supplier. If the option is exercised the purchase price equals the portion of the cost of the tooling not yet repaid by entity X through the piece price per component.
- The tooling is so specific that it cannot be used to fulfil other contracts and entity Y cannot perform the obligation through the use of alternative assets.
- Car seats can be sold exclusively to entity X, which undertakes also the distribution of spare parts. The contract will last three years, a period that equals the economic useful life of the tooling.
- The arrangement sets minimum and maximum production volumes for entity Y, which is committed to structure its capacity accordingly. Entity X submits to entity Y the tentative demand for the following week in advance, no later than 48 hours in advance, X submit to Y the final demand for each day.
- Entity X has the contractual right to perform PDE (Pre Delivery Inspection) at any time for each seat exiting the line, and retains the right to reject defective seats that do not comply with the contractual specifications.

Solution

The tooling agreement contains a lease in accordance with IFRIC 4.

The fulfilment of the arrangement depends on the use of a specific asset [\[IFRIC4.6\]](#): tooling is custom built by entity Y, fully dedicated to that production and the use of alternative assets is not possible. All the output, inclusive of spare parts, can be sold exclusively to the vehicle manufacturer, which has the right of inspection and rejection.

The arrangement conveys a right to use the asset (it conveys the purchaser the right to control the use of the underlying asset) [\[IFRIC4.9\(a\),\(c\)\]](#). Entity X controls the use of the underlying asset because it is remote that any other party than entity X will take more than an insignificant amount of the output of the assets: the only customer of entity Y is entity X, entity X sets minimum and maximum production volumes and has a purchase option at any time on the tooling. Moreover the price for the output is neither contractually fixed per unit of output, because it is a "take or pay" contract (entity X is committed to fully repay to entity Y for the cost of the tooling), nor equal to the current market price, because the supply price is not marked to market during the life of the arrangement.



The payments for the lease are separable from payments from any other elements in the arrangement [IFRIC4.9]: entity Y will recover the costs of the tooling through a piece price per component over the production period.

The agreement contains a finance lease in accordance with IAS 17, because of the specialised nature of the asset and because the term is for the economic life of the asset. The payments under the arrangement are allocated between the lease component for the use of the tool and the component for the manufacturing of the car seats.

Entity Y

Entity Y is the lessor and manufacturer. Y recognises a lease receivable equalling to the amount of the net present value of the minimum lease payments. Since entity Y has no business practice of selling tools and does not have a policy for recognising revenue on sales of tools, no gain or loss should be recognised at inception and the carrying amount of the receivable will equal the production cost of the tools [IAS17.43].

Lease payments received are split into interest income and the reimbursement of the lease receivable. Payments allocated to the manufacturing of the car seats are recognised as sale of goods.

Entity X

Entity X is the lessee and purchaser. Entity X recognises the tool as an asset and a lease liability at the lower of the fair value of the asset or the net present value of the minimum lease payments. If X is not able to reliably separate the minimum lease payments from the contract, it should recognise the asset at fair value [IFRIC4.15(a)]. The tool is amortised over the shorter of the economic useful life or the lease term. Payments allocated to the lease component are split into interest expense and amortisation of the lease liability. Payments allocated to the manufacturing are recognised as cost of goods sold/inventory.