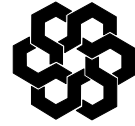




Financial Accounting
Standards Board



INTERNATIONAL
ACCOUNTING STANDARDS
BOARD

<p>For Discussion at the IASB's May 2009 Board Meeting</p>
<p>For Discussion at the FASB's May 18, 2009 Board Meeting</p>

LESSOR ACCOUNTING – RIGHT-OF-USE MODEL

Introduction

1. As discussed in the leases Discussion Paper (DP), *Leases: Preliminary Views*, in July 2008 the boards tentatively decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model. Consequently, the boards have not discussed accounting for lessors in detail. However, the boards included a chapter in the DP, which sets out some of the issues that will need to be resolved in developing any proposed new standard for lessors.

2. The FASB staff is undertaking initial work on lessor accounting issues during the comment period of the DP. The FASB staff plans to meet with the boards twice during the comment period to obtain preliminary views on the following issues:
May 2009 Board Meetings:
 - a. Analysis of rights and obligations in a simple lease contract
 - (1) Lessor has an asset for the right to receive payments over the lease term
 - (2) What is the credit?
 - i. Approach A - The lease contract transfers a portion of the leased item
 - a. Lessor has an asset for its residual rights in the leased item at the end of the lease term
 - b. Lessor derecognizes all or a portion of the leased item
 - c. Lessor recognizes revenue at the start of the lease
 - ii. Approach B - The contract created a new right and obligation
 - a. Lessor has an obligation to permit use of the leased item (no derecognition)
 - b. Revenue is recognized as the performance obligation is satisfied (over the lease term)

- (3) Presentation of Approach A and Approach B (statement of financial position).

July 2009 Board Meetings:

- a. Initial and subsequent measurement of the asset and the liability
 - b. Work with revenue recognition team on contingent fees and options from the lessor's perspective.
3. Following those meetings, the staff will ask the boards, based on the progress made, whether the exposure draft (ED) should include lessor accounting.
4. If the boards decide to include lessor accounting in the ED, the staff will ask the boards at each meeting throughout redeliberations to consider all issues from both a lessee and a lessor perspective. If the boards are able to make decisions on these issues on a timely basis, it may still be possible to meet the proposed timetable (issuing an ED in the first half of 2010).

Analysis of rights and obligations in a simple lease contract

5. If a right-of-use model were applied to lessors, lessors would not be required to classify a lease as a finance lease or an operating lease. Existing standards, which focus on whether risks and rewards of the leased item are transferred, would be replaced with a right-of-use model for lessors. Under a right-of-use model, the lessor would identify rights and obligations arising under the lease contract.
6. After identifying the lessor's rights and obligations arising in a simple lease, the boards will then consider whether those rights and obligations meet the definitions of assets and liabilities. This paper does not consider the measurement of any assets or liabilities identified. That issue will be considered at a later date.
7. Although the wording of the existing IASB and FASB asset and liability definitions are different, the concepts underpinning them are the same. The

IASB's *Framework for the Preparation and Presentation of Financial Statements* and the FASB's Concepts Statement No. 6, *Elements of Financial Statements* (CON 6),¹ have the following characteristics of an asset in common:

- (a) The entity **controls** an economic resource or benefit.
 - (b) It arises out of a **past event**.
 - (c) **Future economic benefits** are expected to flow to the entity.
8. Similarly, the boards' liability definitions contain the same basic characteristics:
- (a) There exists a **present obligation** of the entity.
 - (b) The obligation arises out of a **past event**.
 - (c) The obligation is expected to result in an **outflow of economic benefits**.
9. These common characteristics will be used to analyse whether the rights and obligations identified in a simple lease meet the definition of an asset or liability.
10. The staff has analyzed the rights and obligations arising in a simple lease arrangement using the following example:

Example 1

A machine is leased for a fixed term of five years; the expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machine at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machine has been delivered; these are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.

11. Lease contracts are often much more complex than the lease described in example 1. However, by analysing a simple lease, the boards can identify the rights and obligations that are common to most lease contracts.

¹The boards are currently working on a joint project that will revise the definitions of assets and liabilities (the conceptual framework project). However, until that project is finalised, the boards will use the existing definitions.

12. To simplify the analysis further, only those rights and obligations that exist after the leased item is delivered to the lessee will be considered. Assets and liabilities may arise before delivery of the leased item (eg when the contract is signed). Timing will be discussed at a later date.
13. The lease described in this example is non-cancellable, ie the lessee has no contractual right to terminate the lease agreement, return the machine, and cease making payments to the lessor. Equally, the lessor has no contractual right to terminate the lease agreement and demand the return of the machine before the end of the lease term. Leases that incorporate a contractual right of termination (cancellable leases) will be discussed at a later date.

Lessor's right to receive rental payments during the lease term

14. The boards have previously reached a tentative decision that the right to receive rental payments from the lessee meets the definition of an asset for the lessor. That previous analysis considered that the lessor's right to receive payments (its receivable) becomes unconditional and is controlled by the lessor (it is legally enforceable) once the machine has been delivered. Under a noncancellable lease, the lessee would have to make all lease payments unless the terms of the lease contract are broken.
15. The lessee can normally avoid making payments under the lease contract only if in some way the lessor breaches the terms of the lease contract. The right to receive payments is controlled by the lessor (it is legally enforceable). It arises out of a past event (the delivery of the leased item) and gives rise to future economic benefits.

16. Consequently, this right to receive payments during the lease term meets the definition of an asset for the lessor. The measurement of this asset will be considered at a future meeting.

Question 1 – Do the boards agree that the lessor has an asset for its right to receive rental payments from the lessee?

What is the credit?

17. The next decision that the boards must make is how to apply a right-of-use model to lessors for the credit. That is, does the lessor derecognize all or a portion of the leased item or does the lessor have a liability for the obligation to allow the lessee to use the leased item? Under the first approach, the lessor is viewed as having transferred a portion of the leased item to the lessee. Under the second approach, the lease contract is viewed as creating a new right, leaving the lessor's rights relating to the leased item unchanged. Both of these approaches are further analyzed below.

Approach A: Lease contract transfers a portion of the leased item

18. Under this approach, the lessor exchanges all, or a portion of, its right to use the leased item for the right to receive payments from the lessee over the lease term. In addition, the lessor retains the right to the leased item at the end of the lease term.
19. The exchange results in the lessor derecognizing the leased item and recognizing a receivable (a financial asset) and a residual value asset (a non-financial asset). The receivable asset was discussed above, and would be recognized under either Approach A or Approach B. However, under Approach A, the lessor exchanges its right to use the leased item, but retains a residual right to the leased item at the end of the lease term. That right is discussed further below.

The lessor's residual value asset

20. The lessor's right to the economic benefits from the leased item in the period after the lease term (the residual rights) does not arise from the lease contract. Rather this right existed before the lease contract. Control of the residual right is established through the lessor's legal rights over the leased item, which may be contractual rights (if the lessor is itself a lessee of the leased item) or legal ownership (property) rights. The past event giving rise to those rights was the original acquisition of the leased item. The lessor continues to control the right to the leased item after the end of the lease (it never surrendered that right). Future economic benefits will flow to the lessor through sale or re-lease of the leased item after the end of the lease term. Thus, this right meets the definition of an asset. The measurement of that asset will be considered at a future meeting.

Derecognition and revenue recognition

21. This section addresses the question of "what is the credit?" under Approach A. This approach is essentially the same, from a statement of financial position perspective, as the direct financing and sales-type lease models under current US GAAP and the approach used for finance leases in IFRSs. Alternatively, the lessor could derecognize only a portion of the asset and recognize a receivable for its right to receive rentals.
22. Under this approach, the lessor is not considered to have a liability to permit the lessee to use the leased asset because it does not result in an outflow of future economic benefits. The outflow of economic benefits took place and the lessor performed its obligation when the leased item was delivered. The lessor has transferred a portion of the leased item (the right to use the leased item) to the lessee for a period of time. In effect, the lessor has sold its right to use the leased item during the lease term for a receivable from the lessee.
23. This approach is consistent with the boards' tentative conclusions on lessee accounting. Paragraph 3.16 of the DP indicates that the lessee's right to use the

- leased item is an economic resource that is controlled by the lessee. This conclusion implies that benefits from the right to use the leased asset are separable from the leased item and that the lessor does not have a liability to permit the lessee to use the leased asset. In other words, in a lease contract, the lessor has exchanged its right to use the leased item during the lease term for a receivable from the lessee. The lessor has retained the right to the leased item after the end of the lease. However, it has no right to use the leased item during the lease term.
24. Because under this approach the lessor has sold some of the leased item (the right to use the leased item during the lease term), the lessor no longer has that right and should derecognize some or all of the leased item.
25. In December 2008, the boards published a discussion paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*. That paper suggests that an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer. An entity satisfies a performance obligation and, therefore, recognizes revenue when it transfers a promised asset (such as a good or service) to the customer. The boards propose that an entity has transferred that promised asset when the customer obtains control of it.
26. Under this approach to lessor accounting, the asset transferred by the lessor to the lessee is a discrete right to use the leased asset. Because the lessor has transferred this right to use the asset to the lessee and the lessee has obtained control of it, the lessor has satisfied its performance obligation and would thus recognize revenue representing its sale of the right to use the leased item. This assumes that the performance obligation was created at the time of contract signing, and satisfied upon delivery. The timing of initial recognition of assets and liabilities arising

- from lease contracts (for both lessees and lessors) will be discussed at a future meeting.
27. The key decision under this approach that would enable a lessor to recognize revenue at the start of the lease is that a performance obligation (the transfer of the right to use the leased item) has been satisfied (and control over that right of use transferred) upon delivery of the leased item.
 28. This approach is consistent with the boards' preliminary views that the lessee has purchased a right to use an asset and is funding that acquisition with an obligation to pay rentals (paragraph 5.13 of the DP). Therefore, under this approach, the lessor has sold the lessee a right to use an asset and has a receivable for the rental payments.
 29. In March 2009, the IASB published the exposure draft *Derecognition: Proposed amendments to IAS 39 and IFRS 7*. Although that document applies to financial assets, it can be referenced by analogy to determine whether the lessor should derecognize the leased item. The exposure draft focuses on control and proposes that an entity should derecognize an asset when the entity transfers the asset and has no continuing involvement.
 30. If the whole of the leased item is considered for derecognition, the lessor would never get to derecognize the leased item as the lessor has continuing involvement and the lessee does not normally have the practical ability to sell the leased item. However, if the asset considered for derecognition is the right to use the leased item, then derecognition would seem appropriate as the lessor has no continuing involvement with the right-of-use asset over the lease term. The lessor has given control over the right to use the leased item to the lessee.

31. Therefore, under this approach, the lessor would recognize a receivable for the lease payments, would de-recognize the leased item, and interest revenue would be recognized over the lease term. Thus, the lessee would be recognizing interest expense and the lessor would be recognizing interest income for the financing component of the lease arrangement. In addition, revenue and cost of sales would be recognized at the start of the lease (with any difference being profit or loss). This is consistent with the accounting for a sales-type lease under US GAAP.

Approach B: Lease contract creates a new right and obligation

32. This approach to lessor accounting treats the leased item as the lessor's economic resource. The lessor has granted the lessee the right to use its economic resource. Under this approach, the lessor does not lose control of the leased property for the lease term and thus continues to recognize the leased item. The leased item remains in the lessor's statement of financial position and the lessor is committed to allowing the lessee to use the leased item over the lease term. The lessor remains bound by the terms of the arrangement for the entire lease term, even if prices, availability, or other economic factors change. This obligation would meet the definition of a liability because it would result in an ongoing outflow of future economic benefits to the lessee.
33. This approach could be considered consistent with the boards' tentative conclusions on lessee accounting if viewed as the lessee having an asset representing the right to use the leased property and the lessor having an offsetting liability representing its obligation to provide that use to the lessee over the lease term.
34. It can be argued that the existence of this obligation means that the lessor does not have an unconditional right to receive payments over the lease term. However, this is not the case once the leased item is delivered to the lessee and the lessor has begun its performance. The lessee has an unconditional right to use the leased item because the lessor has no contractual rights to recall the item from the lessee

unless the lessee breaches the contract. Instead, the lessor has an unconditional right to receive payments.

35. In effect, the lease contract has created a new right (an unconditional right to receive payments) with a corresponding liability (an unconditional obligation to permit use of the leased item to the lessee). The lessor would recognize a receivable for its right to receive payments during the lease term on delivery of the leased item or the signing of the lease contract.
36. This approach considers that the lessor has a performance obligation to deliver and continue to permit the lessee to use the leased item and honor the contractual terms of the agreement. The lessor would recognize that performance obligation as a liability on delivery of the leased item or the signing of the lease contract, and that obligation would be settled over the term of the lease.
37. Because the lessor has created a new right with a corresponding liability, the lessor would not derecognize the leased item. Those rights and obligations are separate from the ownership rights that the lessor has over the leased item.

Revenue recognition

38. The discussion paper on revenue recognition suggests that an entity satisfies a performance obligation and, hence, recognizes revenue when it transfers a promised asset (such as a good or service) to the customer.
39. Under this approach to lessor accounting, the lessor is viewed as providing a service to the lessee (the ongoing right to use the leased item) over the lease term. Consequently, revenue is recognized as the lessor satisfies its performance obligation to the lessee (ie revenue is recognized over the term of the lease). The lessor would also recognize interest income on its receivable over the lease term.

40. Under this approach, the boards may need to consider the lessor's recognition of income in situations involving manufacturers or dealers that provide leasing as another means to market their product.
41. Consider the following leasing arrangements:

Example 2 — Lease financing provided by a bank

A bank often offers a customer a lease that finances the use of an asset for a substantial portion of the asset's useful life (perhaps all of the asset's useful life). Typically, these leases are provided by a lessor that is not in the business of selling the assets it leases and that functions essentially as a lender. Often in these leases the lessee receives a copy of the contract by which the lessor acquires the asset before signing the lease. The bank/lessor may never take possession of the leased asset (in fact, the bank/lessor generally has no contact with the leased asset), and its legal obligation to lease the asset does not arise until the lessee accepts the asset from the supplier. The lessee generally has no rights against the bank/lessor if the leased item does not perform.

Example 3 — Lease financing provided by a manufacturer/dealer of the leased asset

A manufacturer or dealer of leased assets offers customers leases that finance the use of an asset for a substantial portion of the asset's useful life (perhaps all of the asset's useful life). One of the main differences between this type of lease and the lease provided by a bank/lessor is that the manufacturer/dealer seeks to earn a profit on the manufacture of the asset in addition to financing income.

42. If the boards conclude that a performance obligation exists for most lease contracts, there may be some lease transactions that give rise to revenue at the start of the lease. For example, the boards may decide it is appropriate to recognize a performance obligation for transactions similar to example 2, but may decide it is appropriate to recognize revenue for transactions similar to example 3.
43. Some board members think that a distinction needs to be made between leases in which the substance of the arrangement is a purchase by the lessee (and a sale by the lessor) and other types of leases. For example, a lease could be viewed as a

sale when the title to the leased item transfers at the end of the lease term. When a lease is a sale of the leased item, some board members think that the lessor should derecognize the leased asset and recognize revenue at the start of the lease, similar to sales-type lessor accounting under US GAAP.

44. Instead of trying to differentiate when the substance of the transaction is a purchase/sale, criteria could be established to determine when, if ever, income should be recognised at the start of a lease.

Presentation under Approach A and Approach B

45. Example 4 illustrates the two approaches to lessor accounting and the presentation in the statement of financial position.

Example 4

A lessor enters into a five-year lease of a machine. Before the lease contract is signed the machine is included in the lessor’s financial statements at a carrying amount of CU10,000. The lessor measures the lease receivable initially at CU9,378.

This example assumes that any performance obligation equals the lease receivable and the residual value asset equals the difference between the carrying amount of the machine and the lease receivable.

	Lease contract transfers a portion of the leased item CU	Lease contract creates a new right CU
Machine	-	10,000
Lease receivable	9,378	9,378
Residual value asset	622	-
Total assets	10,000	19,378
Performance obligation	-	9,378
Total liabilities	-	9,378
Net assets	10,000	10,000

46. The boards would need to consider how this model would affect lessors that provide short-term leases and lessors of real estate.
47. In order to further develop a right-of-use model for lessors, it is first important to determine whether the lease contract:
- a. is viewed as the sale of a portion of the leased item (representing the right-of-use asset) from the lessor to the lessee in exchange for a receivable from the lessee to the lessor and a residual asset retained by the lessor (Approach A) or
 - b. whether the lease contract creates a new right (receivable for the lessor) with an offsetting performance obligation (liability for the lessor) with no change to the lessor's leased item on its statement of financial position (Approach B).

Staff Recommendation

48. The staff recommends Approach A. The staff thinks this approach is more consistent with the lessee accounting model, the proposed revenue recognition model, and the derecognition ED.
49. In a lease contract, the lessor transfers to the lessee the right to use the leased item over the lease term in exchange for a right to receive payments over the lease term. In addition, the lessor retains the right to the leased item at the end of the lease term. This approach implies that the benefits from the right to use the leased asset are separable from the leased item itself, and that the lessor does not have a liability to permit the lessee to use the leased item; therefore, that right-of-use asset should be derecognized by the lessor because the lessor has transferred control of the right to use the leased item over the lease term.

Question 2

This paper describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.

Do you support the staff recommendation, Approach A?