Project **Leases**

Topic **Lessor Accounting**

Objective

1. The objective of this paper is to further discuss the right-of-use model for lessors. The boards will be asked to discuss the following topics:

   (a) The initial and subsequent measurement of the lessor's receivable

   (b) The initial and subsequent measurement of the lessor's performance obligation

   (c) The presentation of a lessor's receivable and performance obligation.

Introduction

2. At their May meetings, the boards discussed applying a right-of-use model to lessors and tentatively concluded that a lessor would recognize an asset representing its right to receive rental payments from the lessee (a lease receivable) and a liability representing its performance obligation under the lease; that is, its obligation to permit the lessee to use one of its assets (the leased item). The lessor would satisfy that performance obligation (and recognize revenue) over the lease term.

Initial and subsequent measurement – lessor's receivable

Initial measurement of a lessor's receivable

3. The purpose of this section is to determine the initial measurement of a lessor's right to receive rental payments from the lessee (the lessor's lease receivable). It should be emphasized that this paper only considers a simple lease contract. More complex leases, for example, leases that include options to renew and leases that include contingent rental payments, will be considered later.

4. The FASB and the IASB have similar definitions of financial assets. US FASB Accounting Standards Codification (ASC) defines a financial asset in its glossary as, "…a contract that conveys to one entity a right to…receive cash…from a second entity." Similarly, paragraph 11 of IAS 32, *Financial Instruments: Presentation*, states that a financial asset is "…any asset that is…a contractual right to receive cash…from another entity…."

5. Therefore, the lessor's receivable from the lessee meets the definition of a financial asset under both US generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs). This paper sets out the following four options for initial measurement of a lessor's receivable:

   (a) Require all entities to use US GAAP approach

   (b) Require all entities to use IFRS approach

   (c) Develop a specific approach for lease receivables

   (d) Require entities to refer to existing applicable standards (APB Opinion No. 21, *Interest on Receivables and Payables*, for US GAAP preparers and IAS 39, *Financial Instruments: Recognition and Measurement*, for IFRS preparers)

US GAAP approach

6. ASC guidance on the initial measurement of receivables (from Opinion 21, section 310-10-30-3, states "…notes exchanged for property, goods, or services are valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar

to that followed for a cash transaction." In addition, ASC 310-10-30-6 states, "…the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable shall be determined by discounting all future payments on the notes using an imputed rate of interest…." The rate used should be the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction.

7. ASC guidance on financial instruments section 825-10-15-5 provides a scope exclusion from electing a fair value option for financial assets and liabilities recognized under leases. Therefore, if this approach is accepted, the boards will have to determine whether to retain this scope exception. That is, should there be a fair value option for a lease receivable?

IFRS approach

8. IAS 39 provides the following guidance on the initial measurement of a financial asset:

> When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

9. The staff notes that this paper is based on existing IFRS and does not take into account any proposed changes to the accounting for financial instruments.

Lease specific approach

10. The boards may consider developing a specific approach for initial measurement of a lessor's receivable that does not cross reference existing US GAAP. This may be a preferable approach if the boards view lease receivables differently than other financial assets.

11. For example, the boards could decide to require initial measurement at either fair value or at the present value of the expected lease payments.

Refer to existing standards

12. The final approach is to refer to existing requirements under either US GAAP or IFRS. That is, US GAAP preparers would apply US GAAP requirements for financial assets and IFRS preparers would apply IAS 39. This approach would be easy for preparers to understand and implement. It also would increase comparability for both US GAAP and IFRS users because all financial assets would be accounted for similarly.

13. However, this approach would result in a non-converged standard if the application of US GAAP does not result in the same initial measurement as the application of IFRSs.

Staff recommendation

14. Although the staff does not want a diverged view for lessors, the staff recommends that the initial measurement of the lessor's lease receivable should be accounted for as other financial assets under either US GAAP or IFRSs.

15. The staff notes that under US GAAP, the initial measurement of the lessor's receivable would be accounted for at the present value of the consideration exchanged between the lessee and the lessor; that is, the present value of the expected lease payments. The staff notes that this initial measurement (the present value of the consideration exchanged) would approximate fair value. Under IFRSs, the initial measurement of the lessor's receivable would be accounted for at fair value. Therefore, in practice, it is possible that the resulting initial measurement of the lessor's receivable would be converged.

Question 1
Question 1 – Do the boards agree with the staff recommendation that the initial measurement of the lessor's right to receive rental payments would follow existing literature for the accounting for financial assets under either US GAAP or IFRSs?

16. The boards may wish to provide guidance on what discount rate to use when determining the present value of the consideration exchanged under US GAAP. The staff has proposed the following alternatives:

    (a) Use the interest rate implicit in the lease.

(b) Use the lessee's incremental borrowing rate.

Using the interest rate implicit in the lease

17. Current lease accounting guidance states that the lessor should use the interest rate implicit in the lease. This would be an appropriate rate to use because it is the rate that the lessor charged in the transaction and is specific to the measurement of the rental payments to be received by the lessor.

18. However, the boards tentatively concluded that the lessee would use the lessee's incremental borrowing rate to initially measure the lessee's obligation to pay rentals. Therefore, if the boards decide that the lessor should use the interest rate implicit in the lease, the measurement of the lessee's obligation to pay rentals may not equal the lessor's lease receivable.

19. In theory, the interest rate implicit in the lease should equal the lessee's incremental borrowing rate; however, the implicit rate is affected by the lessor's estimate of the residual value and also may be affected by other factors known only to the lessor.

Using the lessee's incremental borrowing rate

20. The boards could decide to discount the expected lease payments using the lessee's incremental borrowing rate because (a) that is the rate that the lessee is using to value its right-of-use asset and (b) ASC 835-30-25-12 states that when initially measuring receivables "the rate used should be the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction."

21. However, the staff notes that the FASB rejected using the lessee's incremental borrowing rate in the existing lease accounting guidance for sales-type leases because it would yield an amount to be recorded as the sales price that would be at variance with the known fair value of the leased asset.

Staff recommendation

22. The staff recommends that the lessor use the interest rate implicit in the lease because that is the rate that the lessor charged the lessee in the transaction.

Question 2

Question 2 – Do the boards agree with the staff recommendation to discount the expected lease payments using the interest rate implicit in the lease?

Subsequent measurement of a lessor's receivable

23. Similar to the initial measurement of a lessor's receivable, this paper sets out the following four options for the subsequent measurement of a lessor's receivable:
    (a) Require all entities to use US GAAP approach.
    (b) Require all entities to use IFRS approach.
    (c) Develop a specific approach for lease receivables.
    (d) Require entities to refer to existing applicable standards (Opinion 21 for US GAAP preparers and IAS 39 for IFRS preparers).

US GAAP approach

24. ASC guidance on interest section 835-30-35-2 states that where the imputation of interest is required, the difference between the present value and the face amount should be amortized as interest income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period; that is, the interest method. In addition, ASC also stipulates that the rate used should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

IFRS approach

25. IAS 39 provides guidance for the subsequent measurement of a financial asset depending on the classification of the asset. Paragraph 46 (a) of IAS 39 states that loans and receivables should subsequently be measured at amortized cost using the effective interest method. Therefore, if a lease receivable is defined as a receivable under IAS 39, US GAAP and IFRS would result in similar subsequent accounting.

26. However, more complex leases (for example, leases with contingent rent) may not meet the definition of a receivable under IAS 39 if the rentals are not fixed

or determinable. In that case, the lease receivable would be defined as an available-for-sale financial asset that would be subsequently accounted for at fair value. Although this paper only addresses simple leases, the staff wanted to highlight this potential difference in subsequent measurement under IAS 39.

Lease specific approach

27. The boards may consider developing a specific approach for the subsequent measurement of a lessor's receivable that does not cross reference existing US GAAP. This may be a preferable approach if the boards view lease receivables differently than other financial assets.

28. For example, the boards could require subsequent measurement at either fair value or at amortized cost.

Refer to existing standards

29. The final approach is to refer to existing requirements under either US GAAP or IFRS. This approach would be easy for preparers to understand and implement. It also would increase comparability for both US GAAP and IFRS users because all financial assets would be accounted for similarly.

30. However, this approach could create divergence if the application of US GAAP does not result in the same subsequent measurement as the application of IFRSs.

Staff recommendation

31. Although the staff does not want a diverged view for lessors, the staff recommends that the subsequent measurement of the lessor's lease receivable should be accounted for as other financial assets under either US GAAP or IFRSs.

Question 3
Question 3 – Do the boards agree with the staff recommendation that the subsequent measurement of the lessor's right to receive rental payments would follow existing literature for the accounting for financial assets under either US GAAP or IFRSs?

Initial and subsequent measurement – lessor's performance obligation

Initial measurement of a lessor's performance obligation

32. The boards have tentatively concluded that a lease contract results in the lessor having an obligation to permit the lessee to use the leased item over the lease term. In the Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, the boards discussed the initial measurement of performance obligations. The boards' preliminary view is that performance obligations should be initially measured by allocating the transaction price (that is, the customer consideration) to the performance obligations.

Staff recommendation

33. Therefore, the staff recommends that the initial measurement of the lessor's obligation to permit the lessee to use the leased item should equal the transaction price (that is, the customer consideration). This recommendation would have the initial measurement of the performance obligation equal the initial measurement of the lessor's receivable

Question 4
Question 4 – Do the boards agree with the staff recommendation that the initial measurement of the lessor's performance obligation should equal the transaction price (that is, the customer consideration that will be measured as the amount of the receivable)?

Subsequent measurement of a lessor's performance obligation

34. The staff notes that at contract inception in the revenue recognition project, the initial measurement of the rights would equal the amount allocated to the performance obligations (the asset equals the liability), and, therefore, an entity's net contract position at inception would be nil. In the revenue recognition project, the asset and liability would be shown net. Consequently, an entity would not recognize revenue at contract inception but only when its contract position increases subsequently through the satisfaction of performance obligations. In the leases project, the boards will need to decide whether the contract should be shown gross or net. This issue is discussed later in this paper.

35. The boards' preliminary view in the revenue recognition project is that the subsequent measurement of performance obligations should capture those changes that arise when the entity satisfies a performance obligation.

36. The boards' tentative conclusion in the lease project is that the lessor has a continuing obligation to permit the lessee to use the leased item over the lease term, and, therefore, the lessor satisfies its performance obligation over the lease term.

Staff recommendation

37. The staff recommends that the subsequent measurement of a lessor's performance obligation should depict the decrease in the entity's obligation to permit the lessee to use the leased item. When a performance obligation is satisfied, the amount of revenue recognized is the amount of the transaction price that was allocated to the performance obligation at contract inception. Consequently, the total amount of revenue that an entity recognizes over the life of the lease contract is equal to the transaction price.

Question 5
Question 5 – Do the boards agree with the staff recommendation that the subsequent measurement of the lessor's performance obligation should reflect decreases in the entity's obligation to permit the lessee to use the leased item over the lease term?

Presentation in the lessor's financial statements

38. In theory, at initial measurement the lessor will have a receivable that is equal to its performance obligation. The lessor also will have the leased item remain on its statement of financial position. Next, this paper discusses whether these items should all be presented gross or net. The staff considered the following alternatives:

    (a) Show all three items gross (the leased asset, the lease receivable, and the performance obligation).

    (b) Show the lease receivable net of the performance obligation.

    (c) Show the leased asset net of the performance obligation.

Approach A - Show all three items gross

39. Some would state that the advantages of showing all three items gross is that it reflects the economics of the transaction and clearly shows the changes to the assets and liabilities arising in a lease contract. That is, the lessor still owns the leased item, which should be shown on its financial statements. For presentation purposes and so that the owned item would be distinguished from other owned assets, it could be made clear that the owned item is out on lease.

40. The initial measurement of the receivable and the performance obligation would be equal. However, the interest method for subsequent measurement of the lease receivable and the reduction to the performance obligation over the lease term would result in different subsequent measurements of these items.

41. It should be noted that the revenue recognition project shows the assets and liabilities arising from contracts net, so this approach would not be consistent with the revenue recognition project. The revenue recognition team plans to discuss with the boards whether there are any situations in which the rights under the contract and the performance obligation should be shown gross during the July board meeting.

Approach B - Show the lease receivable net of the performance obligation

42. Some do not like the gross-up effect on the balance sheet that results from recording the leased item, the lease receivable, and the performance obligation all at their gross amounts. They believe that the leased asset, the receivable, and the performance obligation are interdependent and that the presentation of these items in the financial statements should reflect this interdependency.

43. The staff notes that this approach is consistent with the revenue recognition project. The revenue recognition DP discussed the fact that there is a strong interdependency between the contractual rights (customer consideration) and the contractual obligations (performance obligations) and that those rights and obligations give rise to a single asset or liability.

Approach C - Show the leased item net of the performance obligation

44. Some would argue that the fact that the lessor is allowing the lessee to use its leased item reduces the value of that leased item. Therefore, a preferred

approach would be to show the leased item net of the performance obligation. This also would avoid the gross-up of the balance sheet.

45. However, this approach is not consistent with the revenue recognition project. In addition, this approach could pose problems when, for instance, the measurement of the performance obligation exceeds the amount of the leased item in the financial statements. Would there be a negative asset balance in those circumstances?

46. The staff does not support this approach because it is not representationally faithful of the economics of a leasing transaction. That is, the lessor owns the leased item and should present and account for that owned asset by amortizing it over its useful life. There is no precedent for allowing an entity to net a performance obligation liability against an owned asset. Instead, the board could present the leased item separately in its financial statements and indicate that it is under lease and disclose the related lease receivable and performance obligation.

47. In addition, some staff members do not think that the value of a leased item decreases as a result of entering into a lease contract for the right to use its owned asset.

Staff recommendation

48. A comparison of approaches A, B, and C can be found in the appendix to this paper.

49. The FASB staff recommends approach A because it thinks it best depicts the economics of a lease transaction. That is, the lessor still owns the leased item and should continue to account for it and present it in its financial statements as any other owned asset (or could separately present it as an owned asset that is on lease). The assets and liabilities arising from a lease contract should be reflected in the financial statements of the lessor as well. The FASB staff would not object to approach B in which the assets and liabilities arising from a lease contract would be shown net, which is consistent with the revenue recognition project.

50. The IASB staff recommends Approach B, which is consistent with the revenue recognition project.

Question 6
Question 6 – Which presentation approach do the boards support?

Appendix 1

Comparisons of presentation under approaches A, B, and C

A1. The following simplified example of a lease of a machine is used to further illustrate the presentation differences between approaches A, B, and C. Several simplifying assumptions were made with regard to initial and subsequent measurement.

Example 1

A machine is leased for a fixed term of five years; the expected life of the machine is ten 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.

- Equipment with an original equipment cost and fair value of a currency unit (CU) of 10,000 is on the lessor's financial statements.
- Lease term = 5 years, commencing January 1, 2010, with no renewal options.
- Five annual payments due in arrears (at December 31) of CU2,474 (total payments = CU12,370). Payments are made as scheduled (not delinquent).
- Present value of rental payments at the beginning of the lease = CU9,378.
- Interest component of rental payments = CU12,370 – CU9,378 = CU2,992 .
- Lessee's incremental borrowing rate is ten percent.

Simplifying Assumptions:

- The present value of lease payments due to the lessor (the receivable) over the lease term is equal to the performance obligation.
- The lessor's receivable is measured at the present value of future rental payments due during the lease term. Subsequent measurement is based on the effective interest method, discounted using the lessee's incremental borrowing rate.
- The obligation to allow the lessee to use the leased asset would be relieved to income evenly over the lease term.

Approach A-Gross Presentation

(all amounts in CU)

Line Item	1-Jan-10	Change	31-Dec-10	Change	31-Dec-14
Leased asset, net of accumulated depreciation	10,000	(1,800)	8,200	(7,200)	1,000
Lease receivable	9,378	(1,536)	7,842	(7,842)	-
Total assets	19,378	(3,336)	16,042	(15,042)	1,000
Performance obligation	(9,378)	1,875	(7,503)	7,503	-
Total liabilities	(9,378)	1,875	(7,503)	7,503	-
Net assets	10,000	(1,461)	8,539	(7,539)	1,000
Interest income	-	938	938	2,054	2,992
Performance of lease obligation	-	1,875	1,875	7,503	9,378
Total revenues	**-**	2,813	2,813	9,557	12,370
Depreciation expense	-	(1,800)	(1,800)	(7,200)	(9,000)
Net income	**-**	1,013	1,013	2,357	3,370

Approach B-Lease Receivable Presented Net of the Performance Obligation

(all amounts in CU)

Line Item	1-Jan-10	Change	31-Dec-10	Change	31-Dec-14
Leased asset, net of accumulated depreciation	10,000	(1,800)	8,200	(7,200)	1,000
Lease receivable	9,378	(1,536)	7,842	(7,842)	-
Performance obligation	(9,378)	1,875	(7,503)	7,503	-
Net contract	-	339	339	(339)	-
Total assets	10,000	(1,461)	8,539	(7,539)	1,000
Total liabilities	-	-	-	-	-
Net assets	10,000	(1,461)	8,539	(7,539)	1,000
Interest income	-	938	938	2,054	2,992
Performance of lease obligation	-	1,875	1,875	7,503	9,378
Total revenues	-	2,813	2,813	9,557	12,370
Depreciation expense	-	(1,800)	(1,800)	(7,200)	(9,000)
Net income	-	1,013	1,013	2,357	3,370

Approach C-Leased Asset Presented Net of the Performance Obligation

(all amounts in CU)

	1-Jan-10	Change	**31-Dec-10**	Change	**31-Dec-14**
Leased asset, net of accumulated depreciation	10,000	(1,800)	8,200	(7,200)	1,000
Performance obligation	(9,378)	1,875	(7,503)	7,503	-
Net leased asset	622	75	697	303	1,000
Lease receivable	9,378	(1,536)	7,842	(7,842)	-
Total assets	10,000	(1,461)	8,539	(7,539)	1,000
Total liabilities	-	-	-	-	-
Net assets	10,000	(1,461)	8,539	(7,539)	1,000
Interest income	-	938	938	2,054	2,992
Performance of lease obligation	-	1,875	1,875	7,503	9,378
Total revenues	-	2,813	2,813	9,557	12,370
Depreciation expense	-	(1,800)	(1,800)	(7,200)	(9,000)
Net income	-	1,013	1,013	2,357	3,370

Journal Entries

(Note: the journal entries would essentially remain unchanged for each of the three approaches; it is just a matter of presentation.)

January 1, 2010

DR: Lease Receivable	9,378	
CR: Lease Obligation		9,378

December 31, 2010

DR: Cash	2,474	
CR: Lease Receivable		1,536
CR: Interest Income		938
DR: Depreciation Expense	1,800	
CR: Accumulated Depreciation		1,800
DR: Lease Obligation	1,875	
CR: Lease Revenue		1,875

Cumulative Entries 2011–2014

DR: Cash	9,896	
CR: Lease Receivable		7,842
CR: Interest Income		2,054
DR: Depreciation Expense	7,200	
CR: Accumulated Depreciation		7,200
DR: Lease Obligation	7,503	
CR: Lease Revenue		7,503