Financial Accounting Standards Board

INTERNATIONAL ACCOUNTING STANDARDS BOARD

For Discussion at the IASB's May 2009 Board Meeting
For Discussion at the FASB's May 18, 2009 Board Meeting

LESSOR ACCOUNTING – RIGHT-OF-USE MODEL: ADDITIONAL EXAMPLES

Introduction

1. Some FASB members asked the staff to provide additional examples to further illustrate the approaches (Approach A and Approach B from Agenda Paper 11/Memo 29) being considered by the Boards for applying a right-of-use model to lessors. The first example will show how Approaches A and B compare in the statement of financial position and the income statement over the five-year term of a simple lease of a machine.
2. The next section will describe how the two approaches could be applied to different lessors in different scenarios (for example, a manufacturer/dealer, a bank, and a real estate investor). In addition, revenue recognition will be considered in these different scenarios.
3. The purpose of this memo is to help the Boards in considering the advantages and disadvantages of Approaches A and B in different scenarios, with the hope that the Boards are able to reach a decision as to which approach to develop further.

This memo also identifies issues that will need to be analyzed further in a lessor accounting model.

Additional Comparisons of Approaches A and B

4. The following simplified example of a lease of a machine is used to further illustrate the differences between Approaches A and B. To present journal entries, the staff made several simplifying assumptions with regard to revenue recognition and initial and subsequent measurement (as conclusions on those topics have not yet been discussed). Those assumptions are described below and are not intended to represent staff views on revenue recognition or measurement issues; however those assumptions were necessary to present the basic journal entries.

Example 5

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

- Machine with an original cost and fair value of a currency unit (CU) of 10,000 is on the lessor's financial statements.
- Lease term = five 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 (PV) of lease payments at the beginning of the lease = CU9,378.
- Interest component of lease payments = CU12,370 – CU9,378 = CU2,992.
- Unguaranteed residual value (expected fair value at end of lease term) = CU1,000.
- PV of residual value = CU622.
- Interest component of residual value = CU1,000 – CU622 = CU 378.
- Lessee's incremental borrowing rate is 10 percent.

Simplifying Assumptions:

- At initial recognition, 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.
- The present value of lease payments due to the lessor over the lease term is equal to either (a) the amount of equipment to be derecognized by the lessor at the start of the lease or (b) the performance obligation (the credit).
- The lessor's receivable is measured at the present value of future lease payments due during the lease term. Subsequent measurement is amortized cost and interest is accreted to income using the effective interest method.
- A residual value asset is recognized and measured at present value at the start of the lease, with accretion of interest to the asset's expected value at the end of the lease term using the effective interest method.
- The obligation to allow the lessee to use the leased asset would be relieved to income evenly over the lease term.

5. The following chart shows the balances per line item and the changes in those amounts over the five-year lease term. As of December 31, 2014, the income statement amounts are shown as cumulative.

Approach A – Derecognize							
Line Item	**12-31 2009**	**Changes**	**1-31 2009**	**Changes**	**12-31 2010**	**Changes**	**12-31 2014**
Cash	-	-	-	2,474	2,474	9,896	12,370
Machine	10,000	-10,000	-	-	-	-	-
Lease receivable	-	9,378	9,378	-1,536	7,842	-7842	-
Residual value asset	-	622	622	62	684	316	1,000
Total assets	**10,000**	**-**	**10,000**	**1,000**	**11,000**	**2,370**	**13,370**
Performance obligation	-	-	-	-	-	-	-
Total liabilities	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Net assets	**10,000**	**-**	**10,000**	**1,000**	**11,000**	**-**	**-**
Interest income	-	-	-	1,000	-	2,370	3,370
Performance of lease obligation	-	-	-	-	-	-	-
Total revenues	**-**	**-**	**-**	**1,000**	**-**	**2,370**	**3,370**
Depreciation expense	-	-	-	-	-	-	-
Net income	**-**	**-**	**-**	**1,000**	**-**	**2,370**	**3,370**

Journal entries for Approach A—Lessor derecognizes leased asset

January 1, 2010

DR: Lease Receivable	9,378	
DR: Residual Value	622	
CR: Equipment[1]		10,000

December 31, 2010

DR: Cash	2,474	
DR: Residual Value (accretion)	62	
CR: Lease Receivable		1,536
CR: Interest Income		1,000

Cumulative Entries 2011–2014

DR: Cash	9,896	
DR: Residual Value (accretion)	316	
CR: Lease Receivable		7,842
CR: Interest Income		2,370

Approach B – Performance Obligation

Line Item	12-31 2009	Changes	1-31 2009	Changes	12-31 2010	Changes	12-31 2014
Cash	-	-	-	2,474	2,474	9,896	12,370
Machine, net	10,000	-	10,000	-1,800	8,200	-7,200	1,000
Lease receivable	-	9,378	9,378	-1,536	7,842	-7,842	-
Residual value asset	-	-					
Total assets	**10,000**	**9,378**	**19,378**	**-862**	**18,516**	**-5,146**	**13,370**

[1] Alternatively, the amount of equipment derecognized could be equal to CU9,378. This would reflect the view that the residual asset of CU622 has not been transferred by the lessor. The subsequent accounting for the residual asset would be the same as the remaining entries for the residual value in Approach A.

Performance obligation	-	9,378	9,378	-1,875	7,503	-7,503	-
Total liabilities	**-**	**9,378**	**9,378**	**-1875**	**7,503**	**-7,503**	**-**
Net assets	**10,000**	**-**	**10,000**	**1,013**	**11,013**	**2,357**	**13,370**
Interest income	-	-	-	938	-	2,054	2,992
Performance of lease obligation	-	-	-	1,875	-	7, 503	9,378
Total revenues	**-**	**-**	**-**	**2,813**	**-**	**9,557**	**12,370**
Depreciation expense	-	-	-	1,800	-	7,200	9,000
Net income	**-**	**-**	**-**	**1,013**	**-**	**2,357**	**3,370**

Journal entries for Approach B— Lessor does not derecognize leased asset (lessor has a performance obligation)

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

Application of revenue recognition for different lessors

6. The example above does not include any recognition of revenue at the start of the lease. Approach A illustrates financing income recognized over the lease term by the lessor. Approach B illustrates financing income recognized over the lease term, as well as revenue related to the performance of the lease obligation by the lessor over the lease term. Some Board members may consider that Approach A always results in revenue recognition at the start of the lease; however other Board members would only recognize revenue at the start of the lease in certain situations. The Revenue Project has not specifically addressed how revenue would be recognized in a lease contract.

7. When considering examples 2 and 3 from Agenda Paper 11/Memo 29 (lease financing provided by a bank and lease financing provided by a manufacturer) the Boards may decide that there may be some lease transactions that give rise to revenue at the start of the lease (for example, lease financing provided by a manufacturer).

8. Current accounting literature provides for revenue recognition at the start of the lease if there is manufacturer or dealer profit (sales-type leases under U.S. GAAP). Sales would be recorded at the start at the lease and calculated at the present value of the minimum lease payments (CU9,378 in example 5). Cost of sales would be calculated at the carrying amount of the leased item less the

present value of any unguaranteed residual value (CU10,000 – 622 = CU9,378 in example 5).

9. In example 5 (under the stated facts and assumptions), there would not be any profit or loss recognized at the start of the lease because sales equal cost of sales. However, if the facts in example 5 are changed and it is assumed that the carrying value of the equipment is CU5,000, sales would be CU9,378 and cost of sales would be CU 5,000 – CU622 = CU4,378. This would show a profit of CU5,000 at the start of the lease.

10. Some could argue that this would be the case in other leases in which the carrying value is significantly below the lease receivable. Consider a fully depreciated building that has a CU1,000,000 lease receivable. Would the lessor recognize profit at the start of the lease? Or would the lessor have a credit balance for its asset?

11. Some FASB members considered how a right-of-use model would apply to different lessors (manufacturer/dealer, bank, real estate investment trust (REIT). For example, under current lease accounting there are three different models for lessors:

    a. Sales-type leases (assume a manufacturer/dealer)
        (1) Asset is derecognized
        (2) Sales and cost of sales are recognized (with either a profit or loss).
        (3) Finance income is recognized over the lease term
    b. Direct-finance leases (assume a bank)
        (1) Asset is derecognized
        (2) No profit or loss is recorded at the start of the lease.
        (3) Finance income is recognized over the lease term
    c. Operating leases (assume a REIT)
        (1) Asset remains on lessors books
        (2) Rental income is recognized over the lease term.

12. It is difficult to consider these three different models for lessors and how they would fit into a right-of-use model, or whether they would all fit into one lessor model. Although Example 5 is a lease of a machine, the amounts and presentation can be viewed from the aspect of a manufacturer/dealer, bank, or REIT. For example, some question whether it is appropriate for a REIT to derecognize its building. And how would that building be derecognized if the lease receivable exceeds the carrying amount of the building? In addition, some question whether a bank ever (and whether it ever should) have the leased asset on its book in a direct finance lease.
13. Example 5 and the discussion about revenue recognition for different lessors was described to assist Board members when considering Approaches A and B for lessors adopting a right-of-use model and to identify additional issues that will need to be considered for lessors.
14. The Boards are not expected to reach any decisions on revenue recognition or measurement for lessors at the May 2009 meetings. Rather, the Boards are asked to provide direction to the staff for further development a right-of-use model for lessors.