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Project	**Leases**
Topic	**Lessor Accounting – Initial and subsequent measurement of the lessor's receivable and the lessor's performance obligation**

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.
2. At this meeting, the staff recommends initially measuring the lessor's receivable at the present value of the lease payments. A lessor shall discount the present value of the lease payments using the interest rate implicit in the lease. The staff recommends subsequent measurement of the lessor's receivable at amortized cost using the effective interest method.
3. In addition, the staff recommends initially measuring the lessor's performance obligation at the transaction cost (that is, customer (lessee) consideration). This would result in the performance obligation being equal to the receivable at lease inception. The staff recommends subsequent measurement of the lessor's performance obligation should depict the decrease in the entity's obligation to permit the lessee to use the leased item. Generally, this would result in straight line revenue recognition over the lease term as the performance obligation is satisfied unless another systematic basis is more representative of the time pattern in which the lessor is permitting the lessee to use the leased item.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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Background

4. In July 2009, the boards discussed the initial and subsequent measurement of the lessor's receivable and performance obligation. The tentative decisions reached were on the basis of a model that would result in the lessor's recognizing a performance obligation. However, the Boards asked the staff to provide additional analysis on an accounting model for lessors that would result in partial derecognition of the leased item and to revisit the tentative decisions made following discussion of this additional analysis.

5. Subsequently in October 2009, the Boards confirmed their support of the performance obligation approach. Under this approach, the lessor would:

   (a) Recognize an asset representing its right to receive rental payments (a lease receivable), and

   (b) Recognize 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 recognize revenue as that performance obligation is satisfied over the lease term.

Initial and subsequent measurement – lessor's receivable

Initial measurement of a lessor's receivable

6. 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 in separate memos.

7. 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…."

8. It should be considered whether 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). In making that determination, it should be considered whether to look at the contract as a financial instrument to determine whether the asset (lease receivable) is a financial asset, or whether to apply the definition to the asset (lease receivable) separately.

9. 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

10. The FASB has tentatively scoped leases out of the current financial instruments project. ASC guidance on the initial measurement of receivables (from Opinion 21, paragraph 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, paragraph 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.

11. ASC guidance on financial instruments paragraph 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

12. If it is determined that the lessor's lease receivable is a financial asset, then 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.

13. 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

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

15. Developing guidance within the leases project would create a converged approach for leases for both US GAAP and IFRS preparers. This is because the proposed changes to accounting for financial instruments under both US GAAP and IFRS may not be converged.

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

17. The staff note the following advantages to initially measuring the lessor's receivable at fair value:

(a) Fair value reflects current market conditions. Thus, supporters of this approach think that it provides users of financial statements with more relevant information than other measures.

(b) Requiring the use of fair value produces information for users that is more comparable because it ignores entity-specific factors.

18. Although fair value may be the preferable method to measure the receivable conceptually, in practice, no observable market prices are likely to be available.

19. The staff believes that the more preferable method would be to require the initial measurement of a lessor's receivable to be at the present value of the total expected cash flows (expected lease payments). These present value measurements should reflect the time value of money and the risks specific to the cash inflows. This approach is consistent with the conclusions in the G4+1 Special Report, *Leases: Implementation of a New Approach*.

20. Additionally, advantages of this approach are as follows:

(a) The present value of the total expected cash flows (expected lease payments) would be a reasonable approximation to fair value. Consequently, this approach would provide users of financial statements with information similar to measuring the lessor's receivable at fair value.

(b) This approach would normally be simpler and less costly for lessors to apply than a requirement to measure the lessor's receivable at fair value.

Refer to existing standards

21. The final approach is to refer to existing requirements under either US GAAP or IFRS. That is, if it is concluded that lease receivables are financial assets (and are within the scope of any financial instruments projects), US GAAP preparers would apply US GAAP requirements for financial assets and IFRS preparers would apply IFRS requirements for financial assets. 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.

22. However, this approach would result in a nonconverged standard if the application of US GAAP does not result in the same initial measurement as the application of IFRSs.

23. Additionally, the guidance on how to account for financial instruments is in the process of being changed. If this approach were taken, measurement would not be known at this time and could be subject to change.

Staff recommendation

24. Because the staff does not want a diverged view for lessors, the staff recommends that a specific approach for the initial measurement of the lessor's lease receivable should be developed that does not cross refer to existing guidance.

25. While the staff acknowledges that the lease receivable is a financial asset, it most likely will have some features that are unusual in financial assets, for example, depending on how the Boards decide to treat options to renew and contingent rentals.

26. In addition, the staff thinks that at the inception of the lease the amount reported as a lease receivable should be equivalent to the cost of the leased item (the right-of-use asset). The tentative conclusion for the lessee's initial measurement of its right-of-use asset is cost, where cost is the present value of the expected lease payments.

27. Therefore, the staff recommends that the initial measurement of the lessor's lease receivable be at the present value of the total expected cash flows (expected lease payments), reflective of the time value of money and the risks specific to the cash inflows.

Question 1
Question 1 – Do the boards agree with the staff recommendation that a specific approach should be developed for the initial measurement of the lessor's right to receive rental payments within this project?

Question 2
Question 2 – Do the boards agree with the staff recommendation that the initial measurement of the lessor's right to receive rental payments should be measured at the present value of the total expected cash flows?

28. The boards may wish to provide guidance on what discount rate to use when determining the present value of the consideration exchanged. 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

29. 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.

30. However, the staff has recommended in Memo 5A/46 that the lessee would use the interest rate implicit in the lease, if this can be determined, otherwise the lessee would use the lessee's incremental borrowing rate. Therefore, if the boards decide that the lessor should use the interest rate implicit in the lease, and the lessee has two different rates to consider, the measurement of the lessee's obligation to pay rentals may not equal the lessor's lease receivable.

31. 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

32. 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) paragraph 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."

33. 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.

34. Additionally, utilizing the incremental borrowing rate would be inconsistent with the lessee's measurement of the performance obligation when the lessee utilizes the interest rate implicit in the lease.

Staff recommendation

35. 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. The only reason the lessee would not use the interest rate implicit (as proposed in Memo5A/46) in the lease is because it is unknown to the lessee. The lessor would have this information readily available because it is what they are charging in the transaction and would be the more appropriate rate to use in measuring the lessor's receivable.

Question 3
Question 3 – Do the boards agree with the staff recommendation to discount the expected lease payments using the interest rate implicit in the lease?

Initial Direct Costs

36. Lessors often incur costs when negotiating and arranging a lease (for example, evaluating the prospective lessee's financial condition, negotiating lease terms, closing the transaction, etc.). Existing lease guidance refers to these costs as initial direct costs. In general, initial direct costs include only those incremental costs that are directly attributable to negotiating and arranging a lease.

37. At their June 2009 meetings, the boards considered three possible approaches to address how initial direct costs for a lessee should be accounted for:

(a) Capitalizing initial direct costs to the carrying amount of the right-of-use asset;

(b) Allocating initial direct costs between debt issuance costs and asset acquisition costs; and

(c) Recognizing such costs as an expense as incurred.

38. The boards tentatively decided that a lessee would recognize any initial direct costs as an expense when they are incurred.

39. However, a number of respondents to the Discussion Paper, *Leases: Preliminary Views* (DP), were not in agreement with the boards' tentative decision as discussed in Agenda Paper 5A/FASB Memo 46. The staff has subsequently recommended capitalizing initial direct costs of the lessee in the carrying amount of the right-of-use asset and amortizing those costs with that asset.

Staff Analysis

40. There are two possible ways of addressing how initial direct costs of the lessor should be accounted for:

(a) Add initial direct costs to the carrying amount of the lease receivable; or

(b) Recognize initial direct costs as an expense as incurred.

Add initial direct costs to the carrying amount of the lease receivable

41. The boards could decide to add initial direct costs to the carrying amount of the lease receivable. This approach views initial direct costs as costs that are initiated upon the lessee's request for credit (entering into the lease arrangement), are for the benefit of the lessor, and relate directly to originating the loan (the lease receivable). The staff identified the following advantages of this approach:

(a) It is consistent with the treatment of costs associated with other financial assets; consequently, it increases comparability between financial assets.

(b) It is consistent with the staff's recommendation for the initial measurement of the lease receivable as discussed above.

Recognize initial direct costs as an expense as incurred

42. The boards could decide to recognize all such costs as an expense as incurred. This treatment is consistent with the accounting for transaction costs arising in business combinations and arising on the acquisition of some financial instruments that are measured initially at fair value.

Staff recommendation

43. The staff recommends deferring and recognizing initial direct costs over the life of the lease term because of the advantages discussed above.

Question 4
Question 4 – The staff recommends that any initial direct costs should be added to the amount recognized as an asset (lease receivable). Do the boards agree with the staff recommendation?

Subsequent measurement of a lessor's receivable

44. 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.

US GAAP approach

45. The FASB has tentatively scoped leases out of the current financial instruments project. ASC guidance on interest paragraph 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

46. If it is concluded that the lease receivable is a financial asset, 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 under existing guidance.

47. 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.

48. The staff notes that this approach is based on existing IFRS and does not take into account any proposed changes to the accounting for financial instruments. This approach assumes that lease receivables would be within the scope of the financial instruments project.

Lease specific approach

49. The boards may consider developing a specific approach for the subsequent measurement of a lessor's receivable that does not cross reference existing guidance. This may be a preferable approach if the boards view lease receivables differently than other financial assets. It would also create a converged approach for both US GAAP and IFRS preparers.

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

    (a) Subsequently measuring the lessor's receivable at fair value would reflect current market conditions and thus it may provide users of financial statements with more relevant information. However, subsequently measuring the receivable at their relative fair values, in practice, may be difficult as no observable market prices are likely to be available. Therefore, requiring continuous remeasurement of the lessor's receivable would be more costly and complex for preparers.

    (b) Subsequently measuring the lessor's receivable at amortized cost would allocate the rental payments between a repayment of the principal amount of the outstanding receivable and a finance income element. This approach would be simpler and less costly for preparers.

Refer to existing standards

51. 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.

52. 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

53. The staff recommends providing a specific approach for the subsequent measurement of the lessor's lease receivable because it is unclear whether the proposed changes to the accounting for financial instruments will be converged. In addition, leases have tentatively been scoped out of the proposed scope of the financial instruments projects.

54. Similarly, if the boards decided to provide guidance for the initial measurement of the lease receivable within the leases document, it would not make sense to refer to existing GAAP for the subsequent measurement of the lease receivable.

55. The staff recommends that the subsequent measurement of the lessor's lease receivable be at amortized cost using the effective interest method.

Question 5
Question 5 – Do the boards agree with the staff recommendation that a specific approach should be developed for the subsequent measurement of the lessor's right to receive rental payments within this project?

Question 6
Question 6 – Do the boards agree with the staff recommendation that the subsequent measurement of the lessor's right to receive rental payments should be measured at amortized cost using the effective interest method?

Initial and subsequent measurement – lessor's performance obligation

Initial measurement of a lessor's performance obligation

56. 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, a performance obligation. In the Discussion Paper (DP), *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 (lessee) consideration) to the performance obligations.

57. The revenue recognition DP proposes the following definition of a performance obligation:

> An entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer.

58. The staff thinks that the lessor's performance obligation is consistent with this definition as there is a contract with the lessee to transfer the right to use the leased asset to the lessee.

Staff recommendation

59. 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.

60. The staff also notes that this recommendation will need to be consistently reconciled with the revenue recognition project on an ongoing basis.

Question 7
Question 7 – 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

61. 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 zero. 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 tentatively concluded that during the period between the signing of a lease contract and the delivery of the leased item to the lessee:

    (a) Assets and liabilities arise when a contract is signed.

    (b) Between contract signing and delivery, the unit of account is the contract as a whole, and the contract position would be presented net in the statement of financial position of both the lessee and the lessor.

    (c) An entity would initially and subsequently measure the net contract asset or liability on a cost basis, subject to impairment.

62. Presentation of the lessor's assets and liabilities upon delivery of the leased asset will be discussed at a future meeting.

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

64. 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

65. 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.

66. Generally, the result would be straight-line revenue recognition over the lease term as the performance obligation is satisfied unless another systematic basis is more representative of the time pattern in which the lessor is permitting the lessee to use the leased item.

Question 8
Question 8 – 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?