Project **Leases**

Topic **Lessor Accounting—Accounting for the lessor's performance obligation, including consideration of recognizing profit/loss at lease commencement**

Purpose

1. The purpose of this paper is to address the subsequent accounting of the lessor's performance obligations arising from a lease. In addition, this paper addresses whether a lessor should be required to recognize any profit/loss upon lease commencement and, if so, how that profit/loss should be recognized.

2. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Background

   (c) Subsequent measurement of a lessor's performance obligation

   (d) Should a lessor be required to recognize profit/loss at lease commencement?

   (e) If required, who is required?

   (f) If required, how should profit/loss be recognized?

   (g) Transition considerations for profit/loss at lease commencement

Summary of staff recommendations

3. In this paper, the staff recommends:

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(a) subsequent measurement of the lessor's performance obligation should be reduced based on the pattern that the economic benefit derived from the leased asset is provided to the lessee; the satisfaction of the performance obligation (and recognition of revenue)could be based on time, usage or other measure of economic utility

(b) all lessors be prohibited from recognizing profit/loss at lease commencement

   (i) However, if the Boards determine profit/loss recognition at lease commencement is appropriate, the staff recommends that such profit/loss should be limited to the extent to which the underlying asset has been leased

(c) no special transition provisions for existing sales-type/finance leases where profit/loss was recognized at commencement. Upon adoption of the proposed new leases requirements, the lessor would record:

   (i) The underlying asset at the amount that it would have been had it remained on the books and been depreciated

   (ii) A lease receivable and a corresponding performance obligation at an amount representing the present value of the remaining cash payments to be received

   (iii) Any transition adjustments would result in an adjustment to beginning retained earnings, representing the reversal of revenue previously recognized that would not have been recognized under the proposed new leases requirements.

Background

4. After a lease is signed, the lessor has an obligation to deliver the leased asset to the lessee and another obligation to permit the lessee to use the leased asset over the lease term. Upon the delivery of the leased asset, the lessor records a lease receivable and a related performance obligation. Under all leases, the lessor has an obligation to allow the lessee to use the leased asset, which is owned by the lessor, over the lease term.

5. The Boards have tentatively decided that subsequent measurement of the lessor's performance obligation would reflect decreases in the obligation to permit the lessee to use the leased asset over time. However, the Boards have asked the staff to further consider the time pattern of revenue recognition for leases, for example, whether there would be situations that straight-line revenue recognition would not be indicative of the pattern of use of the leased asset by the lessee. Therefore this paper will further explore the subsequent accounting for a lessor's performance obligation.

6. This paper will also discuss profit/loss recognition at the commencement of a lease. Under the requirements in IAS 17, *Leases*, profit/loss at commencement of the lease is only recognized for lessors who are manufacturers and dealers and only if the lease is classified as a finance lease. For a lease to be considered a finance lease under IAS 17, the lease must transfer substantially all the risks and rewards of ownership of the underlying asset.

7. Under the leases requirements in Topic 840 of the *FASB Accounting Standards Codification*™, profit/loss is only recognised at the commencement of the lease if the lease is classified as a sale-type lease. The requirements in Topic 840 defines a sales-type lease as a lease that gives rise to manufacturer's or dealer's profit/loss and that meets one or more of four specific criteria. Generally, a sales type lease results when a lessor leases an asset that at the commencement of the lease has a fair value that is greater or less than its cost (or carrying amount).

Subsequent measurement of a lessor's performance obligation

8. The Boards' preliminary view in the revenue recognition project is that an entity should recognize revenue when it satisfies a performance obligation by transferring a good or service to the customer.

9. 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.

10. At the November 2009 joint Board meeting (Agenda Paper 5F/FASB Memo 51), the staff recommended and the Boards tentatively decided 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. 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.

11. While the Boards agreed with this decision, the Boards asked the staff to clarify further how the performance obligation should be satisfied and how revenue should be recognized. While the Boards agreed that the performance obligation would be satisfied over time as opposed to at lease commencement, many did not believe that time would drive the pattern of revenue recognition in all cases (that is, methods other than straight-line amortization could be appropriate). The staff notes that other drivers, such as economic output produced by the underlying asset or the rate of usage by the lessee, should be considered by the lessor in amortizing its performance obligation.

12. For instance, a lessor may charge a lessee a flat payment for use of leased equipment. However, if the equipment is expected to provide the lessee more utility in the earlier periods of the lease rather than in later periods then the lessor would not be precluded from amortizing the performance obligation relative to the rate at which the lessee obtains the economic output from the underlying asset.

13. The staff notes that in situations where the lessee derives economic output from the underlying at varying rates despite paying a flat rate, it is often difficult for the lessor to estimate the rate of usage and straight-line amortization may be the simplest method of amortizing the performance obligation.

14. Contingent rent arrangements are generally structured so that the cash payments made by the lessee more closely mirror the rate at which it derives economic

benefits from the underlying asset. As noted in Agenda Paper 10A/FASB Memo 66, presented at the February 2010 joint Board meeting, changes in the lessor's receivable due to changes in contingent rents should be allocated to the lessor's performance obligation. If changes are allocated to a satisfied performance obligation, the effect should be recognised in revenue.

Staff Recommendation

15. The staff recommends that the satisfaction of the lessor's performance obligation, and the recognition of revenue, should be performed in a systematic and rational manner as the performance obligation is satisfied. Subsequent measurement of the lessor's performance obligation should be reduced based on the pattern that the economic benefit derived from the leased asset is provided to the lessee; the satisfaction of the performance obligation (and recognition of revenue)could be based on time, usage or other measure of economic utility. The satisfaction of the performance obligation could be based on time, usage or other measure of economic utility.

Question 1
The staff recommends the amortization of the performance obligation be performed in a systematic and rational manner based on the pattern that the economic benefit derived from the leased asset is provided to the lessee. Do the Boards agree?

Should a Lessor Be Required to Recognize Profit/Loss at Lease Commencement?

Approaches to Profit/loss Recognition

16. As noted above, under current leases requirements there are limited circumstances when a lessor is required to recognize revenue (and profit or loss) at lease commencement. The staff have considered the following approaches for profit/loss recognition at lease commencement:

    (a) Recognize profit/loss recognition upon delivery of the leased asset to the lessee

(b) No profit/loss recognition upon delivery of the leased asset to the lessee.

(c) Recognize profit/loss recognition upon delivery of the leased asset to the lessee, but only for some lessors.

Approach A—Recognize profit/loss recognition upon delivery of the leased asset to the lessee

17. Approach A would require all lessors to recognize profit/loss upon delivery of the leased asset to the lessee. Approach A views the lessor as having two performance obligations–one to deliver the leased asset and one to permit the lessee to use the leased asset over the lease term. Approach A considers that there is an element of profit/loss negotiated into every lease contract. Therefore, in accordance with the proposed new revenue recognition requirements, if a lease has a distinct profit/loss margin, it should be recognized as a separate performance obligation. The proposed leases approach also recognizes that there is a financing component to every lease contract. The proposed revenue recognition requirements state that an entity should report the effect of financing separately from the revenue from other goods and services.

18. Therefore, under Approach A the lessor would need to consider the total transaction price and determine how much relates to profit/loss and how much relates to a financing charge. The amount relating to profit/loss would be recognized upon satisfaction of the first performance obligation (delivery of the leased asset). And the amount relating to financing would be recognized as the second performance obligation is satisfied, over the lease term.

19. The staff think that Approach A is theoretically the best approach. However, under Approach A the Boards would have to decide how to calculate the amount that should be recognized as profit/loss. This is discussed further below.

Approach B—No profit/loss recognition upon delivery of the leased asset to the lessee.

20. Approach B would not require any profit/loss recognition for any leases upon delivery of the leased asset to the lessee. This is because the Boards have already defined those contracts that are purchases and sales of the underlying asset.

Because a lease is not a sale of the underlying asset no profit/loss should be recognized. Under Approach B, the lessor records a lease receivable and a corresponding performance obligation. There would be no impact on profit/loss and loss upon delivery of the leased asset to the lessee for any lease under this approach. Revenue would be recognized over the lease term.

21. An advantage to Approach B is that it is more consistent with the performance obligation model, which acknowledges that the lessor has not relinquished control of the underlying asset. Since the asset has not been deemed to have been sold, neither in whole nor in part, then no profit/loss at lease commencement should result. Accounting gains are usually only recorded when an asset is sold for greater than its cost or an asset is revalued. Because the leased asset has not been sold, the delivery of the leased asset by the lessor would not result in any revenue recognition.

Approach C—Recognize profit/loss recognition upon delivery of the leased asset to the lessee, but only for some lessors.

22. Under Approach C, some lessors would be eligible for the recognition of profit/loss upon delivery of the leased asset to the lessee. This is because some argue that some lessors have leases with the same economics as sales of the underlying asset, and this approach would be more reflective of those economics. If the Boards were to select Approach C, they would need to determine how to distinguish which lessors would be required to recognize profit/loss (discussed in further detail below).

23. For example, some may think it is appropriate for a manufacturer or dealer that uses leasing as a means of marketing their products to recognize profit/loss upon delivery of the leased asset and recognized the revenue identified as the finance charge to the lessee over the life of the lease.

24. The advantage of Approach C is that it would be simple for a lessor to implement as it would largely continue existing accounting in use by some lessors that utilize sales-type leasing (under US GAAP) or finance leasing by manufacturers and dealers (under IFRS). Under Approach C, some lessors would record either the net profit/loss or the gross profit/loss and cost of goods

sold upon lease commencement; the distinction between presenting a net profit/loss versus a gross profit/loss is discussed further below.

25. When the economics of the leasing transaction are comparable to those of a sale transaction, the gross and net profit/loss margins for such companies' lease operations would be comparable to the gross and net profit/loss margins for sold goods. This would be true when substantially all the risks and rewards of the underlying have been transferred from the lessor to the lessee. This comparability would be useful to users of financial statements.

26. The primary disadvantage of Approach C is that it could result in different accounting models for different leases, resulting in less comparability. Further, in any of the approaches discussed below in paragraphs 30 through 41, applying Approach C would result in greater complexity.

Staff Recommendation

27. The staff recommends Approach B, that is, all lessors should be precluded from recording a profit/loss at the delivery of the leased asset. Although Approach A is the most theoretically correct approach, the staff thinks there will be difficulty implementing Approach A and significant cost/benefit considerations. Approach B is consistent with the concept behind the performance obligation model that nothing has been sold.

Question 2
The staff recommends that lessors be prohibited from recognizing any profit/loss upon lease commencement. Do the Boards agree?

If Profit/Loss at Lease Commencement is Required, Who is Required?

28. If the Boards select Approach C, that is to require profit/loss to be recognized at lease commencement for some lessors, they will need to determine which lessors are required to recognize profit/loss. The staff have considered the following approaches:

(a) Require profit/loss recognition for any lessor where the carrying amount of the underlying is different from its fair value.

(b) Require only manufacturer and dealer lessors to recognize profit/loss at lease commencement.

29. The staff considered precluding lessors other than manufacturers and dealers from recognizing profit/loss at lease commencement. However, the staff concluded that there is nothing distinct about manufacturers and dealers to justify separate accounting provisions for those lessors.

30. The economics of a lease transaction, rather than the lessor's business model, should drive the accounting. That is, if profit/loss at lease commencement were required, then it should be required in all cases where the fair value of the underlying leased asset is different from its carrying amount.

Staff Recommendation

31. If the Boards decide to require profit/loss at lease commencement recognition, the staff recommends that it be required for any lessor where the carrying amount of the underlying is different from its fair value.

If Required, How Should Profit/loss Be Recognized?

32. The staff have considered the following approaches to how profit/loss at lease commencement should be recognized:

(a) Require profit/loss at lease commencement only in cases where the lease transfers substantially all the risks and rewards of the underlying from the lessor to the lessee, and recognize the full difference between the carrying amount and fair value of the underlying as profit/loss.

(b) A lessor records a portion of the difference between the underlying's carrying amount and fair value as profit/loss at lease commencement; this portion would be based on the proportion of the value of the underlying asset that has been leased to the lessee.

Approach A: Require profit/loss at lease commencement only in cases where the lease transfers substantially all the risks and rewards of the underlying from the lessor to the lessee, and recognize the full difference between the carrying amount and fair value of the underlying as profit/loss.

33. Under Approach A, lessors would be required to treat the lease transaction as a derecognition of the asset provided that the noted criteria have been met, and finance (sales-type) lease accounting would be retained. That is, the difference between the underlying's carrying amount and its fair value would be recognized as lease revenue, the financing portion of the transaction would be deferred as the interest yield of the receivable, and cost of goods sold would be recorded.

34. Accounting under Approach A would be similar to accounting for finance leases entered into by manufacturer/dealer lessors under current accounting requirements in IAS 17. However, if a contract transfers title to the lessee at the end of the lease term or the contract contains a bargain purchase option, then the contract is not considered to be a lease but a purchase and sale of the underlying asset (as discussed at the February 2010 board meeting and in Agenda Paper 10B/FASB Memo 67).

35. One of the advantages of Approach A is that lessors would not have difficulty in applying the required accounting as it does not represent any significant change to what the requirements are today. The only substantive change would be the term "minimum lease payments" rather than the lease payments assumed in recording the lease receivable, when assessing whether the underlying has been leased for substantially all its fair value.

36. Another advantage is that it would result in gross profit/loss and cost of goods sold to be continue to be displayed on the profit/loss and loss statements of those manufacturer lessor that utilize sales-type lease accounting. These are important metrics for users of manufacturer lessor financial statements, and they would otherwise be lost if profit/loss at lease commencement were prohibited.

37. The primary disadvantage of Approach A is that it depicts a sale when the Boards have already determined that such transactions do not meet the criteria to be treated as sales. This approach is inconsistent with the performance

obligation approach, which maintains that the lessor has not relinquished control of the leased asset.

38. Further, Approach A would continue to result in different accounting for similar transactions. If current practice were applied to the principle above, the accounting for the leases that cover 50% of the underlying's useful life would not be comparable to accounting for leases that cover 95% of the life. This would both hinder the comparability of similar transactions, as exists today, and provide possible structuring opportunities.

Approach B: A lessor records a portion of the difference between the underlying's carrying amount and fair value as profit/loss at commencement; this portion would be based on the proportion of the value of the underlying asset that has been leased to the lessee.

39. Under Approach B, any lessor that leases an underlying asset that has a fair value different from its carrying amount would record a profit/loss related to the proportion of manufacturing profit/loss that has resulted through the signing of a lease. Take for instance, the following example:

    (a) An underlying has a fair value of $20,000 and a carrying amount if $15,000, a difference of $5,000.

    (b) At lease commencement, the lessor records a lease receivable of $12,000 or 60% of the underlying's fair value.

    (c) The lessor will record a profit of $3,000 (60% of $5,000)

40. The primary advantage of Approach B is that all manufacturer leases would be subject to the same accounting treatment, thereby depicting all transactions with similar economics consistently and removing structuring opportunities. This approach would also avoid the need to define those transactions that would receive profit recognition, potentially reducing complexity.

41. Unlike Approach A, the lessor does not remove the asset from its balance sheet under Approach B, making it relatively more consistent with the performance obligation model. Also under Approach B, the lessor would not record a gross profit/loss and cost of goods sold; rather, it would only record a net margin. The

net margin figure would still be potentially useful to users of financial statements.

42. The disadvantage of Approach B is that it would be difficult to administer because it represents a significant change in practice and also because, for more complex leases with lease term extension options and contingent rents, the calculation of the proportion of the manufacturing profit/loss earned could be cumbersome.

Staff Recommendation

43. The staff recommends Approach B because it would not require any lease classification which, ultimately, would be arbitrary.

Transition Considerations

44. The staff presented Agenda Paper 9D/FASB Memo 77 on Lessor Transition to the Boards at the 17 March 2010 meeting. In that meeting the Boards tentatively decided the following:

    (a) To require a lessor to recognize and measure all outstanding leases as of the date of initial application of the proposed new leases requirements using a simplified retrospective approach. Under that approach, the lessor's receivable would be measured at the present value of the remaining lease payments. The performance obligation should be measured on the same basis as the receivable.

    (b) The original rate that the lessor is charging the lessee should be used to discount the lease payments.

    (c) A lessor should reinstate previously derecognized leased assets at depreciated cost, adjusted for impairment and revaluation (IFRS preparers only).

    (d) For IFRS preparers, transition disclosures should be required in accordance with the requirements in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* without the disclosure of adjusted basic and diluted earnings per share.

45. Because the staff recommend that profit/loss at lease commencement be prohibited, transition for existing sales-type leases would result in an adjustment to reduce beginning retained earnings for the profit/loss that would not have been recognized under new lease requirements. To do this for an existing sales-type lease (for which a receivable is already on the books), the lessor will record the following:

    a. A leased asset, at the carrying value it would have been at had it been held and depreciated through the effective date rather than sold at lease commencement (or possibly for IFRS preparers at a revalued amount)

    b. An adjustment to the lease receivable in accordance with transition requirements for all other leases

    c. A performance obligation equal to the adjusted lease receivable

    d. Likely, the balancing entry would be a debit to beginning retained earnings to reverse revenue previously recognized that would not be allowed under the proposed leases requirements.

46. Transition for existing operating leases would be expected to be simple if no profit/loss at lease commencement were required, as the staff recommends.

Staff Recommendation

47. The staff recommends no special transition provisions for existing sales-type/finance leases where profit/loss was recognized at commencement. Upon adoption of the proposed new leases requirements, the lessor would record:

    (a) The underlying asset at the amount that it would have been had it remained on the books and been depreciated

    (b) A lease receivable and a corresponding performance obligation at an amount representing the present value of the remaining cash payments to be received

    (c) Any transition adjustments would result in an adjustment to beginning retained earnings, representing the reversal of revenue previously

recognized that would not have been recognized under the proposed new leases requirements.

Questions 3-5

Question 3 – If the Boards decide that lessors should be required to record the profit/loss at lease commencement, the staff recommend that it be required for all lessor where the fair value of the underlying is different from its carrying amount.

Question 4 – If the Boards decide that lessors should be required to record the profit/loss at lease commencement, the staff recommend that the profit/loss be calculated in proportion to the value of the underlying that has been leased.

Question 5 – If the Boards prohibit revenue recognition at lease commencement, the staff recommends that no special transition considerations. An entity would be required to reduce beginning retained earnings to adjust for profit/loss that had been recorded at commencement.

Do the Boards agree?