Project	**Leases**
Topic	**Lessor accounting: derecognition approach Transition**

Purpose

1. The purpose of this paper is to address transition requirements for lessors under the derecognition approach to lessor accounting. It does not address leveraged leases that are within US GAAP; that is addressed in FASB Memo 103.

Background

Decisions to date on the derecognition approach

2. Under the derecognition approach to lessor accounting, the lessor will recognise a receivable and derecognise a portion of the underlying asset based on the relative fair value of the right-of-use transferred and the rights retained.

3. The residual asset that represents the lessor's remaining rights to the underlying asset. It:

   (a) is an allocation of the previous carrying amount of the underlying asset. It will not be re-measured, unless for impairment.

   (b) will reflect changes in the lease term as a result of changes in options to extend or terminate.

   (c) will not reflect changes in contingent rentals or residual value guarantees.

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Boards' decisions under the performance obligation approach

4. When the lessor transitions to the performance obligation approach, the boards tentatively decided:

   (a) to require the lessor to recognise 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 derecognised leased assets at depreciated cost, adjusted for impairment and revaluation (IFRS preparers only).

Staff analysis

Options that we have not pursued

5. The following are transitional options that we rejected for the reasons discussed in paragraphs 4-6 and because the boards have previously rejected them when considering transitional provisions for lessee and lessors:

   (a) retrospective application

   (b) prospective application

   (c) retrospective application for outstanding leases only.

6. Requiring retrospective application provides the most useful information and is consistent with the boards' basic principles that a change in accounting policy or principle should be done retrospectively (Topic 250 and IAS 8). Additionally, it would be consistent with the boards' decisions on revenue recognition. However, retrospective application is the most costly approach, particularly for

lessors who have multiple leases. Some may argue that it may be impossible to do retrospective application because it would require the determination of past management intent, particularly when dealing with options and contingent rentals. It also may be difficult to find the necessary information for leases that were contracted in the past.

7. Prospective application is easier than retrospective application. However, it reduces comparability, thus, reduces usefulness of information because similar leases would be accounted for differently. Applying two sets of requirements is confusing to users (thus less comparable). Moreover, a lessor may have two models for leases if it has many long-term leases.

8. The boards could require the lessor to only apply the proposed leases requirements to all outstanding leases at the date of application. It is less costly than full retrospective, but not much. This is because the only leases that would be exempted are those that expire between the date of transition and the date of application.

Options for the boards to consider

9. Below are two options for consideration:

    (a) Option A: Apply to all leases outstanding at the date of initial application, but

        (i) the residual asset is initially measured at a cost allocation based on historical information; and

        (ii) receivables are measured at the present value of the remaining lease payments, discounted using the rate the lessor is charging the lessee in the lease (as of the date the lease arrangement was entered into).

    (b) Option B: Apply to all leases outstanding at the date of initial application, however;

        (i) the residual asset is initially measured at fair value as deemed cost (a surrogate for cost at the application date); and

(ii) receivables are measured at the present value of the remaining lease payments, discounted using the rate the lessor is charging the lessee in the lease (as of the date the lease arrangement was entered into).

10. The only difference between options A and B is how to measure the residual asset.

11. Both options are easier and simpler than retrospective application, but ensure that all outstanding leases – those that were formerly classified as operating leases and finance leases – have the same starting point; thus increases comparability.

12. We propose carrying forward the tentative decisions made for the performance obligation approach to lessor accounting that a lessor will initially measure receivables at the present value of the remaining lease payments at transition because we think that decision is equally applicable to the derecognition model.

Option A - Apply to all leases outstanding at the date of initial application, but residual asset is initially measured at a cost allocation and receivables are at present value of remaining lease payments

13. Option A requires the lessor to initially measure the residual asset for all outstanding leases at a cost allocation basis. The residual asset would be calculated as follows:

$$\frac{\text{Fair value of the outstanding receivables} \quad \text{X} \quad \text{Calculated carrying amount of underlying asset}}{\text{Fair value of the asset}}$$

14. The equation above reflects how a residual asset is calculated under the partial derecognition model as discussed in the May 2010 joint board meeting. The residual asset is = (fair value of receivables x carrying amount of the asset)/fair value of asset.

15. The calculated carrying amount will be available for operating leases. However, the carrying amount would not be available for finance leases, because the lessor

has previously derecognised the underlying asset. For finance leases, the lessor will have to determine what the carrying amount of the underlying asset would have been based on the original cost less depreciation, and impairment and revaluation (IFRS preparers only).

16. The fair value of the outstanding receivables does not equal the value of the receivables upon transition (present value of the receivables discounted using the rate the lessor is charging the lessee in the lease) because the fair value will reflect an updated (current) discount rate rather than the original rate that the lessor is charging the lessee.

17. The advantage of option A is that it is consistent with the boards' tentative decision that the residual asset is measured on an allocated cost basis.

18. The disadvantages of option A are:

    (a) The lessor will still have to calculate the fair value of the underlying asset.

    (b) The lessor may not be able to determine the calculated carrying amount of the underlying asset. This may be particularly difficult for finance lessors and long-term leases that were acquired some time ago.

Option B – Apply to all leases outstanding at the date of initial application but residual asset is initially measured at fair value and receivables are at present value of remaining lease payments

19. Under option B the lessor would measure the residual asset at fair value on the date of application. That fair value would be considered a surrogate for cost or deemed cost[1].

20. The advantages of option B are:

[1] IFRS 1 defines deemed cost as an amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.

(a) Consistent with the guidance in IFRS 1 *Initial adoption of IFRSs* which permits first-time adopters of IFRSs to use fair value as deemed cost for property, plant and equipment.

(b) Less complicated and difficult particularly for leases that were formerly classified as finance leases because it avoids problems where the lessor may not know the value of the original cost of the underlying asset (finance leases).

21. The disadvantages for option B are:

(a) is not consistent with the boards' tentative decision that the residual asset is measured on an allocated cost basis under the partial derecognition approach.

(b) rare for US GAAP preparers to initially measure property, plant and equipment at fair value as a surrogate for cost when transitioning because most property, plant and equipment are initially measured at historical cost.

Staff Recommendation

22. The staff are split on this issue.

Question 1
Which option do you prefer? a) Option A: Apply to all leases outstanding at the date of initial application except that on transition the receivables are measured at the present value of the remaining lease payments and the residual asset is initially measured at a cost allocation based on historical information. b) Option B: Apply to all leases outstanding at the date of initial application except that on transition the receivables are measured at the present value of the remaining lease payments and the residual asset is measured at fair value on initial application.