Project **Leases**

Topic **Lessor accounting – Accounting models**

Purpose of this meeting

1. At the May 2010 meeting the IASB expressed an interest in using a hybrid lessor accounting model. Under a hybrid model, a lessor would use a performance obligation (PO) approach to lessor accounting in some situations and a partial derecognition approach in other situations. The FASB have tentatively decided to adopt a performance obligation approach (PO approach) for all leases.
2. The IASB instructed the staff to develop proposals regarding when a lessor should use which accounting approach. The IASB staff have prepared a paper that sets out their recommendations on this issue which is reproduced in the appendix. The recommendations in the paper are those of the IASB staff only.
3. The paper will be discussed at an IASB only session early in June Board week. However, no decisions will be made at that session.
4. At the joint meeting on Thursday 18 June:

    (a) the staff will update the FASB on the IASB's discussions regarding a hybrid model

    (b) the IASB will seek feedback from the FASB on their discussion

    (c) the staff will ask for a decision on which accounting model you prefer.

Appendix – IASB agenda paper 6A

Lessor Accounting – Accounting models

Purpose

A1. At the May 2010 meeting the Board expressed an interest in using a hybrid lessor accounting model. Under a hybrid model, a lessor would use a performance obligation (PO) approach to lessor accounting in some situations and a partial derecognition approach in other situations.

A2. The Board instructed the staff to develop proposals regarding when a lessor should use which accounting approach. Consequently, this paper sets out the staff's recommendations for when an entity should use which approach.

A3. The views expressed in this paper reflect the views of the IASB staff only.

Disadvantages of each approach

A4. To help the Board decide when it would be appropriate to use the PO approach and when it would be appropriate to use the partial derecognition approach, the following tables summarise the disadvantages of each approach. The tables also describe how the alternative approach would deal with these problems:

Performance obligation approach	
Disadvantages	**Comments on the partial derecognition approach**
It can be argued that this approach is inconsistent with the proposed approach to lessee accounting. Under the lessee accounting model proposed by the boards, the lessee is viewed as having an unconditional obligation to pay rentals. The obligation is viewed as unconditional	Consistent with the proposed approach to lessee accounting. The lessor is viewed as having delivered a right-of-use asset to the lessee at lease commencement. Consequently, the lessor has no performance obligation and the lessee has an unconditional obligation to pay rentals.

Performance obligation approach	
Disadvantages	**Comments on the partial derecognition approach**
because the lessor has performed under the lease contract at lease commencement. If the lessor has performed, it is unclear why the lessor recognises a performance obligation.	
Double counts assets and grosses up the balance sheet. Under the PO approach the lessor recognises a receivable in respect of amounts due under the lease and continues to recognise the whole of the underlying asset. Consequently, for leases of newly acquired assets, the assets recognised by the lessor will exceed the cash inflows expected from those assets.	Because the lessor derecognises a portion of the underlying asset there is no double counting of assets.
Places significant strain on the lessor's ability to differentiate between purchases/sales and other types of lease (it introduces a 'bright line'). If a contract is classified as a lease, the lessor continues to recognise the underlying asset and recognises no gain/loss. If the contract is classified as a purchase/sale, the underlying asset is derecognised and gains/losses are recognised.	There is no 'bright-line' between a lease and a purchase/sale. The lessor derecognises more of the underlying asset if it transfers more rights to the lessee in the lease contract.
Manufacturer/dealer lessors do not recognise revenue, cost of sales and gains/losses at the start of the lease.	Results in manufacturer/dealers recognising revenue, cost of sales and gains/losses at the start of a lease.
Land leased out under long term leases remains on the lessor's statement of financial position. The boards have tentatively decided that even very long term leases of land (99 years, 999 years) are not sales of the underlying land. Consequently, the lessor continues to recognise the land and a performance	The lessor derecognises a portion of the land representing the lessee's right to use the land during the period of the lease.

Performance obligation approach	
Disadvantages	**Comments on the partial derecognition approach**
obligation that is released to revenue over the term of the lease (99 years, 999 years etc…)	
Results in banks/finance organisation recognising the underlying asset on their books. This will be the case even if the bank's main risk exposure is to the credit risk associated with the receivable.	The assets recognised by a bank/finance organisation will reflect the risks to which it is exposed. If the entity has very little exposure to the risks associated with the underlying asset, the residual asset it recognises will be correspondingly small.

Partial derecognition approach	
Disadvantages	**Comments on the performance obligation approach**
Places significant strain on ability to split payments between lease payments and payments for services. If the split between lease payments and payments for services is not done correctly, the lessor may recognise revenue and/or gains at the start of the lease in respect of services not yet provided to the lessee.	Under the PO approach revenue is recognised over the term of the lease so even if the split between lease payments and payments for services is incorrect, revenue will not be recognised upfront.
Gives rise to gains if the carrying amount of the underlying asset is less than its fair value. The gains recognised reflect the difference between the historical cost carrying amount of the portion of the asset derecognised and the fair value of the right of use granted. (Some would argue that this is not a disadvantage of	No gains or losses arise because the underlying asset is not derecognised.

Partial derecognition approach	
Disadvantages	**Comments on the performance obligation approach**
this approach but a disadvantage of carrying the underlying asset at historical cost).	
Revenue recognised under this approach includes estimates of amounts payable during optional periods and/or under contingent rental arrangements. Consequently, revenue may be recognised in respect of optional periods/contingent rentals before the options are exercised and/or the contingency occurs.	There is some element of upfront revenue recognition for leases under the PO approach because the performance obligation includes estimates of amounts payable during optional periods and/or under contingent rental arrangements. These amounts are recognised in revenue over the term of the lease. However, this is not nearly as significant as under the partial derecognition approach.
No one party has the underlying asset on its books. For example, in a lease of an airplane, the lessee recognises a right-of-use asset and the lessor recognises a residual asset. No one recognises an airplane.	The lessor continues to recognise the underlying asset (the airplane).
This approach may be complex and difficult to apply to very short term leases (eg short term car rentals, hotel rooms).	The Boards tentatively decided that the cost of applying the PO approach to short term leases outweighed the benefits and consequently decided to permit leases with a maximum possible lease term of 12 months or less to be accounted for on an accruals basis.
Does not provide useful information to	The lessor continues to recognise the

Partial derecognition approach	
Disadvantages	**Comments on the performance obligation approach**
users of investment property financial statements. Users of investment property financial statements have stated that they prefer to see a building in the financial statements rather than a receivable and a residual asset. In addition, it is complex to apply to buildings with multiple components (eg 2 storeys of a 20 storey office building).	underlying asset (investment property) in its financial statements under the PO approach. The Board has tentatively decided that the scope of the new lessor accounting requirements will not include leases of investment property carried at fair value.
More complex to apply than the PO approach because the lessor is required to calculate how much of the underlying asset to derecognise not only at the start of the lease but whenever there is a reassessment of whether an option will be exercised. This requires information about the fair value of the underlying asset.	The PO approach requires no such calculations.
Not supported by FASB. Consequently, adopting the partial derecognition approach will result in divergent answers.	The PO approach is supported by the FASB.

Hybrid approaches

A5. The following table summarises a number of hybrid approaches the Board could adopt:

Approach	Description	Comments
A	Use PO approach for all leases except: • Long term leases of land • Manufacturer/dealer leases.	This approach avoids the problems associated with long term leases of land and manufacturer dealers This approach results in the PO approach for most leases.
B	Use PO approach for all leases except very simple leases. Very simple leases would be defined as those leases that do not include options, contingent rental arrangements, residual value guarantees or non-distinct services.	This approach would avoid the problems associated upfront revenue and/or gain recognition for leases that include options, contingent rental arrangements, residual value guarantees or non-distinct services. Many leases include features that would cause them to be classified as non-simple. Consequently, this approach will result in the PO approach for many leases (including many leases currently classified as finance leases)
C	Use PO approach for all leases except: • Long-term leases of land • Manufacturer/dealer leases. • Leases entered into by banks/finance organisations	This approach avoids the problems associated with long term leases of land and manufacturer/dealers The partial derecognition approach would apply to most (but not all) leases currently classified as finance leases. The PO approach would apply to most (but not all) leases currently classified as operating leases.
D	Use PO approach for leases where the lessor's exposure to the risks associated with the underlying asset is significant.	This approach is similar to the existing requirement to classify leases as finance leases or operating leases. The PO approach would apply to leases where the lessor's exposure to the underlying asset is significant (operating leases). The partial derecognition approach would apply to

Approach	Description	Comments
		all other leases (finance leases).
E	Use the partial derecognition approach for all leases except those that include non-distinct services.	This approach avoids recognising revenue upfront in respect of unperformed services.
F	Use the partial derecognition approach for all leases except: • Short term leases • Leases of investment property	This approach avoids the problems associated with short term leases and investment property leases. This approach results the partial derecognition approach for most leases.

Staff analysis and recommendations

A6. The staff note that many commentators oppose the performance obligation approach to lessor accounting. Of those who responded to the lessor accounting questions in the Leases discussion paper, more than half supported the derecognition approach. We have also received a number of unsolicited comment letters from the leasing industry expressing opposition to the PO approach.

A7. In addition, there are significant conceptual problems associated with the PO approach. In particular:

(a) It is arguably inconsistent with the proposed approach to lessee accounting; and

(b) It double counts assets and grosses up the balance sheet.

A8. The staff acknowledge that there are practical problems associated with the partial derecognition approach. However, we think that we can be deal with some of those issues either through requiring the use of the PO approach in some limited situations or by providing additional guidance. The following table summarises those problems and our suggested response:

Disadvantages	Comments
Places significant strain on ability to split payments between lease payments and payments for services.	As discussed in AP 3B/Memo #104 we think that it would be extremely rare for a lessor to be unable to separate the leases element from the service element. In those rare situations, AP 3B/Memo #104 proposes using the estimated cost of the services to enable the payments to be split.
Does not work well for very short term leases (eg short term car rentals, hotel rooms).	The boards have already decided to permit accruals accounting for leases with a maximum possible lease term of less than one year. We recommend that all short term leases should be accounted for using the accruals approach.
Does not work well for investment property. In addition, it is complex to apply to buildings with multiple components (eg 2 storeys of a 20 storey office building).	The boards have already decided that lessors who adopt the fair value model in IAS 40 would be excluded from the scope of the new lessor accounting requirements. We recommend that if holders of investment property do not apply the fair value model they should be required to use the PO approach.

A9. Consequently, the staff think that the partial derecognition approach to lessor accounting should be applied to all leases except:

(a) Short term leases (if accruals accounting is not used)

(b) Leases of investment property (if the FV model in IAS 40 is not adopted).

The PO approach would apply to these leases. This is hybrid approach F.

A10. The staff note that rather than requiring the PO approach for short term leases that are not accounted for using accruals accounting, the Board could instead require the use of accruals accounting for all short term leases.

A11. Hybrid approach F would leave unresolved the following problems with the partial derecognition approach:

Disadvantages	**Comments**
Gives rise to gains if the carrying amount of the underlying asset is less than its fair value.	This is simply a consequence of carrying the underlying asset at historical cost. The boards could decide to require such gains to be deferred. Alternatively, these gains could be recognised in OCI by requiring the lessor to revalue the underlying asset immediately before a new lease is entered into.
Revenue recognised under this approach includes estimates of amounts payable during optional periods and/or under contingent rental arrangements.	This is a consequence of our decision to include options and contingent rentals in the measurement of the receivable.
No one party has the underlying asset on its books.	This reflects the fact that no one party controls all the rights associated with the underlying asset – they are divided between the lessor and the lessee. This approach views the underlying asset as no more than a bundle of rights, some of which are transferred by the lease.
More complex to apply than the PO approach.	This is still the case. However, based on comments received from the leasing industry it would appear that this additional complexity does not worry preparers.

Not supported by FASB.	If the Board adopt the approach proposed by the staff, the lessor accounting proposals will not be converged.

Question 1
The staff recommend that the partial derecognition approach be used for all leases except short term leases and leases of investment property carried at cost. Do you agree?

A12. The staff note that requiring accruals accounting for all short term leases rather than the PO approach for some short term lease leases would increase consistency. Consequently, we recommend, that if the Boards accept the staff recommendation, all short term leases should be accounted for using the accruals approach.

Question 2
The staff recommend, that if the Boards accept the staff recommendation, all short term leases should be accounted for using the accruals approach. Do you agree?

A13. If the Board does not support the staff recommendation, then you will need to decide which of the alternative hybrid approaches described above you would support.

A14. At a recent meeting with users there was some support for using hybrid approach D. Under this approach, the PO approach would be used for leases where the lessor's exposure to the risks associated with the underlying asset is significant. All other leases would be accounted for using the partial derecognition approach. This would mean that most short term leases (that are not accounted for using accruals accounting) and all investment property leases (that do not qualify for the fair value scope exemption) would be accounted for under the PO approach.

A15. In addition the staff note that hybrid approach D would solve the following problems associated with the performance obligation approach:

(a) Manufacturer/dealers would recognise profit upfront if the lease did not expose the manufacturer/dealers to significant risks associated with the underlying asset.

(b) If banks/finance organisations enter into leases that do not expose them to significant risks associated with the underlying asset, they would not recognise the underlying asset on their books.

A16. Consequently, if the boards do not support the staff's recommendation in question 1, the staff recommend hybrid approach D.

A17. The staff note that the ED will provide indicators of when a lessor is deemed to retain significant risks associated with the underlying asset.

Question 3
If the boards do not support the staff's recommendation in question 1, the staff recommend hybrid approach D – that is, the PO approach should be used for leases where the lessor's exposure to the risks associated with the underlying asset is significant. The partial derecognition approach would apply to all other leases. Do the Boards agree? If you do not agree what alternative hybrid approach would you support?

A18. As noted above, if the Board is concerned about the gains that arise under the partial derecognition approach when the carrying amount of the underlying asset is less than its fair value, the Board could decide to:

(a) Defer any gains; or

(b) Require the lessor to revalue the underlying asset immediately before a new lease is entered into. This would result in any gains being recognised in OCI.

A19. The staff think that the gains arising under the partial derecognition approach correctly reflect the fact that the lessor has sold part of the underlying asset in return for a receivable. Consequently, we do not recommend either approach.

Question 4
Should a lessor under the partial derecognition approach be required to: (a) defer any gains (b) revalue the underlying asset immediately before a new lease is entered into?