Appendix to AP 3E/Memo 109

IASB/FASB meeting w/c 14 June 2010

Lease Type	Current Accounting	Ideal Model	Possible Model	Does Not Work
Investment property, entire asset	Operating	PO - Preferred by users over the derecognition model because it continues to show the investment property on the lessor's books and because the straight-lining of the PO would be an adequate proxy for rental income, which is a key metric for users. Moreover, the revenue/cost of sales that results from a derecognition model is not meaningful to the investment property business model.	Derecognition - Does not provide useful information to 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. Under the derecognition model, the lessor would record the residual by reducing the carrying value of the property as a proportion of the fair value of the property being leased out. Upon subseqent measurement, the value would not accrete upwards. At the end of the lease period, the property will revert to the lessor at a value significantly below its actual value. The carrying value would not be meaningful to users of financial statements.	
Investment property, partial asset	Operating	PO - Preferred by users because it continues to show the investment property on the lessor's books and because the straight-lining of the PO would be an adequate proxy for rental income, which is a key metric for users. Moreover, the revenue/cost of sales that results from a derecognition model is not meaningful to the investment property business model.		Derecognition - Does not provide useful information to 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). Under the derecognition model, the lessor would record the residual by reducing the carrying value of the property as a proportion of the fair value of the property being leased out. Upon subseqent measurement, the value would not accrete upwards. At the end of the lease period, the property will revert to the lessor at a value significantly below its actual value. The carrying value would not be meaningful to users of financial statements.

	A	B	C	D	E
6	Equipment, substantially all value/life (non-manufacturer)	Finance	Derecognition - Closest to current accounting by dealers and finance institutions. For finance institutions, the Day 1 gain challenges do not exist because there is no gain to record (fair value of the underlying is presumed to be equal to its carrying basis) and the boards decided that certain business models could present sales and cost of sales on a net basis.	PO - 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. For regulated institutions, unclear as to the impact on regulatory capital if balance sheet is grossed up.	
7	Equipment, medium term (non-manufacturer)	Operating	PO - closest to current accounting. Lessor retains equipment on the books. Under current accounting guidelines, the residual asset is part of a finance lessor's lease receivable. Users of financial statements of companies that are lessors that are only providing financing may argue that the PO model does not give depict the entity's risk exposure on the residual asset because the residual asset is not recorded. However, under derecognition, the value recorded as the residual asset is not its fair value, so it also does not depict the entity's residual exposure. The entity's exposure to residual risk under either model would be communicated to users through disclosure.	Derecognition - Because the partial derecognition model only recognizes proportional gain, and when an entity is only providing financing there is no upfront gain to record, this is a viable model. However, it would be a larger divergence from current accounting for these types of leases as compared to the PO model.	
8	Any lease with non-distinct services	Either	PO - Less stress on the split between lease and service when PO model is used due to no Day 1 gain being recognized.	Derecognition - 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.	
9	Automobile (non-manufacturer)	Operating	Derecognition - Although currently accounted for as an operating lease, automobile finance institutions manage their auto lease portfolio much as a bank would manage their direct finance lease portfolio. The key difference is the much higher level of residual risk taken by the auto finance institution.	PO - Applying the PO model would not be a significant change from the current accounting for these types of leases.	

	A	B	C	D	E
10	Equipment, substantially all value/life (manufacturer)	Finance	Derecognition - This approach retains the sales revenue and cost of goods sold recorded by manufacturers.		PO - If manufacturers that currently record the manufacturing gain at Day 1 are precluded from doing so under the PO approach, this would influence business practice significantly, as such manufacturers would be forced to sell the products to a third-party intermediary who would then be the lessor. This would not reflect the economics of a transaction where substantially all of the asset's value has been monetized through the lease.
11	Equipment, medium term (manufacturer)	Operating	Derecognition - Although under current guidance, these lessors do not record a gain on Day 1, the partial derecognition model would limit that gain to the proportion of the asset leased out.	PO - This model could be justified because it is closest to current accounting. However, a principle would have to be developed if some manufacturers are allowed to record Day 1 gain and others are not.	
12	Short-term leases	Operating	PO (perhaps the lessor will not even apply the PO model and just record on an accrual basis). Clearly the derecognition model does not work and PO is the model that is akin to a pure rental.		Derecognition - short-term lessor cannot apply the derecognition model without a significant amount of calculation and estimation that is not commensurate with any benefits derived from applying such a model.
13	Long-term lease of land	Operating	PO - The lessor is obligated to allow the use of the land and does not have access to any other rights aside from the residual, and the residual is expected to be substantial. The argument for the PO model is identical for any other real estate (see above with regards to investment properties).		Derecognition - Under the derecognition model, the lessor would record the residual by reducing the carrying value of the land as a proportion of the fair value of the land being leased out. Upon subseqent measurement, the value would not accrete upwards. At the end of the lease period, the land will revert to the lessor at a value significantly below its actual value. The carrying value would not be meaningful to users of financial statements.