Project **Leases**

Topic **Additional Analysis of Lessor Models**

Objective

1. The objective of this paper is to discuss different lease arrangements and how the two approaches to lessor accounting could be applied to those arrangements. This paper is a supplement to Agenda Paper 3D/FASB Memo 108, as requested by the FASB members. The views in this paper reflect the views of the FASB staff.
2. In this paper, the FASB staff continues to recommend that the performance obligation approach apply to all lessors. However, should the boards decide to adopt a hybrid approach to lessor accounting, the FASB staff recommends that the boards limit the leases to be accounted for under the derecognition approach to manufacturers and dealers. All other lessors would apply a performance obligation approach to lease arrangements.
3. This paper is structured as follows:
   (a) Background
   (b) Approach to Lessor Accounting
   (c) Staff Recommendation

Background

4. The boards have been discussing two different lessor accounting models: a derecognition approach and a performance obligation approach. The FASB

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.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

tentatively decided to adopt the performance obligation approach in which the lessor retains the leased asset in its statement of financial position, recognizes an asset for its rights to receive rental payments from the lessee and recognizes a liability for its performance obligations under the lease. Revenue would be recognized over the lease term.

5. At the joint meeting in May 2010, the boards discussed in more detail the derecognition approach to lessor accounting in which the lessor derecognizes the portion of the leased asset that it has transferred to the lessee, the right to use the leased asset, retains a residual asset and recognizes an asset for its right to receive rental payments. Revenue would be recognized at lease commencement.

6. At the May 2010 meeting, the IASB expressed an interest in using a hybrid lessor accounting model that would incorporate both the performance obligation approach and the derecognition approach.

7. At the June 9 FASB Education Session, the FASB considered whether one lessor approach would be appropriate in all leases. The FASB subsequently asked the FASB staff to provide additional analysis, including a matrix of various lease types, about whether a hybrid model should be adopted and if so, when each approach should be applied.

Staff Analysis

8. The appendix to this memo includes a chart presenting the following:

    (a) different lease types

    (b) the current accounting treatment for each lease type

    (c) which model seems to be the most appropriate for each lease type

    (d) impact of the alternative model

    (e) whether one of the models would not work for that particular lease type

9. Based on that appendix, the performance obligation approach would work well for almost all lease arrangements except for manufacturers and dealers. In addition, for most leases that are currently accounted for as operating leases the

performance obligation approach would best portray the economics of those lease arrangements. .

10. It is the leases that are currently accounted for as finance leases that the derecognition approach appears to depict the economics better than the performance obligation approach.

11. The staff considered whether there is a principle that could be applied to determine when to use the derecognition approach versus the performance obligation approach. For example, to apply a derecognition approach where the lessor's exposure to the risks associated with the underlying asset is significant (Approach D from agenda paper 3D/FASB Memo 108).

12. Based on discussions with the FASB, there is concern that the current lessor accounting model is not "broken" and applying a performance obligation approach to those leases that are currently accounted for as finance leases would be a change to practice and may not reflect the economics of those leases.

13. Therefore, the staff have summarized the two lease types that are currently accounted for as a finance lease below as:

    (a) manufacturers and dealers, and

    (b) finance leases.

Manufacturers and Dealers

14. The FASB staff thinks that allowing the lessor to recognize revenue at the beginning of the lease term would reflect the economics of the transaction for lessors who are in the business of trading in the kind of assets that are being leased; that is, manufacturers and dealers. Those lessors either manufacture the assets or purchase them at wholesale prices and typically provide their customers an option to either purchase or lease the assets. The business model of these lessors is primarily to sell the assets and derive the revenue from the difference between the asset's cost and its sale price. Leasing is used by these lessors primarily as a method to market their products to customers who are unable or unwilling to pay the full asset price at one time.

15. The derecognition approach seems to be the most appropriate approach for manufacturers and dealers. This approach is similar to the current accounting from a balance sheet perspective and an income statement perspective. The leased asset would be derecognized, a lease receivable would be recognized, and sales and cost of sales would be recognized at lease commencement. Accounting for those leases under the derecognition approach would be dissimilar from current accounting because the lessor's right to any remaining residual value would be presented separately from the lease receivable Under current accounting guidelines, the unguaranteed portion of residual value is recognized as part of the lease receivable balance.

16. Under current accounting guidelines, manufacturer/dealer leases that do not meet any of the criteria to be a finance lease get operating lease accounting, which results in no revenue recognized at lease commencement. Requiring the application of the partial derecognition model even in cases where less than substantially all the value of the underlying has been leased arguably depicts the economics of such lease transactions more appropriately as compared to current accounting guidelines.

Current Finance Leases

17. The staff considered the following example of a lease currently accounted for as a finance lease:

    (a) A bank often offers a customer a lease that finances the use of an asset for all or a substantial portion of the asset's useful life. Typically, these leases are provided by a lessor that is not in the business of selling the assets it leases and that functions essentially as a lender. Often in these leases, the lessee receives a copy of the contract by which the lessor acquires the asset before signing the lease. The bank/lessor may never take possession of the leased asset (in fact, the bank/lessor generally has no contact with the leased asset), and its legal obligation to lease the asset does not arise until the lessee accepts the asset from the supplier. The lessee generally has no rights against the bank/lessor if the leased asset does not perform.

18. The derecognition approach for companies that finance a lessee's use of an asset, those leases currently classified by the lessor as (direct) finance leases, would be similar to the current accounting from a balance sheet perspective. From an income statement perspective, the derecognition approach would result in sales and cost of sales being recognized at lease commencement. However, at the May 2010 joint meeting the boards agreed that the presentation of sales and costs of goods sold would be presented net depending on the lessor's business model.

19. The derecognition approach would differ from current leases guidance for finance leases because any remaining residual value would be presented separately from the lease receivable Under current accounting guidelines, the unguaranteed portion of residual value is recognized as part of the lease receivable balance.

20. Current accounting guidelines rely on a lease being deemed to be for "substantially all" the underlying asset's value or life in order for it to be considered a finance lease. However, whether or not a finance company enters into a finance lease or an operating lease, no revenue or gain is recognized upon lease commencement. In order to avoid having lessors that finance apply two different models, as under current accounting guidelines, it maybe easier to have all such lessors apply the performance obligation model. This approach also avoids having to make a distinction of when an entity has a business model that is considered to be financing.

Approach to Lessor Accounting

21. Some board members do not think that one approach to lessor accounting is appropriate for all leases due to the differences in economics or business models for different lessors. Many working group members suggested that the boards should consider a mix of more than one model for lessors depending on the lessor's business model. In addition, many comment letters and other feedback received from working group members suggested that one model for all lessors would not be appropriate in all circumstances.

22. The FASB staff do not recommend setting out a long list of rules to determine which leases would be accounted for under a performance obligation approach versus which leases would be accounted for under a derecognition approach.

23. Instead, the staff thinks that all leases should be accounted for under the performance obligation approach except for manufacturers and dealers. That is because the derecognition approach better reflects the economics of a manufacturer or dealer's business model.

24. A dual-approach model distinguishes between a lease in which the economic substance is accurately reflected by the recognition of a performance obligation from a lease in which the economic substance is more accurately reflected by partial derecognition of the underlying asset and revenue recognized at lease commencement.

Staff Recommendation

25. The FASB staff recommends that the boards have one approach for all lessors – the performance obligation approach.

26. However, if the boards decide to adopt a hybrid approach to lessor accounting, the FASB staff recommend to limit the leases to be accounted for under the derecognition approach to manufacturers and dealers. All other lease types would be accounted for under the performance obligation approach.