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Project	<b>Leases</b>
Topic	<b>Lessor Accounting—Residual Value Guarantees</b>

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## **Objective**

1. This paper addresses the accounting for residual value guarantees (RVGs) held by lessors.
2. In this paper, the staff recommends that lessors account for amounts to be paid by a lessee under a RVG consistent with the accounting for contingent rentals. Consequently, the staff recommends that:
  - (a) The lease receivable recognized by the lessor would include amounts payable under a RVG if the amount could be measured reliably.
  - (b) The receivable would be measured using an expected outcome technique; however, not every possible scenario would need to be taken into account when measuring the receivable.
  - (c) The carrying amount of the receivable would be reassessed at each reporting date if any new facts or circumstances indicate that there is a material change in the receivable.
  - (d) Any change in the receivable arising from a change in amounts payable under an RVG would be treated as an adjustment to the lessor's receivable balance and performance obligation.
3. In addition, the staff recommends that lessors account for RVGs guaranteed by a third party in accordance with the accounting for other guarantees.

4. This paper is structured as follows:
  - (a) Background Information
  - (b) Staff Analysis
  - (c) Staff Recommendation.

### **Background Information**

5. An RVG reduces a lessor's exposure to the risk that the value of the leased asset will be less than an established amount (within the guarantee arrangement) at the end of the lease term (generally, when the item is returned to the lessor). Under these guarantees, the lessor is compensated if the value of the leased asset is below a specified amount at the end of the lease.
6. RVGs can be provided by the lessee, as well as by an unrelated third party.
7. RVGs can come in different forms, for example, an agreement for the guarantor to pay any deficiency between the value of the asset and the guaranteed amount at the end of the lease, or an agreement for the guarantor to purchase the asset for the guaranteed amount at the end of the lease (for example, to allow the guarantor to refurbish and remarket the item to minimize its losses.
8. If the RVG is provided by a lessee, the lessee will usually pay lower rentals than a lease in which no guarantee is provided. The difference in the payments is the lessee's compensation for assuming the residual value risk. If the RVG is provided by an unrelated third party, the lessor might pay (a) an up-front fee to the guarantor, (b) a fee during the term of the guarantee, (c) a portion of the proceeds upon sale of the asset at the end of the lease, or some combination of items (a)–(c).
9. An RVG provided by a third party related to the lessee would be considered to be the same as an RVG provided by the lessee for accounting purposes.
10. In February 2010, the Boards tentatively decided that, for lessees, RVGs should be accounted for in a manner consistent with that decided for contingent rentals.

11. Although the Boards have not discussed the accounting for RVGs for lessors, the following are the Boards' tentative decisions on the accounting for contingent rentals for lessors:
- (a) The lease receivable recognized by the lessor would include amounts payable under contingent rental arrangements. A lessor would only recognize a receivable for amounts due under contingent rental arrangements if the receivable could be reliably measured. The receivable would be measured using an expected outcome technique. The final leases requirements would clarify that not every possible scenario would need to be taken into account when measuring the receivable.
  - (b) Contingent rentals based on an index or rate would be measured using readily available forward rates. If forward rates are not available, the rates at the inception of the lease would be used.
  - (c) The carrying amount of the receivable would be reassessed at each reporting date if any new facts or circumstances indicate that there would be a material change in the receivable.
  - (d) The discount rate would not be revised when there are subsequent changes in the amounts payable under contingent rentals unless the rentals are contingent on variable reference interest rates.
  - (e) Changes in amounts payable under contingent rental arrangements should be treated as adjustments to the original transaction price and be allocated to the lessor's receivable and the lessor's performance obligation. If a change is allocated to a satisfied performance obligation, the change would be recognized in revenue. If a change is allocated to an unsatisfied performance obligation, the carrying amount of the lessor's performance obligation would be adjusted. The staff plans to discuss when and how a performance obligation is satisfied in a lease contract in a future memo.

## Staff Analysis

### *Recognition of RVG*

12. As mentioned above in paragraph 10, the Boards have tentatively decided that RVGs should be included in the lessee's obligation. The staff thinks that the reasoning behind that decision should be equally applied to lessors. That is, any amount that is expected to be paid to the lessor by the lessee under a RVG would be included in the lessee's obligation and therefore also should be included in the lessor's receivable and performance obligation.
13. The guidance on leases in Topic 840 of the *FASB Accounting Standards Codification*<sup>TM</sup> states that, for a lessor, minimum lease payments comprise any guarantee by the lessee (including by a third party related to the lessee) of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property.
14. IAS 17, *Leases*, also states that minimum lease payments include any RVGs guaranteed to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
15. The following are considered advantages to that approach:
  - (a) It is consistent with the Boards' decision not to adopt a components approach.
  - (b) It reflects the fact that RVGs are often related to other terms of a lease, particularly contractual rental payments and options to renew the lease term.
  - (c) RVGs and contingent rentals are similar in nature; in both cases the lessor has a receivable of an uncertain amount.
16. The staff thinks that the conceptual basis for the lessor's treatment of contingent rentals also should apply to RVGs for the following reasons:
  - (a) The payment under a RVG is may be a contingent payment for the lessee. The lessor has a right to payment under an RVG; the amount of

that right is the only uncertainty, including situations in which no payment may be required.

- (b) The lessor's receivable should reflect all of the payments that the lessor would expect to receive, if any, from the lessee based on facts and circumstances that affect the value of the asset being leased and guaranteed.
17. The staff thinks that any change in the lessor's receivable resulting from an RVG should be allocated to the lessor's receivable and performance obligation as it results from a contractual arrangement existing at the inception of the lease. The staff thinks that the terms of an RVG are consistent with those present in contingent rental terms and, thus, should be treated consistently.

***Third Party RVGs***

18. The above analysis in paragraphs 12-17 is specific to RVGs that are provided by the lessee. The measurement of the lessee's obligation and the lessor's receivable consider the rental payments that would be paid by the lessee to the lessor as part of the lease contract.
19. Paragraph 840-10-25-7 of the Accounting Standards Codification states that minimum lease payments for a lessor should include the following:
- [Any guarantee of the residual value]... by a third party unrelated to either the lessee or the lessor, provided the third party is capable of discharging the obligations that may arise from the guarantee.
20. Under the existing leases requirements, any residual values that are guaranteed from the inception of the lease are included in the minimum lease payments, regardless of whether provided by the lessee or an unrelated third party. That is because the value of the underlying asset is an important factor in classifying a lease under the existing accounting requirements.
21. In addition, as discussed in paragraph 14 above, guidance in IAS 17 states that minimum lease payments for a lessor include any RVG guaranteed to the lessor by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

22. However, under the proposed right-of-use model, the value guaranteed on the underlying asset is not, in itself, relevant to a lease arrangement when the guarantee is from a third party.
23. Thus, the staff thinks that any payment under an RVG provided by an unrelated third party should not be accounted for as part of the lease arrangement because it solely affects the value of the underlying leased asset. Rather, RVGs provided by unrelated third parties should be accounted for as other guarantees.

### Staff Recommendation

24. The staff recommends that lessors account for amounts to be paid by a lessee under an RVG consistent with the accounting for contingent rentals. Consequently, the staff recommends that:
  - (a) The lease receivable recognized by the lessor would include amounts payable under an RVG if the amount could be measured reliably.
  - (b) The receivable would be measured using an expected outcome technique; however, not every possible scenario would need to be taken into account when measuring the receivable.
  - (c) The carrying amount of the receivable would be reassessed at each reporting date if any new facts or circumstances indicate that there would be a material change in the receivable.
  - (d) Any change in the receivable arising from a change in amounts payable under an RVG would be treated as an adjustment to the lessor's receivable balance and performance obligation.
25. In addition, the staff recommends that lessors account for RVGs guaranteed by a third party in accordance with the accounting for guarantees.

#### Question 1

Do the Boards agree with the staff recommendation that a lessor should account for amounts to be paid by a lessee under a RVG consistent with the accounting for contingent rentals? If not, why not?

**Question 2**

Do the Boards agree with the staff recommendation that RVGs from a third party should be accounted for in accordance with the accounting for guarantees?