Project **Leases**

Topic **Derecognition Approach to Lessor Accounting**

Introduction

1. The Boards have been considering how to apply a right-of-use model to lessors under a performance obligation approach. At the March 2010 joint Board meeting, the IASB indicated that it would like to reconsider an alternative accounting approach for lessors (the "derecognition approach").

2. The purpose of this paper is to discuss the rationale for applying the derecognition approach to lessor accounting and two possible ways to apply the derecognition approach—a full derecognition approach and a partial derecognition approach.

3. The structure of this paper is as follows:

   (a) Background

   (b) Description of the derecogniton approach

      (i) Full derecognition

      (ii) Partial derecognition

   (c) Journal entries to illustrate the accounting for both approaches on five types of lease scenarios:

      (i) machine lease for most of the machine's useful life

      (ii) manufacturer/dealer lease

      (iii) short term car lease

(iv) re-lease

(v) lease of 2 stories of a 20 story building

(d) Advantages and disadvantages of the derecognition approach as compared to the performance obligation approach to lessor accounting

(e) Staff recommendation and question for the Boards.

4. The appendix to this paper describes two additional derecognition approaches to lessor accounting that were considered by the staff, a revaluation approach and a transfer approach. The staff do not recommend pursuing those approaches any further for the reasons indicated in the appendix.

Background

5. Prior to issuing the leases Discussion Paper (DP) in March 2009, the Boards had tentatively decided to defer consideration of lessor accounting. Consequently, the Boards had not discussed the accounting for lessors in detail; instead, the DP included a chapter on lessor accounting that discussed possible ways to apply a right-of-use model to lessors. Specifically, two approaches to lessor accounting were outlined in the DP: the performance obligation approach and the derecognition approach.

6. Under a performance obligation approach to lessor accounting, the lease contract creates a new right (the right to receive lease payments) and an obligation (an obligation to permit use of the leased asset to the lessee). Because the lease contract has created a new right with a corresponding liability, the lessor would not derecognize the leased asset because the new right and obligation are separate from the rights that the lessor has over the leased asset. As the lessor has not given up its rights to the leased asset, the leased asset remains recognized in the lessor's statement of financial position. Under a performance obligation approach, a lessor transfers a promised good or service to the lessee over the lease term. The promised good or service is permitting the lessee to use the leased asset over the lease term. Therefore, under a

performance obligation approach, the lessor's performance obligation would be satisfied, and revenue would be recognized, over the lease term.

7. The next section of the paper describes the rationale for applying a derecognition approach to lessor accounting and then describes two ways to apply that approach.

Description of the Derecognition Approach

8. The derecognition approach to lessor accounting views the underlying asset as a bundle of rights, any portion or all of which can be transferred to a lessee at a point in time (similar to a promise to deliver a good rather than a service over time). This is based on the fact that the lessor has exchanged a portion of the rights attached to the leased asset to the lessee during the lease term and the lessee will receive the future economic benefits of the leased asset. The lease contract transfers the right to use the asset that was previously held by the lessor to the lessee.

9. Under the derecognition approach to lessor accounting, the lessor has promised to deliver the rights to use the leased asset to the lessee. Therefore, under this approach the promised asset is the right-of-use asset. Under the proposed revenue recognition requirements, because the lessor transfers the promised asset at lease commencement (at a single point in time), the lessor has a single performance obligation (assuming no other obligations exist such as servicing).

10. The current draft of the proposed revenue recognition guidance states the following with regard to satisfaction of performance obligations:

> An entity shall recognize revenue when it satisfies a performance obligation…by transferring a promised good or service to the customer. A promised good or service is transferred when the customer obtains control of that good or service.

11. Under the derecognition model, the lessor transfers the right-of-use asset to the lessee at lease commencement, and has satisfied its performance obligation at that time. The delivery date would represent the date at which the transfer of the promised asset occurs. This would result in all revenue that is not attributable to

the financing component of the lease arrangement to be recognized upon delivery.

12. The lessor is not considered to have an obligation to permit the lessee to use the leased asset over the lease term (assuming there are no other elements in the lease such as services). The lessor's obligation is satisfied upon delivery and acceptance by the lessee of the leased asset. Permitting the lessee to use the asset over the lease term is not a future performance obligation but rather a right by law (right of quiet enjoyment). It is not conceptually different from the sale of an asset in which payments are made by the customer to the vendor over a period of time. The vendor would allow the customer use of the asset and would not repossess the asset from the customer unless there is a breach of contract.

13. Furthermore, the derecognition approach is consistent with the current proposed lessee model. Under the current proposed lessee model, the lessee recognizes an obligation for its payments under the lease contract upon lease commencement. This indicates that the lessee has received and accepted a good and therefore has an unconditional obligation to pay the lessor for the benefits of using that good.

14. Moreover, the derecognition approach is consistent with the Boards' decision to require the lessor to recognize a receivable at the point of physical delivery of the underlying asset. Recognizing a receivable indicates that the lessor has an unconditional right to consideration which implies that the lessor has satisfied its performance obligation.

15. Therefore, under a derecognition approach to lessor accounting, the lessor exchanges the right to use the leased asset for the right to receive payments over the lease term. In addition, the lessor retains the right to the leased item at the end of the lease term. In effect, the lessor has sold its right to use the leased asset during the lease term for a receivable from the lessee. The lessor has retained the right to the leased item after the end of the lease. However, it has no right to use the leased item during the lease term. The fact that title does not transfer to the lessee should not, in and of itself, result in no revenue being

recognized upon lease commencement. Under a derecognition approach, a lessor transfers a promised good to the lessee at the commencement of the lease (delivery). Therefore, under a derecognition approach, the lessor's performance obligation would be satisfied, and revenue would be recognized, at lease commencement.

16. This paper discusses two different ways to apply the derecognition approach to lessors: a full derecognition approach and a partial derecognition approach.

Description of the full derecognition approach

17. A full derecognition approach results in the lessor derecognizing the full carrying amount of the leased asset and recognizing a receivable (a financial asset) and a residual value asset (a non-financial asset). This model is essentially the same, from a statement of financial position perspective, as the direct financing and sales-type lease models under current U.S. generally accepted accounting principles (GAAP) and the approach used for finance leases in International Financial Reporting Standards (IFRSs). However, under existing GAAP for finance leases the residual asset is not separately presented. The net investment is presented.

18. Because the full derecognition approach views that the lessor has performed by providing an unconditional right to use the leased asset, the lessor would recognize revenue upon delivery of the underlying asset. The lessor would derecognize the underlying asset and reflect that it exchanged the underlying asset for a receivable and its residual value asset (the rights at the end of the lease that the lessor did not transfer). The entries would be as follows:

DR Lease receivable (PV of expected lease payments)

DR Residual Value Asset (PV of the expected residual)

DR Cost of Sales (full carrying amount of the underlying asset)

CR Underlying Asset (full carrying amount)

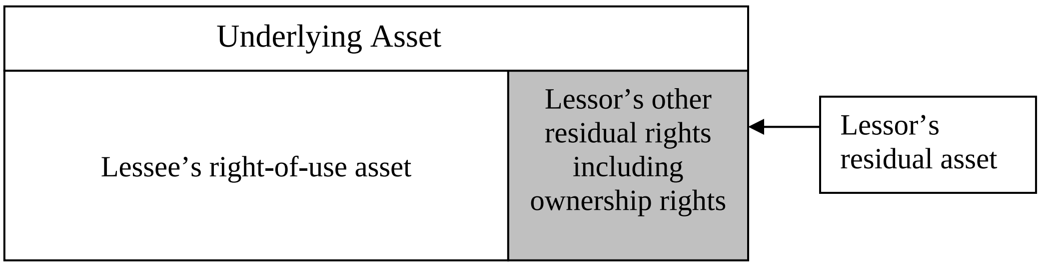
CR Sales (FV of the underlying asset)

19. In the journal above (and subsequently) the staff have separately presented both sales and cost of sales. In practice the Boards may wish for some lease types to present these items on a net basis. This will be discussed in a separate memo.

Description of the partial derecognition approach

20. The view under a partial derecognition approach is that an asset is a resource that comprises a bundle of rights and can be 'broken' down.

21. Consistent with the Boards' tentative decision on lessee accounting where a lessee has acquired an unconditional right to use the underlying asset, the lessor derecognizes the unconditional right to use a portion of the underlying asset for a period of time in return for a receivable. The lessor has no right to use the underlying asset <u>during</u> the lease term. The lessor retains the residual asset representing the lessor's rights to the underlying asset at the end of the lease term.



22. Because the derecognition approach views that the lessor has performed by providing an unconditional right to use the asset, the lessor would recognize revenue upon delivery of the underlying asset.

23. The double entries are:

    DR Lease receivable (PV of expected lease payments)

    DR Cost of Sales (portion of underlying that represents the ROU)

     CR Underlying asset (portion of underlying that represents ROU)

     CR Sales (consideration=PV of lease payments)

24. There could be different ways to allocate the derecognized portion of the underlying asset. For example, the lessor could derecognize that portion based on a time allocation. Applying this method, in a four-year lease for a machine

that has a useful life of 5 years, the lessor could derecognize four-fifths of the carrying amount of underlying asset. Some would view this method to be simple and consistent with the accounting for owned assets. That is, if an entity buys two machines on the same day, each with a five year life, and leases one of the machines at the end of year two, one would expect the machines to have equal value at the end of year four.

25. However, in this paper, the staff assumed that the derecognized portion would be based on the relative fair values of the asset transferred and the fair value of the underlying asset. This is because the staff think that this allocation more faithfully represents the economics of the transaction. Therefore, for each of the examples in the paper, the derecognized portion of the underlying asset under a partial derecognition approach would be calculated as follows:

(PV of receivable/fair value of the asset) x carrying amount of asset

26. As with the full asset derecognition approach, the staff have presented separately both sales and cost of sales. However, the Boards may wish for some lease types to present these items on a net basis. This is a presentation issue that will be discussed in a separate memo.

Journal Entries

27. This section of the paper presents five different lease scenarios and shows the journal entries under both a full derecognition approach and a partial derecognition approach. Several assumptions have been made in these examples that may need to be reconsidered. For example, this memo does not discuss the accounting for the residual value asset.

28. In the examples the staff has assumed that the present value of the receivables plus the residual asset equals the fair value of the machine. The staff also assumed that the present value of the lease payments will equal the right-of-use asset transferred to the lessee.

29. In addition, these examples represent fairly straight-forward leases. Accounting for the residual value, options, contingent rentals, etc. will be discussed in separate memos.

Machine lease for most of the machine's useful life

A machine's original cost is CU[1]150,000. Estimated value at the end of lease is CU15,000.
Estimated useful life is 5 years. The machine is leased for a fixed term of 4 years.
Annual payments due in arrears is CU41,959
Interest rate the lessor is charging the lessee is 8%
The receivable, the present value of the lease payments is CU138,975
Interest component of the lease payments is CU28,861
Present value of estimated value at the end of the lease is CU11,025

30. The following calculations were made for the journal entries under the partial derecognition approach:

(a) The right-of-use asset transferred = The fair value of the receivables = present value of the receivables = CU138,975

(b) The fair value of the residual asset = present value of the residual asset = CU11,025 = $15,000/1.08^4$

(c) Carrying amount of derecognized right to use portion for partial derecogniton=

$$\frac{\text{right-of-use asset transferred}}{\text{fair value of the entire machine}} \times \text{carrying amount of asset}$$

$$= \frac{138{,}975}{138{,}975 + 11{,}025} \times 150{,}000 = 138{,}975$$

[1] CU = currency units

Year 0					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Receivables	138,975		DR Receivables	138,975	
DR Cost of Sales	150,000		DR Cost of Sales	138,975	
DR Residual Value Asset	11,025		CR Underlying Asset		138,975
CR Underlying Asset		150,000	CR Revenue		138,975
CR Sales		150,000			
To derecognize the full carrying amount of the underlying asset, to record a lease receivable and residual value asset and to recognize sales and cost of sales.			*The lessor has leased a machine and to recognize revenue that the lessor has delivered a right-of-use asset.*		

Year 1					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	41,959		DR Cash	41,959	
CR Receivables		41,959	CR Receivables		41,959
DR Receivables	11,118		DR Receivables	11,118	
CR Interest Income		11,118	CR Interest Revenue		11,118
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 2					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	41,959		DR Cash	41,959	
CR Receivables		41,959	CR Receivables		41,959
DR Receivables	8,650		DR Receivables	8,650	
CR Interest Income		8,650	CR Interest Revenue		8,650
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 3					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	41,959		DR Cash	41,959	
CR Receivables		41,959	CR Receivables		41,959
DR Receivables	5,986		DR Receivables	5,986	
CR Interest Revenue		5,986	CR Interest Revenue		5,986
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 4					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	41,959		DR Cash	41,959	
CR Receivables		41,959	CR Receivables		41,959
DR Receivables	3,107		DR Receivables	3,107	
CR Interest Revenue		3,107	CR Interest Revenue		3,107
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Schedule to show effect on the Lessor's financial statement

Year	Statement of financial position			Statement of comprehensive income		
	Receivables at the end of the year	Annual payment	Carrying amount of machine	Revenue	Cost of sales	Revenue interest
Before leasing	-	-	150,000	150,000 or 138,975	150,000 or 138,975	
0	138,975	-	11,025[2]			
1	108,134	41,959				11,118
2	74,825	41,959				8,650
3	38,852	41,959				5,986
4	-	41,959				3,107
Total	-	167,836	-			28,861

Manufacturer/dealer lease

> A manufacturer manufactures a car.
>
> The car's normal selling price is CU26,000. The car's manufacturing cost is CU20,000.
>
> Estimated value at the end of lease is CU2,000
>
> Estimated useful life of the car is 10 years. The car is leased for a fixed term of 5 years.
>
> Annual payments due in arrears is CU6,171
>
> Interest rate the lessor is charging the lessee is 8%
>
> The receivable, the present value of the lease payments is CU24,639
>
> Interest component of the lease payments is CU6,216
>
> Present value of estimated value at the end of the lease is CU1,361

31. Under the partial derecognition approach, the lessor derecognizes a portion of the car equal to 20,000 x 24,639/26,000` = CU18,953. In addition, the lessor recognizes revenue equal to the receivable from the lessee (CU24,639).

[2] A separate paper discusses on how to account for the residual asset.

Therefore, the carrying amount of the car = 20,000 – 18,953 = CU1,047

32. Under the partial derecognition approach, the manufacturer/dealer recognizes a profit of CU5,686 when it has leased out the car. This profit represents a manufacturing profit for the car manufacturer or brokerage profit for the dealer.

33. Under the full derecognition approach, the lessor derecognizes the full carrying amount of the car, CU20,000, and recognizes a profit of CU6,000 (26,000 - 20,000). The revenue recognized is based on the selling price of the car (26,000) rather than the present value of the lease payments (24,639).

Year 0					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Receivables	24,639		DR Receivables	24,639	
DR Cost of Sales	20,000		DR Cost of Sales	18,953	
DR Residual Value Asset	1,361				
CR Underlying Asset		20,000	CR Underlying Asset		18,953
CR Sales		26,000	CR Revenue		24,639
To derecognize the full carrying amount of the underlying asset, to record a lease receivable, and to recognize sales and cost of sales.			*The lessor has leased a machine and to recognize revenue that the lessor has delivered a right-of-use asset.*		

Year 1					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	6,171		DR Cash	6,171	
CR Receivables		6,171	CR Receivables		6,171
DR Receivables	1,971		DR Receivables	1,971	
CR Interest Revenue		1,971	CR Interest Revenue		1,971
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 2					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	6,171		DR Cash	6,171	
CR Receivables		6,171	CR Receivables		6,171
DR Receivables	1,635		DR Receivables	1,635	
CR Interest Revenue		1,635	CR Interest Revenue		1,635
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 3					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	6,171		DR Cash	6,171	
CR Receivables		6,171	CR Receivables		6,171
DR Receivables	1,272		DR Receivables	1,272	
CR Interest Revenue		1,272	CR Interest Revenue		1,272
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 4					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	6,171		DR Cash	6,171	
CR Receivables		6,171	CR Receivables		6,171
DR Receivables	880		DR Receivables	880	
CR Interest Revenue		880	CR Interest Revenue		880
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 5					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	6,171		DR Cash	6,171	
CR Receivables		6,171	CR Receivables		6,171
DR Receivables	458		DR Receivables	458	
CR Interest Revenue		458	CR Interest Revenue		458
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Schedule to show effect on Lessor's financial statement:

Year	Statement of financial position			Statement of comprehensive income		
	Receivable at the end of the year	Annual payment	Carrying amount of the car	Revenue	Cost of Sales	Revenue interest
Before leasing	-	-	20,000			
0	24,639	-	1,361 or 1,047	26,000 or 24,639	20,000 or 18,953	
1	20,439	6,171				1,971
2	15,903	6,171				1,635
3	11,004	6,171				1,272
4	5,713	6,171				880
5	0	6,171				458
Total	-	30,855				6,216

Short-term car lease

A car's original cost is CU20,000

A car's fair value (and carrying amount) is CU18,056

Estimated value at the end of lease is CU15,000

Estimated useful life is 10 years

A car is leased for a fixed term of 2 years

Annual payments due in arrears in total is CU5,000

Interest rate the lessor is charging the lessee is 20%

The receivable, the present value of the lease payments is CU7,639

Interest component of the lease payments is CU2,361

Present value of estimated value at the end of lease is CU 10,417

Year 0									
Full Derecognition Approach					**Partial Derecognition Approach**				
DR Receivables			7,639		DR Receivables			7,639	
DR Cost of Sales			18,056		DR Cost of Sales			7,639	
DR Residual Value Asset			10,417						
	CR Underlying Asset			18,056		CR Underlying Asset			7,639
	CR Sales			18,056		CR Revenue			7,639
To derecognize the full carrying amount of the underlying asset, to record a lease receivable, and to recognize sales and cost of sales.					*The lessor has leased a machine and to recognize revenue that the lessor has delivered a right-of-use asset.*				

Year 1									
Full Derecognition Approach					**Partial Derecognition Approach**				
DR Cash			5,000		DR Cash			5,000	
	CR Receivables			5,000		CR Receivables			5,000
DR Receivables			1,528		DR Receivables			1,528	
	CR Interest Revenue			1,528		CR Interest Revenue			1,528
To recognize receipt of rental payment and interest on receivable.					*To recognize receipt of rental payment and interest on receivable.*				

Year 2									
Full Derecognition Approach					**Partial Derecognition Approach**				
DR Cash			5,000		DR Cash			5,000	
	CR Receivables			5,000		CR Receivables			5,000
DR Receivables			833		DR Receivables			833	
	CR Interest Revenue			833		CR Interest Revenue			833
To recognize receipt of rental payment and interest on receivable.					*To recognize receipt of rental payment and interest on receivable.*				

Schedule to show effect on Lessor's financial statement

Year	Statement of financial position			Statement of comprehensive income		
	Receivable at the end of the year	Annual payment	Carrying amount of the car	Revenue	Cost of Sales	Revenue interest
Before leasing	-	-	18,056	18,056 or	18,056 or 7,639	
0	7,639	-	10,417	7,639		
1	4,167	5,000		-		1,528
2	-	5,000		-		833
Total	-	10,000				2,361

Re-lease

34. In this example an aircraft with a 25-year life is re-leased in year 10.

Aircraft's original cost is CU2 million
Estimated value at the end of lease is CU300,000
Estimated useful life is 25 years
After 10 years, it has a carrying amount of CU520,000
When aircraft is 10 years old, the fair value of the aircraft is CU809,966
When aircraft is 10 years old, the lessor leases it for a fixed term of 10 years
Annual payments due in arrears is CU100,000
Interest rate the lessor is charging the lessee is 8%
The receivable, the present value of the lease payments is CU671,008
Interest component of the lease payments is CU328992
Present value of estimated value at the end of lease is CU138,958

Year 10											
Full Derecognition Approach						**Partial Derecognition Approach**					
DR Receivables			671,008			DR Receivables			671,008		
DR Cost of Sales			520,000			DR Cost of Sales			430,772		
DR Residual Value Asset			138,958								
	CR Underlying Asset			520,000			CR Underlying Asset			430,772	
	CR Revenue			809,966			CR Revenue			671,008	
To derecognize the full carrying amount of the underlying asset, to record a lease receivable, and to recognize sales and cost of sales.						*The lessor has leased a machine and to recognize revenue that the lessor has delivered a right-of-use asset.*					

Year 11										
Full Derecognition Approach					**Partial Derecognition Approach**					
DR Cash			100,000		DR Cash			100,000		
	CR Receivables			100,000		CR Receivables			100,000	
DR Receivables			53,681		DR Receivables			53,681		
	CR Interest Revenue			53,681		CR Interest Revenue			53,681	
To recognize receipt of rental payment and interest on receivable.					*To recognize receipt of rental payment and interest on receivable.*					

Year 12										
Full Derecognition Approach					**Partial Derecognition Approach**					
DR Cash			100,000		DR Cash			100,000		
	CR Receivables			100,000		CR Receivables			100,000	
DR Receivables			49,975		DR Receivables			49,975		
	CR Interest Revenue			49,975		CR Interest Revenue			49,975	
To recognize receipt of rental payment and interest on receivable.					*To recognize receipt of rental payment and interest on receivable.*					

Year 13										
Full Derecognition Approach					**Partial Derecognition Approach**					
DR Cash			100,000		DR Cash			100,000		
	CR Receivables			100,000		CR Receivables			100,000	
DR Receivables			45,973		DR Receivables			45,973		
	CR Interest Revenue			45,973		CR Interest Revenue			45,973	
To recognize receipt of rental payment and interest on receivable.					*To recognize receipt of rental payment and interest on receivable.*					

Year 14										
Full Derecognition Approach					**Partial Derecognition Approach**					
DR Cash			100,000		DR Cash			100,000		
	CR Receivables			100,000		CR Receivables			100,000	
DR Receivables			41,651		DR Receivables			41,651		
	CR Interest Revenue			41,651		CR Interest Revenue			41,651	
To recognize receipt of rental payment and interest on receivable.					*To recognize receipt of rental payment and interest on receivable.*					

Year 15					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	100,000		DR Cash	100,000	
CR Receivables		100,000	CR Receivables		100,000
DR Receivables	36,983		DR Receivables	36,983	
CR Interest Revenue		36,983	CR Interest Revenue		36,983
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 16					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	100,000		DR Cash	100,000	
CR Receivables		100,000	CR Receivables		100,000
DR Receivables	31,942		DR Receivables	31,942	
CR Interest Revenue		31,942	CR Interest Revenue		31,942
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 17					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	100,000		DR Cash	100,000	
CR Receivables		100,000	CR Receivables		100,000
DR Receivables	26,497		DR Receivables	26,497	
CR Interest Revenue		26,497	CR Interest Revenue		26,497
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 18					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	100,000		DR Cash	100,000	
CR Receivables		100,000	CR Receivables		100,000
DR Receivables	20,617		DR Receivables	20,617	
CR Interest Revenue		20,617	CR Interest Revenue		20,617
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 19					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	100,000		DR Cash	100,000	
CR Receivables		100,000	CR Receivables		100,000
DR Receivables	14,266		DR Receivables	14,266	
CR Interest Revenue		14,266	CR Interest Revenue		14,266
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 20					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	100,000		DR Cash	100,000	
CR Receivables		100,000	CR Receivables		100,000
DR Receivables	7,407		DR Receivables	7,407	
CR Interest Revenue		7,407	CR Interest Revenue		7,407
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Schedule to show effect on Lessor's financial statement

Year	Statement of financial position			Statement of comprehensive income		
	Receivable at the end of the year	Annual payment	Carrying amount of aircraft	Revenue	Cost of Sales	Revenue interest
Before leasing	-	-	520,000			
10	671,008		138,958 or 89,228	809,966 or 671,008	520,000 or 430,772	
11	624,689	100,000				53,681
12	574,664	100,000				49,975
13	520,637	100,000				45,973
14	462,288	100,000				41,651
15	399,271	100,000				36,983
16	331,213	100,000				31,942
17	257,710	100,000				26,497
18	178,327	100,000				20,617
19	92,593	100,000				14,266
20	0	100,000				7,407
Total	-	1,000,000				328,992

35. As seen above:

    (a) Under the full derecognition approach the lessor recognizes a profit of CU389,966

    (b) Under a partial derecognition approach the lessor recognizes a profit of CU240,236.

36. These gains arise because the underlying asset (the aircraft) is measured at historical cost rather than fair value. The gain recorded under the full asset approach equals the full difference between the fair value of the aircraft and its carrying value. The gain recognized under the partial asset derecognition approach reflects only the gain arising on the portion of the aircraft that is transferred to the lessee.

Example of a lease of 2 stories of a 20 story building

Building's original cost is CU2 million
Building's fair value is CU3 million
Estimated value at the end of lease is CU2.5 million
Estimated useful life is 25 years
The lessor leases out 2 stories of a 20-story building for a fixed term of 5 years
The lessor estimates fair value of 2 stories is CU300,000 and the fair value of 2 stories at the end of lease is CU250,000[3]
Annual payments due in arrears is CU70,000
Interest rate the lessor is charging the lessee is 12%
The receivable, the present value of the lease payments is CU252,334
Interest component of the lease payments is CU97,666

[3] This could be calculated on an allocation of square footage or some other reasonable basis of allocating the fair value.

Year 0					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Receivables	252,334		DR Receivables	252,334	
DR Cost of Sales	2,000,000		DR Cost of Sales	200,000	
DR Residual Value Asset	2,747,666				
CR Underlying Asset		2,000,000	CR Underlying Asset		200,000
CR Revenue		3,000,000	CR Revenue		252,334
To derecognize the full carrying amount of the underlying asset, to record a lease receivable, and to recognize sales and cost of sales.			*The lessor has leased two stories of a building and to recognize revenue that the lessor has delivered a right-of-use asset.*		

Year 1					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	70,000		DR Cash	70,000	
CR Receivables		70,000	CR Receivables		70,000
DR Receivables	30,280		DR Receivables	30,280	
CR Interest Revenue		30,280	CR Interest Revenue		30,280
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 2					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	70,000		DR Cash	70,000	
CR Receivables		70,000	CR Receivables		70,000
DR Receivables	25,514		DR Receivables	25,514	
CR Interest Revenue		25,514	CR Interest Revenue		25,514
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 3					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	70,000		DR Cash	70,000	
CR Receivables		70,000	CR Receivables		70,000
DR Receivables	20,176		DR Receivables	20,176	
CR Interest Revenue		20,176	CR Interest Revenue		20,176
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 4					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	70,000		DR Cash	70,000	
CR Receivables		70,000	CR Receivables		70,000
DR Receivables	14,196		DR Receivables	14,196	
CR Interest Revenue		14,196	CR Interest Revenue		14,196
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Year 5					
Full Derecognition Approach			**Partial Derecognition Approach**		
DR Cash	70,000		DR Cash	70,000	
CR Receivables		70,000	CR Receivables		70,000
DR Receivables	7,500		DR Receivables	7,500	
CR Interest Revenue		7,500	CR Interest Revenue		7,500
To recognize receipt of rental payment and interest on receivable.			*To recognize receipt of rental payment and interest on receivable.*		

Schedule to show effect on Lessor's financial statement

Year	Statement of financial position			Statement of comprehensive income		
	Receivable at the end of the year	Annual payment	Carrying amount of building[4]	Revenue	Cost of Sales	Revenue interest
Before leasing			2,000,000			
0	252,334		1,800,000	3,000,000 or 252,334	2,000,000 or 200,000	
1	212,614	70,000				30,280
2	168,128	70,000				25,514
3	118,304	70,000				20,176
4	62,500	70,000				14,196
5	0	70,000				7,500
Total	-	350,000				97,666

37. As seen above, under a partial derecognition approach the lessor recognizes a profit of CU52,334 and under a full derecognition approach, the lessor recognizes a profit of CU1,000,000 when it leased out the two floors. This is because the building is measured using cost where the carrying amount of the underlying asset does not reflect the market value of the underlying asset.

38. Some would propose a different approach to the full derecognition approach in this example. This would consider the value of the two floors that are being leased, as opposed to the entire building. The journal entries would be as follows:

DR Receivables 252,334
DR Cost of Sales 200,000
DR Residual Value 47,666
  CR Underlying Asset 200,000
  CR Revenue 300,000

[4] Assume that the entire building is measured using the cost under IAS 40 *Investment Property* rather than the fair value model.

Advantages and disadvantages of a derecognition approach as compared to the performance obligation approach to lessor accounting

Advantages	**Disadvantages**
• Consistent with the lessee model, which states that the lessee has an unconditional obligation. There is no continuing obligation for the lessor. • Consistent with the lessee model, which states that the lessee has purchased a right-of-use asset; therefore the lessor must have sold a right-of-use asset; therefore appropriately removes all (or a portion of) the leased asset from the books of the lessor that the lessor no longer controls (no double counting of the asset). • Not necessary to develop much guidance on in-substance purchase/sale of the underlying asset. This is because the lessor derecognizes (all or a portion of) the underlying asset because the lessee gained control of the underlying asset upon delivery. • Recognizing profit/loss at lease commencement is consistent with the current accounting for manufacturer/dealer lessors. • Partial derecognition approach has an advantage over the full derecognition approach in that it limits the amount of revenue recognized to represent only that portion of the leased asset that was sold (i.e. revenue is not recognized on the portion of the asset retained by the lessor).	• The leased asset would not appear on either party's accounting books, since (a) the lessee would recognize the right-of-use asset rather than the physical asset and (b) the lessor would record a receivable and a residual asset. (Under a partial derecognition approach, some may find it difficult to accept that a physical asset can be 'broken-up'). • Complex because the lessor has to calculate the value of its residual asset. • Sales and cost of sales could be recognized, which may not properly reflect the economics in many leases (although these could be presented net for some lease types). • Under the full derecogntion approach, the lessor recognizes a profit on day one equal to the difference between the carrying amount of the underlying asset (or portion of the underlying asset derecognized) and its fair value. • Determining how to measure the portion of the underlying asset that "was sold" in a partial derecognition approach could be costly and burdensome.

Staff recommendation and question for the boards

39. Although the staff acknowledge that the partial derecognition approach is more complex to apply, they think it better reflects the economic of lease contracts than the full asset derecognition approach because:

    (a) It results in the derecognition of only that portion of the underlying asset that is transferred to the lessee; and

    (b) Gain and losses arising on commencement of the lease represent only those gains and losses arising on the potion of the under lying asset transferred to the lessee.

40. Consequently, the staff prefer the partial derecognition approach to the full asset derecognition approach.

Question 1
If the Boards were to adopt a derecognition approach to lessor accounting which of the two approaches outlined above would the Boards prefer?

Appendix A: Other approaches considered by the staff

A1. In developing the derecognition model to lessor accounting, the staff discussed two other possible approaches. The staff rejected these approaches because the staff think that they are not operational. This appendix describes the two rejected approaches – revaluation and transfer approaches.

Revaluation approach

Description of approach

A2. Under a derecognition approach the lessor transfers a right-of-use asset to the lessee at the start of the lease. This transfer creates an unconditional obligation for the lessee to pay rentals and an unconditional right for the lessor to receive those rentals. Consequently, the lessor recognizes a receivable and revenue.

A3. The revaluation approach assumes that the transfer of the right-of-use asset to the lessee triggers a revaluation of the underlying asset. The valuation of the underlying asset should reflect the fact that the lessor has (i) surrendered its right to use the asset during the term of the lease; and (ii) recognized a separate receivable for the cash inflows from the asset during the term of the lease. Consequently, if the underlying asset is carried at fair value immediately before the start of the lease, the revaluation would result in a decrease in the value of the underlying asset.

A4. The change in value of the underlying would be recognized in profit or loss.

Journals

A5. Consider the following example under the revaluation approach.

Direct finance type lease

(a) A machine's original cost is CU150,000

(b) Estimated value at the end of lease is CU15,000

(c) Estimated useful life is 5 years

(d) The machine is leased for a fixed term of 4 years

(e) Annual payments due in arrears is CU41,959

(f) Interest rate the lessor is charging the lessee is 8%

(g) The receivable, the present value of the lease payments is CU138,975

(h) Interest component of the lease payments is CU28,863

	Statement of financial position			Statement of comprehensive income	
Year	Receivable at the end of the year	Annual payment	Carrying amount of machine	Revenue	Revaluation
0	138,975	-	150,000	138,975	(138,975)
1	108,133	41,959	11,025	11,118	-
2	74,825	41,959	11,025	8,651	-
3	38,851	41,959	11,025	5,986	-
4	-	41,959	11,025	3,108	-
Totals	-	167,836	-	167,838	

A6. At the lease inception, the lessor estimates that the fair value of its remaining interest in the machine is CU11,025, which equals to the present value of the unguaranteed residual value of the asset at the end of the lease term.

A7. The journals in Year 0 are as follows:

DR Receivable 138,975

CR Revenue 138,975

To recognize receivable

DR Revaluation 138,975

CR Underlying asset 138,975

To recognize asset at revalued amount of CU11,025

A8. The Boards could decide to present net of revenue and revaluation in the statement of comprehensive income. Under the simplest version of this approach, the revaluation of the underlying asset would take place on day 1 only.

A9. Journals from Year 1 to Year 4 are illustrated as follows:

	Year 1	Year 2	Year 3	Year 4
DR Cash	41,959	41,959	41,959	41,959
CR Receivable	41,959	41,959	41,959	41,959

To recognize receipt of rental payment				
DR Receivable	11,118	8,651	5,986	3,108
CR Interest revenue	11,118	8,651	5,986	3,108
To recognize interest on receivable				

Advantages and disadvantages

Advantages	**Disadvantages**
• Consistent with the proposed lessee accounting model • Provides users with useful and relevant information (eg fair value of the residual asset) • Does not result in negative value of the underlying asset	• Difficult to determine fair value (eg in some jurisdictions, for leases currently classified as operating leases) • Requiring fair value measurement of the underlying asset is inconsistent with the measurement of other non-financial assets • Fair value measurement of the asset creates gain/loss recognition, resulting in structuring opportunities by entering into a lease contract (eg greater gain recognition when re-leasing asset that is close to fully depreciated) • Creates volatility in the statement of comprehensive income

Reasons for rejection

A10. The staff rejected the revaluation approach for the disadvantages outlined above.

Transfer approach

Description of approach

A11. Under this approach the lessor transfers a right-of-use asset from the lessor to the lessee at lease inception. This transfer results in an unconditional obligation for the lessee to pay rentals. Consequently, the lessor recognizes a corresponding right to receive those rentals.

A12. This approach assumes that the transfer of the right-of-use asset to the lessee results in the lessor's receivable. Therefore, at the start of the lease, the lessor recognizes/reclassifies the transferred value of the underlying asset to the value of the receivable. For example,

DR Receivable

CR Underlying asset

Journals

A13. Consider the following example under the transfer approach.

Manufacturer/dealer lease

(a) A manufacturer manufactures a car

(b) The car's normal selling price is CU26,000

(c) The car's manufacturing cost is CU20,000

(d) Estimated value at the end of lease is CU2,000

(e) Estimated useful life is 10 years

(f) The car is leased for a fixed term of 5 years

(g) Annual payments due in arrears is CU6,171

(h) Interest rate the lessor is charging the lessee is 8%

(i) The receivable, the present value of the lease payments is CU24,639

(j) Interest component of the lease payments is CU5,759

(k) Present value of estimated value at the end of lease is CU 1,361

	Statement of financial position			Statement of comprehensive income
Year	Receivable at the end of the year	Annual payment	Carrying amount of car	Revenue
0	24,639	-	20,000	-
1	20,439	6,171	(4,639)	1,971
2	15,903	6,171	(4,639)	1,635
3	11,004	6,171	(4,639)	1,272
4	5,714	6,171	(4,639)	880
5	-	6,171	(4,639)	457
Totals	-	30,855	-	6,216

A14. The journal is as follows at the start of the lease (Year 0).

DR Receivable 24,639

CR Underlying asset 24,639

To recognize receivable

A15. Journals from Year 1 to Year 5 are illustrated as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
DR Cash	6,171	6,171	6,171	6,171	6,171
CR Receivable	6,171	6,171	6,171	6,171	6,171
To recognize receipt of rental payment					
DR Receivable	1,971	1,635	1,272	880	457
CR Interest revenue	1,971	1,635	1,272	880	457
To recognize interest on receivable					

Advantages and disadvantages

A16. This approach results in negative value of the underlying asset from Year 1 under the manufacturer/dealer lease and re-lease examples because the amount of receivable is greater than that of the underlying asset. Therefore, the Boards would need to consider what to do with the negative value of the asset: a) recognize gain; b) defer gain; or c) carry forward the negative value of the asset.

A17. Because of the problem associated with this approach, the staff think that unless the underlying asset is continuously revalued to fair value, this approach would not be operational. The table below summarises the advantages and disadvantages of the transfer approach.

Advantages	Disadvantages
• Consistent with the proposed lessee accounting model • Simple because the lessor's transfer of the right to use the underlying asset during the lease term is fully recognized as a receivable	• Results in negative value of the underlying asset in some situations because of a cost-based measurement of the asset

Reasons for rejection

A18. The staff rejected the transfer approach because of the disadvantages outlined above.