Project **Leases**

Topic **Lessor accounting: Derecognition approach**
Residual asset

Purpose

1. Under all of the derecognition approaches, the lessor recognises an asset that represents its interest in the underlying asset at the end of the lease (the residual asset). Board members are asked to decide how the lessor should measure this residual asset.

Staff analysis

2. In measuring its residual asset, the lessor has to consider the following factors:

   (a) The condition of the underlying asset will have changed by the end of the lease. The asset will be older, it may even be obsolete. Consequently, it is likely to have a lower value at the end on the lease. However other assets, such as land, could be worth more at the end of the lease than at the start of the lease.

   (b) The lessor will be unable to access the benefits associated with the underlying asset until the end of the lease. Therefore, the measurement of the residual asset should reflect the fact that the lessor may not be able to obtain cash flows from the residual asset until some point in the future (ie the valuation of the residual asset should reflect the time value of money).

3. The second factor can be illustrated with the example of a long-term lease of land. If a lessor enters into a 99-year lease of land it would not expect the value of the land to fall over the term of the lease (this is because freehold land is a non-depreciating asset). However, the value of the lessor's residual asset should reflect the fact that the lessor will be unable to obtain cash flows associated with the land until after the end of the lease (ie in 99 years time)[1]. This means that the value of the lessor's residual asset in a very long term lease is likely to be small at the inception of the lease as compared to the value of the land at end of the lease term.

4. The concept of the lessor's *residual asset* is different from the concept of a *residual value* under existing guidance:

   (a) IFRSs – IAS 16 *Property, Plant and Equipment* defines residual value as follows:

   > The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. (IAS 16.6)

   (b) The glossary in *FASB Accounting Standards Codification*™ defines a residual value as:

   > The estimated fair value of the leased property at the end of the lease term.

5. Both definitions ignore the time value of money effect described in paragraph 2b. However, it should be noted that under both IFRSs and US GAAP, the residual value of the leased asset is discounted in arriving at the lessor's net investment in the lease.

[1] The lessor could of course sell its residual asset before the end of the lease term. However, the proceeds it would receive from such a sale would reflect the fact the purchaser would be unable to obtain cash flows associated with the land until after the end of the lease.

Initial measurement

Full derecognition approach

6. Under the full asset derecognition approach the lessor could initially measure the residual asset at an amount that represents the difference between the carrying amount of the underlying asset that was derecognised and the amount of the lease receivable recognised. However, we rejected this approach because it could result in negative value of the underlying asset when the carrying amount of the asset is less than the receivables (eg in manufacturer/dealer or re-leases).

7. Therefore for the full derecognition approach, we recommend that the residual asset is initially measured at fair value (assumed to equal the present value of the expected value of the underlying asset at the end of the lease). We acknowledge that fair valuing the residual asset would create gains or losses when a lease commences. But we continue to support this approach because it provides more relevant information to users because the lessor's residual asset would reflect current expectations about the residual asset.

Partial derecognition approach

8. Under the partial asset derecognition approach to lessor accounting the residual asset is an allocation of the previous carrying amount of the underlying asset.

9. When the lease commences, the boards could require the lessor to remeasure the residual asset to fair value.

10. Some staff support this approach because:

    (a) Fair value provides more relevant information to users because the lessor's residual asset would reflect current expectations about the residual asset.

    (b) In pricing their leases, most lessors will have made assumptions about the expected value of the underlying asset at the end of the lease. Consequently, it should be possible to determine the fair value of the residual asset.

11. However other staff disagree because they think that it may be difficult for some lessors to obtain fair value information about the residual asset in some jurisdictions. Consequently, they do not recommend remeasurement at lease commencement under the partial derecognition approach.

Staff Recommendation

12. For the full derecognition approach, we recommend that the residual asset is measured at fair value (assumed to equal the present value of the expected value of the underlying asset at the end of the lease).

13. We are split on how to deal with partial derecognition.

Question 1 *Initial measurement*
a) Full derecognition approach: We recommend that the lessor initially measures the residual asset at fair value. Do you agree? b) For partial derecognition: Should the lessor under a partial derecognition approach be required to remeasure its residual asset to fair value at lease commencement?

Subsequent measurement

14. We considered the following approaches to subsequent measurement of the lessor's residual asset:

    (a) Measure the residual asset at fair value.

    (b) Accrete or unwind the carrying amount of the residual asset up to its expected value at the end of the lease.

15. We considered but rejected an approach whereby the carrying amount of the residual asset is frozen after initial measurement (other than for impairment). Although this approach is simple to apply, it ignores the fact that the residual asset accretes in value over time because of the time value of money.

Approach A: Measure the residual asset at fair value

16. Under this approach, the lessor would have to update its residual asset and recognise any gains and losses in profit/loss. The double entries are:

DR/CR Underlying asset

Dr/CR Gains/losses on remeasurement

17. The advantages for this approach are:

    (a) Provides more relevant information to users of financial statements (the lessor's residual asset reflects current expectation about residuals).

    (b) The lessor does not have to consider impairment.

18. The disadvantages are:

    (a) Requiring frequent remeasurements may be burdensome for preparers.

    (b) Decreases comparability with long-term physical assets that are measured on a cost-basis.

    (c) Fair value may be difficult to determine in some jurisdictions.

19. We note that many lessors would already be monitoring the expected value of their residual assets particularly in situations where their interest in the residual is significant (eg many leases currently classified as operating leases). Consequently, for these lessors, requiring the residual asset to be measured at fair value may not represent a significant burden. However, other lessors may not monitor their residuals as closely either because they are not significant or because they are only concerned about potential falls in value. For these lessors, requiring fair value measurement would represent a significant change.

Approach B: Accrete or unwind the carrying amount of the residual asset

20. Under Approach B, the lessor would unwind or accrete the residual asset up to its expected value at the end of the lease. The expected value of the residual asset at the end of the lease would be determined at the start of the lease and would not be changed subsequently, unless the lessor determined the residual

asset is impaired. In reviewing the asset for impairment, the lessor would apply the general impairment rules for non-financial assets.

21. The double entries to unwind or accrete the value of the residual asset:

DR Underlying asset

CR Profit/loss

22. Let's illustrate using the manufacturer/dealer example (relevant extracts are copied below):

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.
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

<u>If the residual asset was not initially measured at fair value</u>

(a) The portion of the car transferred in the lease = 20,000 x 24,639/26,000 = CU18,953. Therefore, the carrying amount of the residual asset = 20,000 – 18,953 = CU1,047.

(b) The interest rate used to accrete the residual asset would be the rate that equates the carrying amount of the residual asset to its estimated value at the end of the lease. In this example, the interest rate that equates the carrying value of CU1,047 to the estimated value of CU2,000 is 13.8%. (This rate is not the same as the rate the lessor is charging in the lease because of the unrecognised manufacturer's profit inherent in the residual asset.)

Residual asset	**Year**				
	1	**2**	**3**	**4**	**5**
Opening carrying amount	1,047	1,191	1,356	1,543	1,757
Interest income (at 13.8%)	144	165	187	214	243
Closing carrying amount	1,191	1,356	1,543	1,757	2,000

(c) Journals to accrete the asset in years 1 – 5 are:

	Year 1	Year 2	Year 3	Year 4	Year 5
DR Underlying asset	144	165	187	214	243
CR Income on unwinding	144	165	187	214	243
To increase the residual asset					

<u>If the residual asset was initially measured at fair value</u>

(d) The fair value of the residual asset on initial measurement = CU1,361

(e) In this situation, the rate used is the rate the lessor is charging in the lease because the manufacturer's profit inherent in the residual asset has been recognised.

Residual asset	**Year**				
	1	**2**	**3**	**4**	**5**
Opening carrying amount	1,361	1,470	1,587	1,714	1,851
Interest income (at 8%)	109	117	127	137	149
Closing carrying amount	1,470	1,587	1,714	1,851	2,000

(f) Journals to accrete the asset in years 1 – 5 are:

	Year 1	Year 2	Year 3	Year 4	Year 5
DR Underlying asset	109	117	127	137	149
CR Income on unwinding	109	117	127	137	149
To increase the residual asset					

23. The lessor could unwind/accrete the residual asset on a straight-line basis. This is simpler, more straight-forward and would provide a more consistent revenue stream for users to see. However, we question the usefulness of this information and think that the straight-line method may not necessarily reflect the value of the economic benefits to the entity.

24. The advantages to unwinding/accreting the residual asset are:

    (a) The residual asset – for both the full derecognition and partial derecognition approaches – continues to be on a historical-cost based measurement. This ensures comparability with other long-term physical assets that are measured on a cost basis.

    (b) Less complex and onerous for preparers for simple leases (when there is no remeasurement as a result of options and contingencies. This issue is discussed further in May 2010 Agenda papers 5D and 5E/Memos 95 and 96).

    (c) It is consistent with existing practice in US GAAP.

25. The disadvantages to unwinding/accreting the residual asset are:

    (a) Arguably provides less useful information than the fair valuing the residual asset, Approach A.

    (b) More complex and onerous when dealing with remeasuring the lease term as a result of changes in options and contingencies (this issue is discussed further in Agenda papers 5D and 5E/Memos 95 and 96).

Staff recommendation

26. The staff are split on the two approaches.

Question 2 ***Subsequent measurement***
In regards to subsequent measurement on the residual asset, do the boards prefer: a) Approach A: remeasure at fair value; or b) Approach B: unwind/accrete the residual asset up to its expected value at the end of the lease?