Project **Leases**

Topic **Derecognition approach – Treatment of options**

Purpose

1. The purpose of this paper is to discuss how to account for leases that include options to extend or terminate a lease under a derecognition approach to lessor accounting.

2. This paper also discusses how to account for leases that include purchase options.

3. The staff recommend the following:

    (a) The residual value asset recognised by the lessor should reflect the asset's value at the end of the longest possible lease term that is more likely than not to occur.

    (b) Whenever there is a revision to the expected lease term the, lessor should also remeasure its residual asset to reflect the revised lease term.

    (c) Changes in the lessor's receivable and changes in the lessor's residual asset arising from a change in lease term should be recognised in profit or loss and should be presented net.

    (d) Leases that include purchase options should be accounted for in the same way as leases that include options to extend or terminate the lease.

Background

4. The boards made the following tentative decisions regarding lease contracts that grant the lessee the right to extend or terminate the lease under a **performance obligation** approach:

   (a) The accounting by lessors for options would be symmetrical with the accounting by lessees for these options. However, the boards noted that the objective of symmetry might not result in the same measurement of lease payments by the lessee and the lessor.

   (b) A lessor's receivable and performance obligation should be recognised based on the lease payments that would be received over the lease term. The recognised leased term would be the longest possible lease term that is more likely than not to occur.

   (c) The lease term would be reassessed at each reporting date. Detailed examination of every lease would not be required unless there is a change in facts or circumstances that would indicate that the lease term may need to be revised.

   (d) The lessor’s discount rate would not be revised when there are subsequent changes in the expected lease term.

   (e) Any change to the lease receivable resulting from a reassessment of the lease term would be recorded as an adjustment to the performance obligation.

5. At the January 2010 board meeting the boards also discussed leases that include non-bargain purchase options. The boards tentatively decided that leases that include non-bargain options to purchase the underlying asset should be accounted for in the same way as leases that include options to extend or terminate the lease.

Overall approach to leases with options

6. Throughout this paper we have assumed that the boards will want to retain the same overall approach to leases with options as they decided to follow under the performance obligation approach. That is:

   (a) Options should not be recognised separately.

   (b) A lessor's receivable should be recognised based on the lease payments that would be received over the lease term. The recognised leased term would be the longest possible lease term that is more likely than not to occur.

   (c) The lease term would be reassessed at each reporting date. Detailed examination of every lease would not be required unless there is a change in facts or circumstances that would indicate that the lease term may need to be revised.

   (d) Purchase options should be accounted for in the same way as leases that include options to extend or terminate the lease

7. The boards should be aware that treating options this way under a derecognition approach will result in the lessor recognising revenue and/or gains or losses based upon expectations of whether or not an option will be exercised. Some staff are concerned that this approach could provide reporting entities with the ability to manipulate their results by changing expectations regarding whether an option will be exercised. Consequently, they would recommend only recognising amounts due in optional periods when the option is actually exercised. Other staff note that changing the approach to options for lessors would lead to inconsistencies between lessee and lessor accounting.

8. If the boards wish to adopt a different overall approach to leases with options (for example only recognising them when they are exercised), the staff would need to undertake additional analysis.

Initial measurement of leases with options to extend or terminate

9. On initial measurement of a lease that includes options to extend or terminate the lease the lessor will recognise a receivable based upon the longest possible lease term that is more likely that not to occur.

10. Agenda paper 5C/Memo 94 discusses initial measurement of the lessor's residual asset for a simple lease. The staff think that the initial measurement of the lessor's residual asset in a lease that includes an option to extend or terminate the lease should be consistent with the expected lease term. This means that:

    (a) Under a full asset derecognition model, the residual asset recognised by the lessor should reflect the asset's value at the end of the longest possible lease term that is more likely than not to occur.

    (b) Under a partial asset derecognition model, the lessor should derecognise the right to use a portion of the underlying asset based upon the relative fair value of what has been transferred (the receivable) and what has been retained (the residual asset). The fair value of the residual asset should reflect the expected value of the underlying asset at the end of the longest possible lease term that is more likely than not to occur.

Question 1
Do the boards agree that initial measurement of the residual asset recognised by the lessor should be consistent with the assessed lease term (ie the longest possible lease term that is more likely than not to occur?

Subsequent measurement of leases with options to extend or terminate

11. The staff have identified two different approaches to accounting for a reassessment of the expected lease term:

(a) **Approach A** – Treat the reassessment as a new derecognition/re-recognition event

(b) **Approach B –** Recognise changes in the lessor's receivable in profit or loss and remeasure the lessor's residual asset whenever there is a change in the expected lease term.

12. The appendix illustrates these two approaches with a simple example.

Approach A - Treat the reassessment as a new derecognition/re-recognition event

13. In theory, when an entity exercises (or expects to exercise) an option to extend or terminate a lease it is acquiring more or less of the right to use the underlying asset. Consequently, reassessment of the expected lease term should lead to the lessor derecognising more or less of the underlying asset. For each of the lessor derecognition models this would mean the following:

(a) Under the full asset derecognition approach the lessor would derecognise its residual asset, recognise a receivable and a new residual asset. To be consistent with the accounting at lease commencement revenue and cost of sales would also be recognised.

(b) Under the partial asset derecognition approach the lessor would derecognise/reinstate a portion of its residual asset. The amount of the underlying asset derecognised/reinstated would be based upon the relative fair value of what has been transferred (the receivable) and what has been retained (the residual asset). The fair value of the residual asset should reflect the expected value of the underlying asset at the end of the revised lease term. Again revenue and cost of sales would be recognised.

14. Even if the revenue and cost of sales are presented net, changes in lease term may affect profit and loss.

Approach B - Recognise changes in the lessor's receivable in profit or loss and remeasure the lessor's residual asset whenever there is a change in the expected lease term

15. Under this approach the lessor would be required to remeasure its residual asset whenever there is a change in the expected lease term. Changes in the receivable and changes in the residual asset arising from changes in the expected lease term would be recognised in profit or loss. Because the changes arise from the same event (a reassessment of lease term), the staff think the changes should be presented net in profit or loss.

16. In general, an increase in the expected lease term would lead to an increase in the lessor's receivable and a decrease in the value of the residual asset at the end of the lease. For example, if the lessor revises its lease term from 5 years to 8 years it will recognise:

    (a) an increase in its receivable (to reflect 3 years extra rentals); and

    (b) a decrease in the residual asset because at the end of the lease (which is now 3 years later than originally estimated) it will expect to get back an 8 year old asset (instead of a 5 year old asset).

17. Under this approach the residual asset could be remeasured to fair value or simply remeasured to reflect the revised lease term (assuming the boards do not decide to require fair value measurement of the residual asset as discussed in agenda paper 5C/Memo94).

18. An increase in the receivable arising from a reassessment of lease term will generally lead to a decrease in the residual. However, this will not always be the case (for example, if the underlying asset has increased in value, the value of the residual might not fall). In addition, the change in the receivable recognised will not, in most cases, equal the change in the residual asset. Consequently, changes in lease term may affect profit or loss.

Staff recommendation

19. Approach A is consistent with the view that when an entity exercises an option to extend or terminate a lease it is acquiring more or less of the right to use the

underlying asset. Consequently, some staff support approach A. However, this approach is complex to apply.

20. Approach B is less complex to apply. Consequently, some staff support approach B. However, if the boards adopt a partial derecognition approach, it would result in a manufacturer/dealer recognising all of the unrecognised profit in the residual asset on reassessment of the lease term.

Question 2
Which approach do the boards support?

Accounting for leases with purchase options

21. Under the performance obligation approach to lessor accounting, the boards have tentatively decided that purchase options (other than bargain purchase options) should be accounted for in the same way as options to extend or terminate the lease. Under a derecognition approach, this would mean the following:

    (a) Initial measurement of the lessor's residual asset should be consistent with its decision about whether an option to purchase will be exercised. If purchase is considered the most likely outcome, the residual asset will be measured at nil.

    (b) Revisions to the expected outcome would either:

        (i) lead to a new derecognition/recognition event under approach A; or

        (ii) lead to a remeasurement of the lessor's residual asset under approach B (ie the residual asset would be reinstated if the option was thought unlikely to be exercised, the residual asset would be derecognised if the purchase option was likely to be exercised).

22. However, the staff note that some FASB Board members have expressed concerns about the proposed approach to options under the performance obligation approach to lessor accounting. They are concerned that the proposed approach could lead to revenue being recognised ahead of a purchase option being exercised. This will be a more significant issue under the derecognition approach to lessor accounting. Under the derecognition approach, revenue is recognised in respect of purchase options that are likely to be exercised at commencement of the lease.

23. Some staff would support only recognising amounts due in respect of purchase options when the options are exercised. Other staff note that adopting this approach would be inconsistent with the proposed approach to lessee accounting and options to extend a lease.

24. The staff note that if the boards tentatively decide to recognise purchase options only when they are exercised, we will need to undertake additional analysis of how this might affect leases with multiple options (ie leases with both extension and purchase options.

Question 3
Should purchase options be accounted for (a) in the same way as options to extend or terminate the lease; or (b) only when they are exercised.

Appendix – Illustration of the two approaches to subsequent measurement of leases with options to extend or terminate

A1. The following simple example illustrates the two approaches to subsequent measurement of leases with options to extend or terminate the lease.

> Entity A enters into a 3 year lease of a machine
>
> The lease includes an option to extend for an additional 2 years
>
> Annual rentals payable in arrears are CU1,000
>
> The rate the lessor is charging in the lease is 8%
>
> The fair value and carrying amount of the machine at the start of the lease is CU10,000
>
> The lessor initially estimates the lease term will be 3 years
>
> The present value of 3 years of lease payments is CU2,577
>
> At the end of 3 years the lessor expects the machine to be worth CU9,351 (present value = CU7,423)
>
> At the end of year 1, the lessor reassesses the lease term and determines it will be 5 years
>
> The fair value of the machine at the end of year 1 is CU9,500
>
> At the end of 5 years the lessor expects the machine to be worth CU8,419 (present value = CU6,188)
>
> The present value of the expected 4 years of lease payments is CU3,312

A2. The lessor records the following journals on lease commencement

Year 0						
Full Derecognition Approach			**Partial Derecognition Approach**			
Dr	Receivables	2,577	Dr	Receivables	2,577	
Dr	Cost of sales	10,000	Dr	Cost of sales	2,577	
Dr	Residual asset	7,423		Cr	Underlying asset	2,577

Cr	Underlying asset	10,000	Cr	Revenue	2,577
Cr	Revenue	10,000			
To derecognise the full carrying amount of the underlying asset, to record a lease receivable and residual value asset and to recognise sales and cost of sales			*To derecognise the portion of the asset transferred to the lessee, to record a lease receivable and to recognise sales and cost of sales*		

Year 1							
Full Derecognition Approach				**Partial Derecognition Approach**			
Dr	Cash		1,000	Dr	Cash		1,000
Cr		Receivables	1,000	Cr		Receivables	1,000
Dr	Receivables		206	Dr	Receivables		206
Cr		Interest income	206	Cr		Interest income	206
To recognise receipt of rental payment and interest on the receivable				*To recognise receipt of rental payment and interest on the receivable*			

A3. At the end of the first year the receivable is carried at CU1,783 under both approaches. To simplify this example we have assumed that until the lease term is reassessed the carrying value of the residual asset, remains unchanged at CU7,423.

Approach A- Treat the reassessment as a new derecognition/re-recognition event

A4. Upon reassessing the lease term the lessor records the following journals:

On reassessment						
Full Derecognition Approach			**Partial Derecognition Approach**			
Dr	Receivables	1,529	Dr	Receivables		1,529
Dr	Cost of sales	7,423	Dr	Cost of sales		1,195
Dr	Residual	6,188	Cr		Underlying	1,195

asset			asset		
Cr	Underlying asset	7,423	Cr	Revenue	1,529
Cr	Revenue	7,717			
To derecognise the full carrying amount of the underlying/residual asset, to record a lease receivable and residual value asset and to recognise sales and cost of sales			*To derecognise the portion of the asset transferred to the lessee, to record a lease receivable and to recognise sales and cost of sales*		

A5. Under both approaches the lessor increases the carrying amount of the receivable by the difference between the original carrying amount of the receivable at the end of year 1 (CU1,783) and the revised carrying amount (CU3,312).

A6. Under the partial derecognition approach the carrying amount of the underlying/residual asset derecognised = Carrying amount X (fair value of receivable/Fair value of the underlying) = 7,423 X (1,529/9,500).

Approach B - Recognise changes in the lessor's receivable in profit or loss and remeasure the lessor's residual asset whenever there is a change in the expected lease term

A7. Upon reassessing the lease term the lessor records the following journals:

On reassessment				
Dr	Receivables		1,529	
	Cr	Profit or loss		1,529
To recognise increase in value of the receivable				
Dr	Profit or loss		1,235	
	Cr	Residual asset		1,235
To recognise decrease in value of the residual asset from its previous carrying amount of CU7,423 to its revised value of CU6,188.				