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Project **Leases**

Topic **Lessor accounting: Derecognition approach Contingent rentals and residual value guarantees**

Purpose

1. The purpose of this paper is to address the accounting for contingent rentals and residual value guarantees under the derecognition approach to lessor accounting.

Background

2. There are three main categories of contingent rentals:

   (a) contingent rentals based on usage. For example, a car lease may require the lessee to pay additional rentals if the lessee exceeds a specified mileage.

   (b) contingent rentals based on the lessee's performance derived from the leased item. An example is a lease of retail property under which the lessee pays rentals on the basis of an agreed percentage of sales made from that property.

   (c) contingent rentals based on price changes or an index. In this type of lease, rentals are adjusted for changes in market lease rates or other indices, such as market interest rates or the consumer price index.

3. Under lessee accounting and the performance obligation model, the boards have tentatively considered residual value guarantees (RVGs) similarly to how contingent rentals are accounted for. Like contingent rental payments, payments under RVGs are conditional on future events. The appendix to this paper

outlines the boards' tentative decisions on the performance obligation model on contingent rentals and RVGs.

Recognition and initial measurement

4. In regards to recognition and initial measurement of the lessor's receivable, we think the decisions made on the performance obligation approach to lessor accounting should be applied because the boards' reasons are equally applicable to the derecognition model. Therefore:
   (a) the amounts receivable under contingent rental arrangements and RVGs will be included in the receivable recognised by the lessor if the amount of the receivable can be measured reliably.
   (b) the lessor will use an expected outcome technique to estimate the amount of rental payments that it will receive. However, that expected outcome technique will not have to consider every possible scenario.
5. We have also assumed that third party RVGs will be accounted for in the same way as other guarantees.
6. If the boards wish to adopt a different approach to recognition and initial measurement for leases with contingent rentals and RVGs, the staff would need to undertake additional analysis.

Subsequent measurement

7. We have also assumed that the boards would wish to require reassessment of the amounts receivable at each reporting date because the reason for this decision is still valid in the context of a derecognition model – reassessments provide users with more relevant information because it reflects current conditions. 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.

8. Under the performance obligation approach to lessor accounting, changes in amounts payable under contingent rental arrangements and RVGs should be treated as adjustments to the original transaction price and be allocated to the lessor's lease receivable and performance obligation.

9. Under the derecognition approach to lessor accounting there is no performance obligation to allocate changes in the receivable to. Consequently there are two possible approaches to accounting for changes in the lessor's receivable. The lessor could recognise the changes:

   (a) as an adjustment to the residual asset; or

   (b) in profit or loss.

If residual asset is measured at fair value

10. If the boards decide to require the lessor to measure its residual asset at fair value (see May 2010 agenda paper 5C/FASB Memo 94) all changes in the receivable should be recognised in profit or loss. This is because recognising changes in the receivable as an adjustment to the residual asset would result in the asset being recorded at other than fair value.

11. In addition for residual value guarantees, an increase/decrease in amounts receivable under a RVG is likely to lead to an offsetting fair value loss/gain on remeasurement of the residual asset.

If residual asset is measured other than fair value

Contingent rentals based on performance or index

12. For contingent rentals based on performance or on index, some would support recognising changes in the receivables as an adjustment to the residual asset because:

   (a) they think that an increase in a lessee's performance could indicate more use of the underlying asset, and thus affect the value of the residual asset; and

(b) it minimises fluctuations in the statement of financial performance.

13. Others disagree with those arguments and think that any changes in the receivables should be reflected in profit/loss. But often there is no direct correlation between the value of the residual asset and the amounts receivable (equivalent to the value of the right-of-use asset) under contingent rentals arrangements. For example, an increase in performance-based rentals due on a retail outlet does not necessarily lead to a decrease in the value of the lessor's residual interest in that store (indeed in some situations it might indicate an increase in the value of the lessor's residual asset). Hence:

(a) there is no technical justification for recognising changes in the lessor's receivable arising from performance based or index based contingent rentals as adjustments to the lessor's residual asset; and

(b) changes in the lessor's receivable arising from a change in contingent rentals represent a change in the consideration that the lessor receives for transferring a right-of-use asset to the lessee. Because the original consideration received by the lessor is recognised in profit or loss under the derecognition approach, changes in the expected consideration should also be recognised in profit or loss.

Staff recommendation

14. We think that the changes to the receivables arising from contingent rentals based on performance or index should be recognised in profit/loss for the reasons described above in paragraph 13.

Contingent rentals based on usage

15. For contingent rentals based on usage, any increase or decrease in the lessor's receivable, could mean that the lessee has purchased, and the lessor has sold, more or less of the right to use the underlying asset. Therefore, any changes in contingent rentals would affect the residual asset. For the two approaches to lessor derecognition 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. 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). Revenue and cost of sales would also be recognised.

Staff recommendation

16. Some staff members think that the lessor should recognise the changes in usage-based contingent rentals as an adjustment to the residual asset because it is the correct accounting for this transaction. Moreover, they think that this approach is consistent with the boards' decisions on how the lessor should account for its contingent rentals under the performance obligation approach (the appendix outlines the boards' decisions on the performance obligation model).

17. Other staff members, while acknowledging that the approach above is more accurate, think it is more onerous. Therefore they recommend that any changes in the receivable resulting from contingencies arising from usage be reflected in profit/loss because it is simpler and easier (cost/benefit reasons), and because it results in consistent accounting for contingent rentals by both lessees and lessors.

Residual value guarantees

18. In lease contracts, a lessee may compensate the lessor if the value of the leased item at the end of the lease is below a specified value. Residual value guarantees are used to protect the lessor's expected return.

19. Increases in amounts receivable under a residual value guarantee indicate a decrease in the value of the residual asset (and vice versa). Consequently, Some staff support recognising changes in the lessor's receivable arising from changes

in the amount receivable under residual value guarantees as an adjustment to the residual asset.

20. However other staff think that changes in the lessor's receivable arising from a change in residual value guarantees represent a change in the consideration that the lessor receives for transferring a right-of-use asset to the lessee. The original consideration received by the lessor is recognised in profit or loss under the derecognition approach. Consequently, changes in the expected consideration should also be recognised in profit or loss. The lessor will also have to assess the residual asset for impairment if the RVG increases. If impairment exists, it should be reflected in profit/loss.

Staff recommendation

21. The staff are split on how to deal with this issue.

Questions to the boards

Question 1 ***Contingencies based on performance or an index***
A lessor will reflect any changes in the receivable arising from contingent rentals based on the lessee's performance or an index in profit or loss. Do you agree?

Question 2 ***Contingencies based on usage***
Shall the lessor reflect any changes in the receivable arising from contingent rentals based on usage in: a) profit or loss; or b) as an adjustment to the residual asset?

Question 3 ***Residual value guarantees***
Shall the lessor reflect any changes in the receivable arising from RVGs in: a) profit or loss; or b) as an adjustment to the residual asset?

Appendix: Tentative decisions made on the performance obligation model

Contingent rentals

A1. The obligation to pay rentals recognised by the lessee, and the receivable recognised by the lessor, would include amounts payable under contingent rental arrangements.

A2. Consistent with the boards' tentative decisions on revenue recognition, a lessor would only recognise a receivable for amounts due under contingent rental arrangements if the receivable could be measured reliably.

A3. The obligation/receivable would be measured using an expected outcome technique. The final requirements would clarify that not every possible scenario would need to be taken into account when measuring the obligation/receivable.

A4. 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.

A5. The carrying amount of the obligation/receivable would be reassessed at each reporting date if any new facts or circumstances indicate that there is a material change in the obligation.

A6. 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 performance obligation.

A7. If a change is allocated to a satisfied performance obligation, the change would be recognised in revenue. If a change is allocated to an unsatisfied performance obligation, the carrying amount of the lessor's performance obligation would be adjusted.

Residual value guarantee

A8. The lease receivable recognised by the lessor would include amounts payable under a residual value guarantee if the amount could be measured reliably.

A9. 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.

A10. 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.

A11. Any change in the receivable arising from a change in amounts payable under a residual value guarantee would be treated as an adjustment to the lessor's receivable and performance obligation, consistent with the boards' tentative decision on the accounting for contingent rentals.

A12. Residual value guarantees from an unrelated third party should be accounted for in accordance with the accounting for other guarantees.