Project **Leases**

Topic **Supplement**
Lessor accounting: Derecognition approach
Residual asset (freezing residual asset approach)

Purpose

1. This paper illustrates what would happen if the carrying amount of the residual asset does not change after initial measurement, other than for impairment, in three situations: release, sell and retain for its own use.

Illustrations in three situations

2. We have used the short-term car lease example from the May 2010 Agenda Paper 5B/Memo 93(copied below).

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.
The 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

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			
0	7,639	-	10,417	7,639	7,639	
1	4,167	5,000	10,417	-		1,528
2	-	5,000	10,417	-		833
Total	-	10,000	10,417			2,361

Release

3. If the lessor releases the car as soon as the first lessee returns it to the lessor, the carrying amount of that car upon release is CU10,417, rather than CU15,000 if the lessor used the accretion approach.

4. The lessor would also use the amount of CU10,417 to determine the cost of sales and the new residual asset for the second lease. It is likely that the lessor will have a larger profit on releasing the car, compared to if the asset is not accreted. The example below illustrates why.

The lessor releases the car as soon as the first lessee returns the car.

The car is leased out for 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

Estimated value at the end of the lease is CU12,000

Present value of estimated value at the end of lease is CU8,333

The car's fair value is CU15,972

5. If the lessor does not accrete the residual asset, the schedule below shows the effects on its financial statements.

<u>Year 3 (when release occurs):</u>

DR Receivables 7,639

DR Cost of sales 4,982

CR Underlying asset 4,982

CR Revenue 7,639

Profit = CU2,657

(The lessor has leased a car and recognised revenue for leasing for it. The portion of the car derecognised is 10,417 x 7,639/15,972 = CU4,982)

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	-	-	10,417			
0	7,639	-	5,435	7,639	4,982	
1	4,167	5,000	5,435	-		1,528
2	-	5,000	5,435	-		833
Total	-	10,000	5,435	7,639	4,982	2,361

6. In contrast, if the lessor had accreted the residual asset, the schedule below shows the effects on its financial statements.

DR Receivables 7,639

DR COS 7,174

CR Underlying asset 7,174

CR Revenue 7,639

Profit = CU465

(The lessor has leased a car and recognised revenue for leasing for it. The portion of the car derecognised is 15,000 x 7,639/15,972 = CU7,174)

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	-	-	15,000			
0	7,639	-	7,826	7,639	7,639	
1	4,167	5,000		-		1,528
2	-	5,000		-		833
Total	-	10,000		7,639		2,361

Sell

7. If the lessor sells the car for proceeds equal to its expected fair value of CU15,000 as soon as it is returned by the lessee to a separate third party, the lessor will recognise a gain on disposal. The gain is CU4,583 = CU15,000 (proceeds) – CU10,417 (carrying amount of residual asset).

8. There would not be any gains/losses if the lessor accreted the residual asset.

Retain for own use

9. If the lessor retains the car for its own use, the carrying amount of the car will be CU10,417. This will be the new 'cost' of the asset for depreciation purposes going forward.