Project **Leases**

Topic **Supplement: Derecognition approach – Treatment of options**

Purpose

1. This paper shows the lessor journals for an option to terminate a lease earlier than the originally determined lease term. The journals in this paper treat the reassessment as a new derecognition/re-recognition event (Approach A).

2. Under Approach A in the partial 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 value of the residual asset should reflect the expected value of the underlying asset at the end of the revised lease term. Revenue and cost of sales would be recognised.

3. Consider the following simple example.

> Entity A enters into a 3 year lease of a machine
>
> The lease includes an option to terminate after 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 teminated The fair value of the machine at the end of year 1 is CU8,943 At the end of year 2 the lessor expects the machine to be worth CU8,658 The present value of the expected 1 year of lease payments is CU926

4. The lessor records the following journals on lease commencement. The carrying amount of the underlying/residual asset derecognised = Carrying amount X (fair value of receivable/fair value of the underlying) = 10,000 X (2,577/10,000).

Dr	Receivables		2,577	
Dr	Cost of sales		2,577	
	Cr	Underlying asset		2,577
	Cr	Revenue		2,577

To derecognise the portion of the asset transferred to the lessee, to recognise a lease receivable and to recognise sales and cost of sales

5. Year 1:

Dr	Cash		1,000	
	Cr	Receivables	1,000	
Dr	Receivables		206	
	Cr	Interest income		206

To recognise receipt of rental payment and interest on the receivable

6. At the end of the first year the receivable is carried at CU1,783. Consistent with the boards' tentative decision, the carrying value of the residual asset remains unchanged at CU7,423 (10,000-2,577).

7. Upon reassessing the lease term (Year 1) the lessor records the following journals:

Dr	Revenue		857	
Dr	Underlying asset		711	
	Cr	Cost of sales		711
	Cr	Receivables		857

To reinstate the portion of the asset transferred to the lessee, to record a lease receivable and to recognise sales and cost of sales

8. The lessor decreases 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 CU926.

9. Under the partial derecognition approach the carrying amount of the residual asset reinstated = Carrying amount X (fair value of adjustment to receivable/fair value of the underlying) = 7,423 X (857/8,943).

10. The underlying asset's balance:

Beginning	10,000
Derecognised on lease commencement	(2,577)
Reinstated on reassessment	<u>711</u>
Ending	8,134