IASB/FASB Meeting
Week commencing 11 April 2011

IASB Agenda reference **1K**

Staff Paper

IASB/FASB education session

FASB Memorandum **165**

Project **Leases**

Topic **Lessor accounting – finance leases (underlying asset)**

Purpose

1. The purpose of this paper is to discuss how lessors should account for the underlying asset, which is the subject of a finance lease contract.

2. This paper should be read in conjunction with Agenda Paper 1L / FASB memo 166. Together the two papers address the following:

   (a) The underlying asset—whether a finance lessor should derecognise all or a portion of the carrying amount of the underlying asset (discussed in this paper).

   (b) The lease receivable—initial and subsequent measurement (discussed in Agenda Paper 1L / FASB memo 166).

   (c) The residual asset—initial and subsequent measurement (discussed in Agenda Paper 1L / FASB memo 166).

3. The feedback from respondents included in paragraphs 11-18 of this paper includes comments on all of the topics discussed in both papers.

4. This paper does not discuss:

   (a) lessor accounting for other-than-finance leases, which is discussed in IASB Agenda Paper 1I/FASB Memo 163.

   (b) whether there is more than one type of lease and, if so, how to distinguish between those types. These topics are discussed in IASB Agenda Papers 1E, 1F and 1G/FASB Memos 159,160 and 161.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

5. However, decisions on these topics are relevant to this paper and the staff recommendation differs depending on those decisions.

Structure of this paper

6. This paper is organised into the following sections:
   - (a) Summary of staff recommendations
   - (b) Summary of proposals in the leases exposure draft
   - (c) Feedback received (from outreach and comment letter respondents)
   - (d) Staff analysis and recommendation

Summary of staff recommendations

7. Some staff recommend that lessors account for the underlying asset in a finance lease by fully derecognising the carrying amount of the underlying asset (Approach A).

8. Other staff recommendations depends on whether, and how, the boards identify a principle for distinguishing between finance and other-than-finance leases as follows:
   - (a) If the boards decide to identify principles and application guidance for distinguishing between finance and other-than-finance leases that result in finance leases only when the lessor does not retain significant asset risk (ie an approach similar to current guidance), the staff recommend that lessor apply Approach A to finance leases and derecognise all of the carrying amount of the underlying asset.
   - (b) However, if the boards decide to revise the principles and application guidance for distinguishing between finance and other-than-finance leases that exist currently in IAS 17 *Leases*, and specifically if the intent of the boards is that more leases are treated as finance leases, the staff recommend Approach B—derecognise a portion of the carrying amount of the underlying asset.

Summary of the proposals in the ED

9. The ED proposes that, if the lessor has determined that it no longer retains exposure to significant risks or benefits associated with the underlying asset, a lessor should:

    (a) recognise a right to receive lease payments in the statement of financial position.

    (b) derecognise from the statement of financial position the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the term of the lease. The portion derecognised is calculated by multiplying the carrying amount of the underlying asset by the fair value of the right to receive lease payments divided by the fair value of the underlying asset.

    (c) reclassify as a residual asset the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains.

10. The boards rejected a 'full' derecognition approach to lessor accounting (ie derecognising the entire underlying asset) because of concerns that the lessor would recognise a profit on initial recognition of the lease contract equal to the difference between the carrying amount of the underlying asset and its fair value even when only a portion of the underlying asset has been transferred.

Feedback Received

Comment letter feedback received

11. Almost all respondents supported the derecognition of, at least, a portion of the underlying asset by the lessor in finance leases, with many respondents saying that a derecognition-based approach should be applied by lessors to all leases.

12. However, many of these respondents did not think that the approach proposed in the ED (derecognising a portion of the carrying amount of the underlying asset) is an improvement on the current accounting for finance leases in IFRSs and US GAAP. This was because of views that:

    (a) current accounting better reflects the economics of the transaction.

    > We think that derecognition of the underlying asset is appropriate only when the lease is an in substance sale. Accordingly, we do not support the ED's derecognition model (which we would characterize as a partial sale model) for leases in which the lessor retains control of the underlying asset (CL # 545)

    (b) consistency between lessees and lessors is not required.

    > The FASB is of the belief that there needs to be consistency between lessee and lessor accounting. We do not believe there is sufficient theoretical support and precedent for such a position. There are a number of examples where the opposite parties to a transaction use different accounting. (CL # 558)

    (c) the proposed accounting for the residual asset in the ED should be amended because:

        (i) subsequent measurement of residual assets would not be accreted over the lease term and consequently does not provide users with useful information on the level of residual asset risks.

        (ii) the residual asset is not an item of property, plant and equipment because it is not an asset the lessor uses or intends to use in its business; it is more like a financial asset.

(iii) multiple assets are presented when they are viewed as one asset by users.

13. Those views set out in paragraph 12 above are summarised in this comment letter extract:

> Applying a cost allocation approach to residual valuation, freezing the residual asset, including it in property, plant and equipment and eliminating residual asset accretion are a step backwards in the evolution of lease accounting. (CL #180)

14. However, many respondents were supportive of accreting the residual asset over the lease term because it:

    (a) is conceptually consistent with the right-of-use model for lessees.

    (b) reflects the view that a lease creates a transfer of rights from one party to another.

    (c) allows manufacturer/dealer lessors to recognise sales revenue to the extent of the rights they have transferred to the lessee.

    (d) could be applied to all leases as only the rights transferred under the lease would be derecognised.

15. Some respondents, specifically those currently reporting in accordance with US GAAP, disagreed with applying an approach based on derecognition of some, or all, of the underlying asset. Specifically this included responses from the US real estate industry. These respondents expressed concern with the application of a derecognition-based approach and were supportive of applying a fair value based model (similar to IAS 40 *Investment Properties*). Lessor respondents, which enter into contracts that contain a lease but also contain significant service elements (eg when an item of equipment is bundled with significant maintenance and service elements) also disagreed with applying a derecognition-based approach.

User feedback received

16. Many users did not think the proposals in the ED represented an improvement from current practice. They supported applying a derecognition-based

approach to finance-type leases, but expressed concerns, similar to those indicated in other comment letters on the proposed approach in the ED that:

(a) the residual asset is misrepresented by not allowing accretion or a fair value measurement;

(b) transparency of the whole asset value is reduced by the partial derecognition method; and

(c) additional complexity may be added, especially with the accounting for reassessments.

17. Several users emphasised that they view leased assets as one set of future cash flows which is best presented together, for example:

> Regardless of whether leases are currently accounted for as operating leases or direct financing leases, most leases are viewed and managed primarily as a right to receive cash flows. For nearly all of these leases, the asset will either be sold at the end of the lease term or released. As a result, including the *residual value of the leased asset as an integral component of the lease financing receivable* would be a reasonable approach for all leases and likely easier for financial statement users to understand…. We propose the residual value continue to be included with the receivable and accreted to its future value as it is now under direct finance lease accounting. (CL # 584) (emphasis added)

Private company feedback received

18. Similar feedback to what is summarised in paragraphs 11-17 was given with respect to private companies.

Staff analysis and recommendation

19. The staff have considered only derecognition of part, or all, of the carrying amount of the underlying asset as a possible approach for lessors of finance leases, because there was limited support in the comment letters (outside of concerns raised by the US real estate industry) for *finance* lessors not to derecognise any of the underlying asset.

20. The question that needs to be answered is whether lessors should account for finance leases by derecognising the entire carrying amount of the underlying asset or only a portion of the carrying amount of the underlying asset.

21. This paper therefore considers two approaches:

    (a) Approach A: Derecognise the entire carrying amount of the underlying asset

    (b) Approach B: Derecognise a portion of the carrying amount of the underlying asset.

Approach A: Derecognise the entire carrying amount of the underlying asset

22. In Approach A, the lessor derecognises the entire underlying asset and recognises a lease receivable and a residual asset.

23. This approach of derecognising the entire underlying asset is consistent with the direct financing and sales-type lease approaches in current US GAAP and the approach used for finance leases in IFRSs.

24. Approach A views the underlying asset as one unit of account, something that cannot be componentised. When the underlying asset is leased and the lease is a finance lease, the lessor derecognises the entire carrying amount of the underlying asset.

25. Approach A views the lessor as having performed by providing an unconditional right to use the asset at the commencement of the lease. The lessor could therefore recognise a gain upon delivery of the underlying asset.

26. The advantages of derecognising all of the carrying amount of the underlying asset are that:

    (a) It reduces complexity because there is no need to determine how much to derecognise, either initially or for reassessments. It also makes sublease accounting easier, again because there is no need to determine how much of the asset to derecognise.

    (b) It improves comparability of the profit or loss for manufacturer/dealers that either sell or lease assets (often with

purchase options) in what they might view as economically similar transactions (assuming that manufacturer/dealers recognise revenue and cost of sales on finance lease contracts).

(c) It is an approach current practice is already familiar with so implementing it will not cause incremental costs.

(d) It can be seen as more consistent with the idea of two approaches to lessor accounting. If one approach does not affect the underlying asset, despite the right of use for a portion of the asset's life being transferred, it seems logical to fully derecognise the underlying asset under the other approach in which the right of use for the bigger portion of the asset's life is transferred, ie there is no middle ground where only portions of the assets are derecognised. This is consistent with the view that the underlying asset is either recognised in the statement of financial position or not recognised at all.

27. The disadvantages of this approach are:

(a) A day one gain may be recognised in respect of the whole underlying asset (eg for manufacturer/dealers), rather than just the portion of the asset transferred to the lessee (assuming that the residual asset is not measured as an allocation of the carrying amount of the underlying asset). Therefore, it arguably does not faithfully depict the transfer of benefits from the lessor to the lessee, where the lessor has performed only in relation to the right of use transferred, not the whole asset.

(b) Some would argue that in substance a lease and a sale are different types of transactions with different economics. They think it is counterintuitive to treat transactions that are economically different in the same way.

Approach B: Derecognise a portion of the underlying asset

28. This approach was proposed in the ED. The view under Approach B is that the underlying asset is a resource that comprises a bundle of rights and can be componentised.

29. Consistent with how some view the boards' tentative decision on lessee accounting where a lessee has acquired an unconditional right to use the underlying asset, the lessor derecognises the unconditional right to use a portion of the underlying asset for a period of time in return for a receivable and retains a residual asset representing the lessor's retained rights to the underlying asset.

30. Approach B views the lessor as having performed by providing an unconditional right to use the asset at the commencement of the lease. The lessor would therefore recognise a gain upon delivery of the underlying asset representing any difference between the present value of the lease payments and the portion of the underlying asset derecognised.

31. The advantages of derecognising only a portion of the underlying asset are:

    (a) It is viewed by some as consistent with the right-of-use approach applied by lessees, as the lessor derecognises the right of use that is recognised by the lessee and nothing else.

    (b) A day one gain recognised for the portion of the ROU asset transferred arguably more faithfully depicts the transfer of benefits from the lessor to the lessee, where the lessor has performed only in relation to the right of use transferred, not the whole asset. (This assumes that the residual asset is measured as an allocation of the carrying amount of the underlying asset.)

    (c) It arguably works well for any finance lease, regardless of where the boards draw the line between finance lease and other than finance lease.

32. The disadvantages are:

    (a) It could be considered overly complex, particularly if reassessments are required, eg for lease term or possibly in relation to variable lease payments—some might question whether it is an improvement over the current approach in US GAAP and IFRSs.

    (b) In some cases, the present value of lease payments is not a good proxy for fair value, for example when the contract includes variable lease

payments (subject to the boards' decisions on variable lease payments). Assuming that the residual asset is measured as an allocation of the carrying amount of the underlying asset, this may result in more value being allocated to the residual asset than its fair value.

Staff recommendation

33. Some staff think that Approach B (derecognise a portion of the underlying asset) best reflects the economics of finance type leases. Approach B views the lessor's asset as a bundle of rights. Upon entering into a lease, the lessor transfers its right to use the leased asset during the lease term in exchange for a right to receive lease payments. The lessor retains a residual asset, being the lessors retained rights to the underlying asset.

34. However, if the boards retain a distinction between finance and other-than-finance leases based on the current principles and guidance in IAS 17, the staff questions the benefits of requiring Approach B instead of Approach A from a cost benefit perspective. This is because:

    (a) the effect of changing to Approach B from Approach A is limited to when a lessor recognises day one profit in applying current IFRSs/US GAAP. Even for those finance lessors, the effect of requiring Approach B would not result in a significant change because profit on the residual asset would be relatively insignificant.

    (b) the accounting under Approach B is arguably more complex even though these complexities have been reduced by recent tentative decisions taken by the boards (eg variable lease payments and lease term).

35. If however, the boards intend more leases to be classified as financial leases than in current practice, those staff recommend Approach B for the reasons set out in paragraph 33 of this paper.

36. Other staff recommend Approach A: derecognise the entire carrying amount of the underlying asset for finance lessors.

Question: Lessor accounting—finance leases

If the boards decide to identify principles and application guidance for distinguishing between finance and other-than-finance leases that are similar to the principles and criteria that exist in IAS 17 *Leases*, some staff recommend that finance lessors derecognise the entire underlying asset.

If the boards decide to revise the principles and application guidance for distinguishing between finance and other-than-finance leases that exist currently in IAS 17, and specifically if the intent of the boards is that more leases are treated as finance leases, some staff recommend that finance lessors derecognise only a portion of the underlying asset.

Other staff recommend that finance lessors derecognise the entire underlying asset regardless of the principles and indicators that are applied for identifying finance type leases.

Which approach do the boards prefer? Why?