Project	**Leases**
Topic	**Lessor accounting**

Objective

1. In this session, working group members will be asked to consider six lease examples and discuss their thoughts on how transactions should be recorded by the lessor.
2. To enhance the effectiveness of the session, it would be helpful, time permitting, if you could submit your responses relating to the accounting for the six examples before the working group meeting so that we can analyze your thoughts.
3. Please submit your response at: http://www.surveymonkey.com/s/HXDW5R3.

Background

4. When developing the Discussion Paper (DP) on leases, the Boards initially focused on lessee accounting. However many respondents to the DP were concerned about inconsistency with the accounting for lessors and requested that the Boards consider the accounting for lessors at the same time as lessee accounting.

5. In developing the Exposure Draft on leases (ED), the Boards decided that an approach based on whether a lessor retains exposure to the significant risks or benefits associated with the underlying asset either during or after the lease term provides the most useful information for decision making. An assessment of the proposed approach in the ED is in Appendix 1 of this memo.

6. In reaching those views, the Boards observed that the partial derecognition approach works well for finance and manufacturer/dealer types of lessors. In contrast, the performance obligation approach (P/O) provides useful information for short-term and certain property leases (e.g., a situation in which only one floor of a building is being leased) and leases with significant nondistinct services.

7. The feedback received during outreach activities on the proposals in the ED has been mixed, with support expressed for the following:

   (a) Consistent with lessee accounting, requiring only one approach for lessor accounting

   (b) Retaining the current guidance in IFRS/U.S. GAAP for lessor accounting, subject to certain amendments that are required as a result of the lessee accounting proposals (e.g., guidance for sub-leases)

   (c) Applying the model proposed in the ED, but with additional guidance provided for when the P/O or derecognition approaches should be applied.

Examples

Example 1: A one-week rental of a compact car by a Car Rental Company

Example 2: A three-year lease of an aircraft by the aircraft manufacturer. The estimated useful life of the aircraft is 25 years.

Example 3: A five-year lease of a retail outlet in a shopping center (mall) by the landlord.

Example 4: A 20-year lease of an aircraft, with a 25-year useful life, from the following:

a) A bank

b) The aircraft manufacturer.

Example 5: Medical equipment manufacturer leases an X-ray machine for nine years. The machine's useful life is 10 years.

Example 6: A landlord leases land to developers for 99 years.

Questions for discussion

8. The questions below are applicable for <u>each</u> of the examples listed above. Where possible, please explain the reasons for your choice (e.g., cost/benefit consideration, a conceptual consideration, depiction of financial performance, representation of financial position, etc.).

Q1 Do you think the underlying asset on the statement of financial position (balance sheet) of the lessor should be adjusted as a result of this transaction?

(a) No adjustment is needed as a result of this transaction.
(b) The lessor should record a lease receivable and an obligation to provide the leased asset to the lessee.
(c) The underlying asset should remain on the lessor's balance sheet and be measured at fair value.
(d) The carrying amount of the asset should be reduced to reflect rights transferred to the lessee – i.e., only the residual amount should remain.
(e) Other – please explain.

Q2 What new assets/liabilities do you think should be recorded on the balance sheet of the lessor as a result of entering into the lease contract?

(a) Nothing (i.e., current operating lease accounting); there is no need to recognize assets and liabilities arising out of this contract.
(b) Receivable representing lease payments due under the contract.
(c) Receivable representing lease payments due under the contract plus residual asset.
(d) Receivable representing lease payments due under the contract and a liability reflecting the obligation to permit the lessee to use the asset.
(e) Other – please explain.

Q3 How do you think assets/liabilities arising out of the contract should be subsequently measured?

(a) Underlying asset (if applicable)

(i) Amortized cost
(ii) Fair value
(iii) Other – please explain.

(b) Receivable (if applicable)

(i) Amortized cost
(ii) Fair value
(iii) Other – please explain.

(c) Residual asset (if applicable)

(i) Amortized cost
(ii) Accreted amount
(iii) Fair value
(iv) Other – please explain.

(d) Lease liability (if applicable)

(i) Amortized cost
(ii) Fair value
(iii) Other – please explain.

Q4 Under an approach in which part of the underlying asset is derecognized, a profit might arise on contract inception if the carrying amount of the underlying asset is less than its fair value. Do you think that the lessor should be able to recognize profit immediately upon entering into this contract?

(a) Yes
(b) No.

Q5 What pattern of income recognition do you think the lessor should apply?

(a) Straight line

(b) Equal to contractual cash-flows

(c) Interest method, consistent with debt financing

(d) Other – please explain.

Q6 Regarding the income that the lessor earns over the term of the lease, how should that income be reported?

(a) As lease income

(b) As interest income

(c) As lease income and interest income (split between the components)

(d) Other – please explain.

9. After answering those questions, do you think there should be two approaches for lessor accounting? If so, which of the following variants should be used?

(a) Retain the approach proposed in the ED which depends upon an assessment of risks and benefits.

(b) Retain the approach proposed in the ED, but modify the guidance on when to apply each approach.

(c) Use the partial derecognition approach for all leases except for some specified exceptions (e.g., short-term leases and investment properties).

(d) Use the P/O approach for all leases except for some specified exceptions (e.g., manufacturers/dealers and financial institutions).

(e) Retain current IFRS / U.S. GAAP approach (operating and finance lease).

Appendix 2 of this memo provides a brief analysis of these approaches.

APPENDIX 1: Assessment of the approach proposed in the ED

Advantages	**Disadvantages**
Addresses some of the concerns with applying either the P/O or derecognition models to all leases.	Having two approaches is arguably inconsistent with the proposals for lessee accounting in which one model is used.
Because the P/O approach would be applied for leases in which lessors retain significant risks or benefits associated with the underlying assets: • There will be no day one profits for lessors of shorter term leases. • It will be simpler to apply. • There will be less strain on the ability to split payments between lease payments and those for services, because revenue is recognized over the term of the lease. Accordingly, even if the split between lease payments and those for services is incorrect, revenue will not be recognized upfront.	For the P/O approach, the disadvantages that remain include the following: • Some are concerned with the practical problems of recognizing the underlying asset and a right to receive lease payments. For example, for a regulated bank, there is the risk that both the receivable and the leased assets are subject to capital risk-weighting. • It can be argued that the approach is inconsistent with the rationale for the proposed approach to lessee accounting and the proposals in the recent Exposure Draft on revenue recognition. Under the lessee accounting model proposed by the Boards, the lessee is viewed as having an unconditional obligation to pay rentals because the lessor has performed under the lease contract at lease commencement.
Because the derecognition approach would be used for leases in which lessors do not retain exposure to the significant risks or benefits associated with the underlying assets, the following will occur:	For the derecognition approach, the disadvantages that remain include the following: • Gives rise to gains if the carrying amount of the underlying asset is less than its fair value. The gains

Advantages	**Disadvantages**
• Banks will not have to keep tangible assets that they lease on their books. • Manufacturer/dealer lessors will be able to recognize day one sales and profits, consistent with current accounting for finance leases.	recognized reflect the difference between the historical cost carrying amount of the portion of the asset derecognized and the fair value of the right of use granted. (Some would argue that this is not a disadvantage of this approach but a disadvantage of carrying the underlying asset at historical cost.) • Revenue recognized under this approach includes estimates of amounts receivable associated with optional periods and/or that are under contingent rental arrangements. Consequently, revenue may be recognized in respect of optional periods/contingent rentals before the options are exercised and/or the contingency is resolved. • It is complex to apply, requiring an entity to determine the fair value of the underlying asset even though the underlying asset is not subsequently measured at fair value. • The proposed model does not work very well in the case of remeasurements because it produces counter-intuitive results (because the residual value is frozen). For example, if, during reassessment, it is determined that the lease term will be significantly shorter than initially assessed, the amount of underlying asset that gets reinstated is much smaller than it would have been if the initial lease term estimate was the shorter lease term. Also, because of the frozen residual value, significant

Advantages	**Disadvantages**
	revenue (gain) is recognized at the end of the lease term, even in cases in which the residual was liquidated at the amount estimated at inception.

APPENDIX 2: Alternative approaches

A1. The ED makes the distinction between the two approaches to lessor accounting based on the lessor's exposure to significant risks or benefits of the underlying asset. Some constituents have observed that the approach taken in the ED appears similar to the current operating/finance lease model. Others have noted that the proposed approaches may be viewed as inconsistent with proposals under the revenue recognition project, which uses the notion of control rather than risks and benefits.

A2. Alternative approaches that the Boards could consider adopting include the following:

Approach	Description	Comments
A	Use the partial derecognition approach for all leases except: • Short-term leases • Leases of investment property.	This approach avoids the problems associated with short-term leases and investment property leases noted above. The exceptions also could be extended to address contracts that contain both service and lease components, but in which the service component is not distinct. This approach applies the partial derecognition approach for most leases. In other words, as short-term leases and leases of investment property carried at fair value are scoped out, the performance obligation approach would only be applied to leases of investment property carried at cost. Many of the other pros and cons of the derecognition approach described above would also apply.

Approach	Description	Comments
B	Use the P/O approach for all leases except: • Long-term leases of land • Manufacturer/dealer leases.	This approach avoids the problems associated with long-term leases of land and manufacturer dealers. It could, however, be a problem for banks regarding double-counting of assets for regulatory capital purposes. This approach results in the P/O approach for most leases.
C	Use the P/O approach for all leases except: • Long-term leases of land • Manufacturer/dealer leases • Leases entered into by banks/finance organizations.	This approach avoids the problems associated with long-term leases of land and manufacturer/dealers. The partial derecognition approach would apply to most (but not all) leases currently classified as finance leases. The P/O approach would apply to most (but not all) leases currently classified as operating leases.

A3. The exceptions listed above to Approaches A, B, and C could be accounted for in one of the following ways:

1	Performance obligation	As above, except for split between the two models. Double-counting problem remains.
2	Operating lease	This avoids the problem of double-counting the assets. However, it does not take into account assets arising out of the lease contract (unless the underlying asset is measured at fair value). Same problem with distinguishing between the two very different models.

3	Operating lease model, with mandatory fair value	This avoids the problem of double-counting the assets. Assets arising out of the lease contract would be embedded in fair value. All assets would have to be fair valued, which increases complexity. Same problem with distinguishing between the two very different models.