Project **Leases**

Topic **Lessor accounting**

Objective

1. This paper discusses the accounting for lessors.

2. The purpose of this paper is to form a basis for discussion on what the next steps should be for undertaking redeliberations of the lessor accounting model under a right-of-use (ROU) approach to lease accounting, as proposed in the Leases Exposure Draft.

3. The staff think that the Boards should determine both the extent and timing of their proposed redeliberations on lessor accounting as a priority to enable the staff to effectively plan the process for redeliberations and to coordinate with the revenue recognition project team

Background

4. Many constituents noted that the lessor accounting proposed in the ED is less developed than the lessee accounting model. Some constituents have urged the Boards to perform additional field testing of the new proposals prior to finalizing the leases guidance. In addition, the following concerns have been raised in our outreach activities:

   (a) Is the current lessor model under Topic 840 Leases/IAS 17 *Leases* "broken"? Additionally, can adjustments be made to the current guidance rather than creating a new model for lessor accounting?

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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.

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(b) Are the lessor accounting proposals in the ED considered to be an improvement to current financial reporting?

(c) Can the Boards deliberate some or all of the proposals on lessee accounting separately from the proposals on lessor accounting?

(d) Should the Boards substantially complete redeliberations on their revenue recognition project and the FASB deliberations on its investment property project before redeliberating lessor accounting?

5. **The Boards are asked to focus on the following questions for discussion during this meeting.**

Questions for the Boards
1. Is the lessor accounting guidance under current US GAAP/IFRSs "broken"?
2. Can the lessee accounting model move forward without consideration of the lessor accounting model?
3. What next steps should the Boards take for lessor accounting?

Structure of the Paper

6. To aid the Boards' discussion in answering the questions above, the paper is structured as follows:

Topic	Paragraph in this paper
(a) Summary of ED proposals and feedback received to date	Paragraphs 7-9
(b) Possible approaches	Paragraphs 10-11
(c) Preliminary staff views on the possible ways forward for lessor accounting	Paragraphs 12-18
(d) Appendix A: Advantages/Disadvantages of possible ways forward for lessor accounting.	A1-A3

ED proposals and preliminary feedback

7. The ED proposes a model that, depending on the risks or benefits the lessor retains, a lessor will account for the lease transaction either under the performance obligation (PO) approach or the derecognition approach. To determine which approach should be applied, the lessor should consider whether it retains exposure to significant risks or benefits associated with the underlying asset either (a) during the expected term of the lease, or (b) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset.

8. The majority of respondents on the leases ED have commented that they do not think that the existing lessor accounting guidance is broken and, that the proposals in the ED are not an improvement to financial reporting. However, some respondents noted that there are areas for improvement in existing US GAAP and IFRSs.

9. The feedback received to date has been as follows:

Proposals	**Feedback**
A lessor should account for the lease contract under a performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset either during or at the end of the expected lease term. Otherwise, the lessor should apply the derecognition approach.	• Most that support the PO approach think that the transfer of the ROU asset is a continuous transfer over the lease term. However, those that do not support the PO approach question whether the PO approach is consistent with the approach in the revenue recognition document because they do not agree with recognizing a receivable for an obligation that the lessor has yet to perform. • Some respondents have questioned whether the PO approach is consistent with the lessee ROU model. • Most that support the derecognition approach think that the transfer of the ROU asset occurs at the inception of the lease, and therefore revenue is recognized at that time. However, some do not think this model works well for all

Proposals	Feedback
	leases. • Some question why the leases ED uses a risks and rewards approach when the revenue recognition ED uses a control-based approach.
Under a PO approach, a lessor will recognize in its balance sheet the underlying asset, the lease receivable and the performance obligation liability (representing the lessor's obligation to permit the lessee to use the underlying asset over the lease term). These three items will all be presented gross in the balance sheet with a subtotal representing the net lease asset or net lease liability.	• Some view the PO approach as a "grossing up" of the balance sheet for the assets by including both the underlying asset and the lease receivable. • Questions were raised on how to do impairment testing under a PO approach.
Under a PO approach, a lessor will recognize rental income (performance of the obligation), interest income (accretion of the receivable) and depreciation expense (underlying asset.)	• Many operating lessors think that the economics of their lease arrangement are not the sale of a ROU asset that is financed and therefore disagree with the recognition of interest income. They would prefer to have rental income in the income statement.
The derecognition approach considers the lease as transferring a portion of the underlying asset, that is, the portion representing the right to use the underlying asset.	• Most supporting the derecognition approach acknowledge that there is a transfer of a portion of the underlying asset, being the right to use the underlying asset from the lessor to the lessee. • Some argue that dividing the lessor's asset between a receivable and a residual asset gives users more transparency to residual risk and is, thus, an improvement over current financial reporting. • However, those that do not support the derecognition approach disagree with the componentization of a tangible asset, especially in the context of real estate (for example, the transfer of one floor of an office building) because they think the

Proposals	**Feedback**
	risks of the asset are not divisible.
Under a derecognition approach, the residual asset is initially measured as a cost allocation and is not subsequently remeasured.	• Some think that the residual asset is an expected cash flow from the investment in the lease and that fair value will give users of financial statements the best information. • Many respondents noted that the residual asset should be accreted over the lease term, which is consistent with current accounting.
The ED proposes changes to both lessee and lessor accounting.	• Many respondents urged the Boards to consider both lessee and lessor accounting at the same time. They noted that the analysis performed in developing the proposed lessor approaches to the ROU model led the Boards to reconsider and revise tentative decisions reached in the initial development of the accounting model for lessees. Additional matters may arise in the further development and completion of any proposed accounting approach for lessors that could affect the views of the Boards in regard to the proposed for lessees.
Lessor accounting is tied to revenue recognition and therefore refers to the guidance proposed in the proposed revenue recognition ED.	• Many have pointed out the fact that lessor accounting is inseparable from revenue recognition and therefore the proposed model for lessor accounting should be fully aligned with the revenue recognition proposals which are currently being redeliberated.
The Leases Discussion Paper, issued in 2009, focused mainly on lessee accounting. Although the ED provides two approaches to lessor accounting, those approaches did not receive as much time for development as the lessee right-of-use model.	• Many have commented that the proposals related to lessor accounting do not seem to be as fully developed as the proposals for lessee accounting and therefore recommend that the Boards spend more time, effort, and fieldwork to better understand the effects of the proposed lessor accounting models on the financial statements.

Proposals	Feedback
The leases project was initially added to the Boards' agenda primarily to address off-balance sheet accounting by lessees. Currently, users of lessee financial statements typically adjust operating leases by adding them back as debt in the balance sheet while also, in some instances, adding a component of interest and amortization expense to the income statement in their analysis.	• Many have noted that there are no current "problems" associated with the present lessor accounting model and that the proposed approaches do not reflect an improvement to financial reporting. Therefore, they suggest that this project should focus solely on lessee accounting. • There has been no indication of users of lessor financial statements routinely adjusting lessors' financial statements.

Possible approaches

10. The staff have proposed the following three approaches for lessor accounting:

    (a) Continue deliberating the proposed approach to lessor accounting in the Exposure Draft, revised to address constituents' concerns over aspects of the performance obligation and derecognition approaches as well as the guidance to distinguish when to use each of the approaches. Redeliberations would include both lessee and lessor issues towards the issuance of a final leases standard addressing both lessees and lessors.

    (b) Retain the current guidance for lessors under Topic 840/IAS 17 (with perhaps some updates, which could be minor or may end up being substantial) and recognize that there will not be symmetry between lessees and lessors.

        (i) This would require providing guidance to sublessors that would be required to adopt a ROU approach as a lessee, and the current operating/capital lease model as a lessor. As noted in earlier Board deliberations, this is one of the key areas of concern for not addressing lessor accounting under a ROU model at the same time as addressing a new model for lessees.

(c) Continue redeliberating both lessee and lessor accounting initially but limit the issues in lessor accounting to those that are critical to both lessees and lessors (for example, options to renew, contingent rent, definition of a lease, etc.). This will allow time to assess how the revenue recognition project, the FASB's investment property project, and the revised lessee model align with current US GAAP/IFRS lessor accounting. The Boards could then decide later in the current leases project whether changes to the present lessor accounting model are needed, and if so, whether these changes should be made as part of the current leases project or as part of a separate project.

11. Appendix A lists the advantages and disadvantages of these approaches.

Preliminary staff views

Questions for the Boards
1. Is the lessor accounting guidance under current US GAAP/IFRSs "broken"?
2. Can the lessee accounting model move forward without consideration of the lessor accounting model?
3. What next steps should the Boards take for lessor accounting?

12. The staff is sympathetic to the views of many constituents that indicated that there may not be a problem with current lessor accounting and support those who think that present lessor accounting in US GAAP and IFRS is not broken. Constituents also noted that they do not think that the ED represents an improvement to warrant the additional costs to implement the lessor accounting proposals in the ED.

13. However, at many of the recent roundtables (including both public and private companies), at the working group meeting, and as expressed in many of the comment letters, there were many that supported considering issues relating to both lessee and lessor accounting at the same time.

14. The staff think that one of the key areas for redeliberation in this project is the definition of a lease. Further, the staff think that the definition of a lease should be consistent from both the lessee and the lessor side of the transaction (as discussed in Agenda Paper 4, FASB Memo 125).

15. In addition, many respondents disagreed with the proposals, for both lessees and the lessors, in many areas such as renewal options and variable lease payments and have suggested a variety of alterative solutions.

16. Regardless of whether a completely new model is applied to lessor accounting, or whether there are some changes made to either the ED proposals or existing GAAP, the staff think that any changes made to the (a) definition of a lease (b) lease term, and (c) variable lease payments for lessees, should also be made for lessors. The staff also think that other issues may arise during the redeliberations on lessee accounting where reassessment from a lessors' perspective would be beneficial to the redeliberation process.

17. Therefore, the staff recommend approach c) and focusing on the lessee model and only initially addressing those issues in lessor accounting that are critical to both lessees and lessors (for examples, lease term, contingent rent, definition of a lease, etc.).

18. The staff do not support approach a) because of the lack of support from constituents for the model proposed in the ED. Based on significant outreach performed over the four month comment period, it is clear that there are concerns over whether the proposals, as expressed in the ED, are an improvement to current lessor accounting and whether (a) the costs of implementation outweigh the benefits and (b) the proposals present the users of financial statements with more relevant information over what is provided under current US GAAP/IFRSs. Consequently, the staff are concerned that redeliberations on the overall lessor accounting model may delay the Boards in issuing guidance to address the significant lessee accounting concerns that currently exist in practice.

19. The staff note that the Boards could consider approach b) and provide additional accounting guidance or disclosure requirements to address consistency issues that may arise, for example, subleases.

20. However, the staff think that certain decisions made to finalize the lessee accounting, such as the definition of a lease, consideration of lease term, and consideration of variable lease payments should be considered from both a lessee and a lessor perspective during the Boards' redeliberations. In addition, the staff think that the Boards should consider linking the rationale for the accounting by lessees under a ROU model and the new revenue recognition model to the accounting by lessors.

Appendix A

A1. One of the approaches for lessor accounting is to fully redeliberate the proposals for lessor accounting included in the ED. The following table illustrates the advantages and disadvantages of this approach:

Advantages	Disadvantages
May create consistency between the model for lessors to the ROU model for lessees.	There was not a lot of support for the proposed approach to lessor accounting identified in the ED.
Many constituents expressed the view that two approaches are necessary for lessors and are not supportive of the objective of a single lessor accounting model that is symmetrical with lessee accounting.	Although many constituents expressed the view that two approaches are necessary for lessors, many seemed comfortable with the two approaches under present lease accounting guidance.
Much feedback was received on the ED that the Boards can use to help in the redeliberation decision-making process.	Many think that the revenue recognition guidance needs to be further developed before a new lessor model can be developed.
The proposals in the ED were tied to the lessee ROU approach and the revenue recognition discussion. Those ties and a more robust analysis and basis for conclusions can be further developed in the redeliberation process.	Many are concerned with the amount of time (or lack thereof) that was spent developing the lessor approaches and therefore recommend “fixing” lessee accounting, then spending the proper amount of time analyzing lessor accounting before determining whether a new model is necessary for lessors. They do not want the improvements for financial reporting for lessees held up by the substantial amount of work that still needs to be done in the lessor area.
Consistent accounting for organizations that have subleasing arrangements.	Costs/benefits of any proposed changes should be carefully evaluated and considered because the financial reporting outcomes may not be significantly different from the application of current US GAAP or

	IFRS.
	The ED approach is inconsistent with only one right-of-use approach for lessees. This could result in problems with inconsistency between treatment of intercompany and related party leases.
	This approach could create a new "bright-line" and increase complexity and subjectivity for lessors in determining which approach to apply.

A2. A second approach for lessor accounting is to leave the current guidance in place, that is, the guidance under Topic 840/IAS 17. The following table illustrates the advantages and disadvantages of this approach:

Advantages	Disadvantages
Many constituents do not think that the current model for lessor accounting is broken.	Would need to reconcile subleases under a ROU model for lessees with the current guidance for lessors.
Users of financial statements do not routinely adjust lessor financial statements. Therefore, maintaining current guidance may be preferable to users.	Would need to consider the impact of any changes to lessee guidance (definition of a lease, lease term, variable lease payments, etc) on lessor guidance and whether additional changes would also need to be made to current lessor guidance to be symmetrical.
Could complete lessee accounting, and address the main concern of off-balance sheet financing, in a quicker time frame.	May not be consistent with the current thinking in the revenue recognition project.
Many support a business model approach to lessor accounting that would more closely reflect the economics of lease transactions. This approach could be applied to current GAAP (for example, by replacing the	Would be a different model than the lessee right-of-use model which many think should be consistent.

current bright lines with a business model approach).	
	Further development of a lessor model in the future could force the revisiting of decisions reached for the lessee model. This could result in further changes to the lessee model.

A3. A third approach is to limit the issues in lessor accounting to those that are critical to both lessees and lessors (for example: lease term, variable lease payments, definition of a lease, etc.).

Advantages	**Disadvantages**
Many of the issues will need to be addressed from the perspective of both the lessee and the lessor (definition of a lease, lease term, variable lease payments).	
This approach will allow the revenue recognition and investment property projects to make progress on its redeliberations, which could help the thinking with other issues in the lessor model. Many respondents to the ED encouraged the lessor model to be consistent with revenue recognition.	