



Project

Leases

Topic

Lessor Accounting

Objective and background

1. At the May 2011 joint Board meeting, the Boards tentatively decided that, for all leases (except short-term leases), a lessee should recognise and measure a right-of-use (ROU) asset and a liability to make lease payments, consistently with the lessee accounting proposals in the *Leases* exposure draft (ED). That decision results in a single lessee accounting model.
2. That decision led the Boards to question whether it might also be appropriate to have a single lessor accounting model. At the May and June 2011 joint Board meetings, the Boards discussed a single lessor accounting model in which, at lease commencement, the lessor would recognise a lease receivable and a residual asset (described in this paper as the ‘receivable and residual’ approach). Board members raised a number of questions and concerns about the single lessor accounting model at those meetings, which are addressed in this paper. This paper also incorporates previous tentative decisions on lessor accounting for completeness but does not ask the Boards to redeliberate those decisions.
3. IASB agenda papers 1F, 1G, and 1I/ FASB memos 160, 161 and 163 (discussed in April 2011), IASB agenda papers 2E and 2F / FASB memos 172 and 173 (discussed in May 2011) and IASB agenda paper 2A / FASB memo 180 (discussed in June 2011) also address lessor accounting. Those papers provide a summary of the proposals in the *Leases* Exposure Draft (ED), further background on lessor accounting and a more comprehensive discussion of the

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.

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current dual lessor accounting approach. That information has not been repeated in full in this paper.

4. As in previous papers, when the staff refer to the lease contract and lease payments, the staff are referring *only* to the lease component of any contract and, thus, *only* to lease payments that are made for the right to use the underlying asset. If the lessor provides other services to the lessee, the lessor would separate those non-lease components from the lease component, consistently with the Boards' tentative decision regarding non-lease components of a contract. The lessor would account for those non-lease components in accordance with other applicable standards.
5. The paper is structured to ask the Boards the following questions:

Question 1: What is the scope of the lessor accounting approach (regardless of whether the approach is a single or dual model approach)? (paragraphs 14-28 of this paper)



Question 3: Should there be a single lessor accounting model or a dual lessor accounting approach? This question is raised in paragraph 31 of this paper. However the question can be answered only when the Boards have discussed what form the single lessor accounting model should take. It is thus posed as the final question at the end of the paper (after paragraph 100).



Question 2: How does the single lessor model work, including the measurement of the residual asset and the timing of profit recognition? (paragraphs 44-96 of this paper)

Staff recommendations for lessor accounting

6. Some staff recommend a single lessor accounting model (the ‘receivable and residual’ approach). A lessor would apply that model to all leases, except short-term leases and leases of investment property measured at fair value.
7. According to that ‘receivable and residual’ approach, a lessor would:
 - (a) initially measure the lease receivable at the present value of lease payments discounted using the rate charged in the lease, and subsequently measure the lease receivable at amortised cost using the effective interest method.
 - (b) initially measure the residual asset on an allocated cost basis (ie based on the proportion of the underlying asset’s fair value that is the subject of the lease) and subsequently accrete the residual asset using the rate charged in the lease.
 - (c) recognise profit at lease commencement for any difference between (i) the previous carrying amount of the underlying asset and (ii) the sum of the lease receivable and the residual asset recognised, subject to the profit being reasonably assured. Any profit would relate only to the right-of-use transferred to the lessee and *not* to the residual asset.
 - (d) recognise interest income on the receivable and residual asset over the lease term.
8. For leases in which the profit on the ROU asset transferred is not reasonably assured, a lessor would apply the approach set out in paragraph 7, except that the lessor would initially measure the residual asset as the difference between the carrying amount of the underlying asset and the lease receivable. The lessor would subsequently accrete the residual asset, using a constant rate of return, to an amount equivalent to the underlying asset’s carrying amount at the end of the lease term as if it had been subject to depreciation.
9. Other staff think that the single lessor model does not reflect the economics of all lease transactions. Consequently, those staff recommend retaining current lessor accounting, but updated to reflect the Boards’ tentative decisions (for

example, the definition of a lease, the accounting for variable lease payments, etc.).

Comment letters and other feedback

10. As a reminder, the following paragraphs summarise the feedback received on the lessor accounting proposals included in the ED.
11. The ED proposed a dual lessor accounting approach in which a lessor would apply:
 - (a) a derecognition approach (similar to what this paper describes as the ‘receivable and residual’ approach) when the lessor does not retain exposure to significant risks and benefits associated with the underlying asset; or
 - (b) a performance obligation approach when the lessor retains exposure to significant risks and benefits associated with the underlying asset. In the performance obligation approach, a lessor would recognise a lease receivable and lease liability at lease commencement (as well as continuing to recognise the underlying asset), and would recognise lease income and interest income over the lease term.
12. The majority of respondents to the *Leases* ED who commented on the lessor accounting proposals disagreed with the proposed dual lessor accounting approach. Some of those responding expressed a preference for a single lessor accounting model (either a derecognition or performance obligation approach for all leases), or for retaining the current operating and finance lessor accounting models. The distribution of responses is shown in the following table.

Response	IFRS constituents	US GAAP constituents	TOTAL
All derecognition	74%	43%	64%
All performance obligation	7%	12%	9%
Current accounting	19%	45%	27%

13. Feedback received in other outreach meetings confirmed those views, with the general messages being as follows:
- (a) There was very little support for the performance obligation approach proposed in the ED.
 - (b) Many questioned whether the current dual lessor accounting approach under Topic 840 *Leases* in the *FASB Accounting Standards Codification*[®]/IAS 17 *Leases* is broken. In particular, some ‘operating’ lessors (mainly real estate and other lessors that lease out assets multiple times over the life of the asset) think that the economics of their leasing arrangements are not the sale of a right-of-use asset that is financed. They support retaining the current operating lease accounting model for lessors and think that recognising rental or lease income on a straight line basis over the lease term is a better reflection of their leasing activity.
 - (c) Others, and in particular the equipment leasing industry, support a derecognition approach. They disagree with the view that current lessor accounting is not ‘broken’. They think that the changes being made to the lessee accounting model necessitate a change to the lessor accounting model.
 - (d) The real estate industry supports using a fair value measurement model for all investment property / real estate leases.
 - (e) Many noted that lessor accounting should be aligned with the revenue recognition proposals.

The scope of the lessor accounting approach developed

Investment property measured at fair value

Proposals in the ED and comments received on those proposals

14. The IASB's *Leases* ED states that:

An entity shall apply [the leases proposals] to investment property that it holds under a lease. However:

(a) after initial recognition, a lessee may measure a right-of-use asset in accordance with the fair value model in IAS 40 *Investment Property*. The lessee shall recognise in profit or loss changes in the liability to make lease payments arising after initial recognition in accordance with IAS 40.

(b) a lessor shall apply IAS 40 and not [the leases proposals] to leases of investment properties that are measured at fair value in accordance with IAS 40.

15. Those proposals in the IASB's ED were different from the proposals in the FASB's ED. This is because an investment property accounting standard did not exist in US GAAP at the date of publication of the ED. However, as discussed at the June 2011 joint education session, the FASB has an active investment properties project and is soon to publish proposals for investment property entities.
16. There was significant support from IASB respondents for excluding lessors that measure their investment property at fair value in accordance with IAS 40 *Investment Property* from the leases standard. The real estate industry in IFRS jurisdictions overwhelmingly stated that the fair value model in IAS 40 provides useful information to users of financial statements.
17. Respondents from the US real estate industry supported a similar scope exclusion for lessors that measure their investment property at fair value for US GAAP, even though it was not included in the FASB's ED, encouraging the FASB to continue developing a separate standard on investment property that would be similar to IAS 40. They observed that including scope and fair value measurement guidance in US GAAP that is consistent with IAS 40 would resolve comparability concerns and provide more useful information than requiring lessors of investment property to apply the proposed lessor accounting model.

Should investment property measured at fair value be within the scope of lessor accounting?

18. The combination of the following attributes of investment property makes it somewhat different from many other assets that are leased:
 - (a) Investment property is a long-lived asset, often with an appreciating value.
 - (b) Investment property is often leased numerous times by different lessees over its useful life.
 - (c) Investment property can be divided into physically-distinct portions, which are often leased as individual units to different lessees.
19. The owner of investment property typically acquires the property to generate a return on its investment in the property either through capital appreciation or by renting all, or portions, of the property to tenants, or both.
20. As noted by the Boards when discussing lessee accounting, all lease contracts contain a financing element. There is thus a financing element or property yield built into the pricing of investment property leases, just as there is for other lease contracts. Consistent with other lessors, the lessor of investment property will price lease contracts over the life of the investment property to achieve a desired return on its investment in the property.
21. However, given the nature of investment property, the pricing of investment property leases is often very influenced by market factors (the discount rate or property yield also being market-driven). Unlike car or equipment leases, a lessor of investment property does not necessarily price an individual lease contract to compensate the lessor for the decrease in value of the asset during the lease term plus a desired return on that investment. The value of an investment property would typically be expected to *increase* in value during the lease term.
22. Those who support the single lessor accounting model (ie the 'receivable and residual' approach) think that, in theory, the same lessor accounting approach could be applied to all leases, including investment property leases. When a lessor enters into a 3-year lease of a building, or a 3-year lease of one floor of a

40-floor building, the lessor has ‘given up’ a piece of the value of the building in exchange for the lease receivable—the lessor has transferred control of the use of the building, or the floor, throughout the lease term to the lessee. Some might therefore argue that recognising the lease receivable and residual asset separately would provide useful information to users of financial statements.

23. Nonetheless, because investment property is typically an appreciating asset, preparers from the real estate industry have informed us that a more appropriate reflection of an investment property lessor’s business is for the lessor to measure the entire investment property at fair value and recognise lease income over the lease term on a straight-line (or other more appropriate systematic) basis. In addition, those preparers have informed us that it would be difficult to apply the ‘receivable and residual’ approach to investment property leases. This is particularly the case when the investment property is a multi-tenant property, such as an office building or shopping mall with numerous tenants with lease contracts spanning different time periods. Such an approach would require the lessor to obtain fair value information for individual units within one building, which would be theoretically possible but would not be how investment property is typically valued (for example, it might require the allocation of common areas to each individual unit to calculate fair value).
24. Furthermore, users have informed us that the fair value of an entire investment property gives them more useful information than other measures. Rental income and changes in fair value are inextricably linked as integral components of the performance of an investment property and measurement at fair value is necessary if that performance is to be reported in a meaningful way.
25. For those reasons, the staff recommend that leases of investment property measured at fair value (either in accordance with IAS 40 or with the final FASB *Investment Properties* standard) should be excluded from the scope of the lessor accounting approach discussed in this paper, consistently with the proposals in the IASB’s ED. For those lease contracts, the lessor would

recognise lease income over the lease term on a straight-line (or other more appropriate systematic) basis.

26. Real estate that either does not meet the definition of investment property in either US GAAP or IFRS, or that is not measured at fair value, is discussed later in paragraphs 81-90 of this paper.

Short-term leases

27. Some lessors are in the business of leasing assets for very short periods, numerous times over the life of the asset. For example, car rental companies lease cars on a daily basis; equipment lessors can lease projectors, earth moving equipment, gardening equipment, etc. on a daily or weekly basis.
28. For such short-term leases, those supporting the ‘receivable and residual’ approach again think that, in theory, the same lessor accounting approach could be applied to all leases, including short-term leases. However, the Boards have already tentatively decided that lessors can apply current operating lease accounting to contracts that have a maximum term of less than 12 months. The staff think that operating lease accounting works well for short-term contracts because the cost of applying the proposed ‘receivable and residual’ approach is likely to outweigh the benefit. Given the short-term nature of the contracts, depreciation is a good proxy for the consumption of the underlying asset by the lessee during the lease term.

Question 1 for the Boards—scope of the lessor accounting approach

The staff recommend that leases of investment property measured at fair value should be excluded from the scope of the lessor accounting approach.

Do the Boards agree?

A single-model versus dual-model approach to lessor accounting

29. As noted in paragraph 1 of this paper, the Boards have tentatively decided that there should be a single lessee accounting model in which a lessee accounts for all leases in the same way (except short-term leases), regardless of the nature of the underlying asset or of the extent of transfer of risks and rewards of ownership of the underlying asset to the lessee.
30. Those supporting a single lessor accounting model think that, to be consistent with the Boards' tentative decisions regarding lessee accounting, there should also be a single lessor accounting model. This is *not* because there must always be symmetrical accounting applied by the lessee and the lessor. Instead, this is because it is difficult to justify concluding that, from the lessee's perspective, the spectrum of lease contracts is *not* so different as to warrant two different accounting models but then to conclude that, from the lessor's perspective, those same lease contracts are different and should be accounted for in different ways. The dual lessor accounting approach in current lease standards (and the dual approach proposed in the ED) implies two different patterns of transfer of benefits to the lessee—for finance leases, the transfer of benefits occurs at lease commencement, whereas for operating leases, the transfer of benefits occurs over the lease term. That would appear to be inconsistent with the Boards' conclusions that there is a single lessee accounting model.
31. For those reasons, the staff's view is that the preferred approach would be to have a single model rather than a dual lessor accounting approach. The question is, having considered how that single lessor accounting model would be applied to different leases, whether the single lessor accounting model is considered to be an improvement when compared to the current dual lessor accounting approach. This question (**Question 3** in the paper) is posed at the end of this paper.
32. If the Boards do not support a single lessor accounting model, they have already tentatively decided that the alternative is to retain the current lessor accounting approach (updated to reflect tentative decisions made to date, eg

changes to the definition of a lease and the accounting for variable lease payments). This classifies leases into two different types (operating and finance), which are then accounted for differently as follows:

- (a) Apply finance lease accounting to lease contracts that transfer substantially all the risks and rewards of ownership of the underlying asset to the lessee. The lessor recognises a lease receivable and residual asset at lease commencement, initially measured at the present value of lease payments and expected value of the residual. The lessor thus recognises any profit on the entire underlying asset at lease commencement, and recognises interest income over the lease term.
 - (b) Apply operating lease accounting to lease contracts that do not transfer substantially all the risks and rewards of ownership of the underlying asset to the lessee. The lessor continues to recognise the underlying asset, which it depreciates over the lease term. The lessor also recognises lease income over the lease term on a straight-line (or other more appropriate systematic) basis. The lessor would *not* recognise a lease receivable.
 - (c) The principle and indicators used to distinguish between operating and finance leases would be based on those in IAS 17 *Leases*, as discussed and decided at the May 2011 joint board meeting.
33. Those staff that support retaining a lessor model more consistent with current lessor accounting think that there are key economic differences for lessors in different lease transactions, primarily relating to the profit or loss recognition pattern. Those staff reconcile having a single lessee model by acknowledging that there is a threshold difference for revenue recognition (lessor) as compared to liability recognition (lessee). Specifically, when present, elements of continuing involvement in lease transactions cause some staff to think that revenue recognition over time is more appropriate and consistent with the economics of the arrangement. For other lease transactions, revenue recognition at lease commencement is more appropriate and consistent with the economics of the arrangement. Also, those staff think that some lessors'

financial position is better reflected with the underlying asset retained on the statement of financial position.

What is the single lessor accounting model?

34. If the Boards decide to apply a single lessor accounting model to, most or, all leases (other than short-term leases), that single lessor accounting model would be a 'receivable and residual' approach. This is because the Boards have already discussed and rejected other alternatives.
35. At the April and May 2011 joint board meetings, the Boards discussed and rejected both the gross performance obligation approach, which has been proposed in the ED, and a net performance obligation approach. As noted in paragraphs 12 and 13 of this paper, there was very little support for the gross performance obligation approach from respondents to the ED and from other outreach activities—the approach was viewed by many as inappropriately 'grossing-up' the lessor's statement of financial position.
36. The Boards also rejected the net performance obligation approach because the benefits of applying such an approach did not outweigh the costs when compared to current operating lease accounting. The net performance obligation approach and current operating lease accounting would result in a lessor recognising the same amounts on its statement of financial position and in profit or loss for virtually all current operating leases. However, the net performance obligation approach would be more complex and costly to apply.
37. In addition, the Boards have already tentatively decided that, if the lessor transfers substantially all the risks and rewards of ownership of an asset to the lessee, the lessor would apply a 'receivable and residual' approach.
38. The following section of the paper discusses the single lessor accounting model and is set out as follows:
 - (a) Paragraphs 40-43 discuss the link between the lessee accounting model and the 'receivable and residual' approach.

- (b) Paragraphs 44-49 describe how the 'receivable and residual' approach works, including how the lessor would initially measure the residual asset.
 - (c) Paragraphs 50-96 then discuss the following concerns that have been raised about the 'receivable and residual' approach:
 - (i) Does the approach reflect the economics of lease transactions (paragraphs 50-58)?
 - (ii) When should a lessor recognise profit on a lease contract (paragraphs 59-80)?
 - (iii) Should a lessor apply the approach to leases of investment property/real estate measured at cost (paragraphs 81-90)?
 - (iv) How would a lessor apply the approach to portions of a larger asset (paragraphs 91-96)?
39. The following examples will be used to illustrate the single lessor accounting model and contrast it with current lessor accounting. The examples selected are operating leases according to current lease standards (ie the lessor has not transferred substantially all the risks and rewards of ownership of the underlying asset to the lessee).

- (a) A manufacturer lessor leases equipment to a lessee for 3 years. The asset has a useful life of 6 years.
 The carrying amount of the equipment is CU100; and its fair value at lease commencement is CU120.
 The estimated residual value at the end of the lease term is CU55. (The present value of that estimated residual value is CU46.)
 The lessee pays CU28 annually. (The present value of those lease payments at lease commencement is CU74.)
- (b) If the lessor were a financial institution lessor, such a lessor is assumed to purchase the equipment from the manufacturer for CU120 and immediately lease it to the lessee under the same terms as the manufacturer lessor above.

The link between lessee accounting and the 'receivable and residual' approach

40. A lease contract is defined as a contract in which the right to use an asset (the underlying asset) is conveyed for a period of time in exchange for

consideration. Accordingly, a lease contract transfers the right to control the use of an underlying asset from the lessor to the lessee at lease commencement. The lessor retains title to the underlying asset and has the right to the return of the underlying asset at the end of the lease term.

41. At lease commencement, the lessee recognises its right to use the underlying asset as an asset (a right-of-use (ROU) asset). At the same time, the lessee recognises a liability to make lease payments, which is accounted for similarly as for a loan, because the lessee measures the liability at amortised cost and recognises interest expense over the lease term. The lessee accounting model reflects the fact that the lessee has received something of value at lease commencement—the ROU asset—that it pays for over time. The lease contract is a financing transaction.
42. To be consistent with those conclusions, a lease contract should also be treated as a financing transaction from the lessor's perspective. Accordingly, having transferred the right to control the use of the underlying asset to the lessee, the lessor has two rights that arise from the lease contract:
 - (a) A right to receive lease payments from the lessee (the lease receivable).
 - (b) A right to the return of the underlying asset at the end of the lease term (the residual asset), which includes any rights to the underlying asset that the lessor retains during the lease term.
43. The single lessor accounting model proposes that the lessor should recognise those rights arising from the lease contract—the lease receivable and the residual asset. That accounting reflects the fact that the lessor no longer controls the use of the underlying asset during the lease term—the lessee controls that use. The lessor has transferred or 'given up' some of the value of the asset in exchange for a receivable, and it also has a right to receive the underlying asset back at the end of the lease term.

How the 'receivable and residual' approach works

44. At lease commencement, a lessor recognises the lease receivable and the residual asset.

Measuring the lease receivable

45. The lessor would initially measure the lease receivable at the present value of the lease payments, discounted using the rate charged in the lease, and would subsequently measure the lease receivable at amortised cost using the effective interest method. This is largely consistent with the accounting for other financial assets of a similar nature to a lease receivable. In the example in paragraph 39 of this paper, the lease receivable is initially measured at CU74 (the present value of three annual lease payments of CU28).

Measuring the residual asset

46. The residual asset represents the lessor's right to obtain the underlying asset at the end of the lease term. Some would view the residual asset as being the rights in the underlying asset that the lessor retains. Others would view the nature of the residual asset to be somewhat different from the underlying asset itself, because it is a right to the underlying asset at some point in the future rather than a right to the underlying asset today. Regardless of how the residual asset is characterised, the Boards indicated at both the May and June 2011 joint board meetings that, if they were to support a single lessor accounting model, the lessor should initially measure the residual asset as an allocation of the previous carrying amount of the underlying asset. That allocated cost would be calculated based on the proportion of the underlying asset's fair value that is the subject of the lease. This is the same as the derecognition approach proposed in the ED. However, unlike the ED, the residual asset would be accreted over the lease term using the rate charged in the lease. Using the example in paragraph 39 of this paper, the residual asset is initially measured as follows:

Cost of underlying – (Cost x lease receivable/FV of underlying)

$$\text{CU100} - \text{CU100} \times \frac{\text{CU74}}{\text{CU120}} = \text{CU38}$$

47. The alternative way to measure the residual asset at lease commencement would be to measure it at fair value, or as a proxy for fair value, at the present value of the estimated residual value. Using the example in paragraph 39 of this paper, according to such an approach the lessor would initially measure the residual asset at CU46. This is the same as current finance lease accounting, and would more accurately reflect the way in which many lessors price lease contracts. It would also provide better information for users about the value of the residual asset, including the effect of any residual value guarantees.
48. Nonetheless, when considering the application of a 'receivable and residual' approach to all leases (and not only finance leases), the Boards rejected initially measuring the residual asset at fair value for the following reasons:
- (a) Measuring the residual asset on an allocated cost basis more accurately reflects that a lessor has not 'sold' all of the underlying asset when it enters into a lease contract. Thus, under such an approach, a manufacturer lessor would recognise profit only on the ROU asset transferred to the lessee. In the example in paragraph 39 of this paper, the potential profit to be recognised is CU12, which represents the portion of the total manufacturing profit of CU20 (CU120-CU100) that relates to the ROU asset transferred to the lessee. Thus, if the lease is for a short portion of the useful life of an asset, the potential profit to be recognised would be a small portion of any manufacturing profit. If the lease were for the majority of the useful life of an asset, then the potential profit to be recognised would represent the majority of any manufacturing profit. The lessor potentially recognises profit at lease commencement only on the portion of the underlying asset consumed during the lease term, and *not* on the residual asset until the end of the lease term.
 - (b) Measuring the residual asset at fair value, or at a proxy for fair value, would, in effect, result in remeasuring the entire underlying asset to fair value at lease commencement with resulting gains recognised in profit or loss, irrespective of the length of the lease. In the absence of a lease contract, an entity would not be permitted to measure such an

underlying asset, which would be a tangible asset, at fair value under US GAAP or, although permitted under IFRS, the entity would recognise any fair value movements in other comprehensive income (with the exception of investment property).

49. Notwithstanding that tentative decision regarding the measurement of the residual asset, the staff think that it is worth noting that the single model could be developed so that the residual asset would be measured at fair value, bearing in mind the following:
- (a) Lessors attribute significant importance to the residual asset and the fair value of the residual asset is of significant interest to users.
 - (b) The residual represents the right to the cash flows that the lessor expects to receive at the end of the lease term that will ultimately be realised through sale, residual value guarantees, or re-lease of the underlying asset. Consequently, some lessors view the residual asset to be more akin to a financial asset.
 - (c) Measuring the residual asset on an allocated cost basis might result in the lessor measuring the residual asset at an amount that is lower than what the lessor would receive from a residual value guarantee. Using the example in paragraph 39 of this paper, assume that the lessor has a residual value guarantee from a third party whereby the guarantor would pay the lessor any difference between the selling price of the underlying asset at the end of the lease and CU55 (if the selling price is lower than CU55). In this case, the lessor would *not* remeasure the residual asset to the present value of CU55 (being CU46) but would retain the allocated cost measurement basis of CU38. This is because, according to the ‘receivable and residual’ approach, the lessor does not recognise any profit on the residual asset until that residual asset has been sold or released. Obtaining the residual value guarantee gives the lessor more assurance about the value of its residual asset but it does not mean that the lessor has, in effect, ‘sold’ the residual asset at lease commencement. Consequently, according to the ‘receivable and residual’ approach, the lessor would measure the

residual asset at CU38 and not recognise any profit on that residual asset until the end of the lease term. (Residual value guarantees will be discussed in more detail in a separate staff paper.)

Does the 'receivable and residual' approach reflect the economics of lease transactions?

50. The following paragraphs discuss whether the 'receivable and residual' approach would reflect the economics of lease transactions from the perspective of a financial institution lessor and a manufacturer/dealer lessor. Paragraphs 18-22 and 84-86 of this paper discuss whether the 'receivable and residual' approach would reflect the economics of lease transactions from the perspective of an investment property/real estate lessor.
51. Although there are some lessors that may not fit within any one of those three categories, the staff think that an analysis of those three perspectives is adequate to assess the approach. This is because the staff think that the economics of lease transactions largely depend on the nature of the leased asset, one of the main factors being whether the value of the asset decreases over the lease term. Assets leased by financial institutions and manufacturer/dealer lessors tend to be depreciating assets, whose value decreases over the lease term. Although some of those assets have longer lives (eg rail cars, aircraft, ships), the value of the asset would still be expected to decrease over the lease term and the pricing of the lease contract would be influenced primarily by an assessment of that decreasing value. The staff therefore think that an analysis of the economics of lease transactions from the perspective of financial institutions and manufacturer/dealer lessors could be applied to most other leases of assets whose value decreases over the lease term. The analysis from an investment property lessor perspective should cover leases of any other asset that has a very long life and whose value may appreciate over the lease term.

Financial institution lessors

52. A financial institution lessor principally enters into a lease contract to earn interest income on its investment in the leased asset. The lessor prices a lease

contract on a cash flow basis. The lessor estimates the residual value of the underlying asset at the end of the lease term, and applies an interest rate that it would like to achieve on its investment in the leased asset (which is the interest rate implicit in the lease). The lessor then reviews and monitors the residual asset values throughout the lease term, assessing those values for impairment where necessary. Financial institution lessors often do not assume as much residual asset risk as other lessors. Consequently, the residual asset is often less significant in the lease transaction than it might be in other lease transactions.

53. Using the example in paragraph 39 of this paper to illustrate, a financial institution lessor would recognise the following:

Yr	Receivable and residual approach			Return on assets (b)	Current operating lease accounting		Return on assets
	Lease Receivable	Residual asset	Profit (a)		Underlying asset	Profit (c)	
0	74	46	-		120	-	
1	51	49	8	6.4%	98	6.33	5.3%
2	26	52	6	6.4%	77	6.33	6.4%
3	-	55	5	6.4%	55	6.33	8.3%
			<u>19</u>			<u>19</u>	

(a) Profit = Interest income on the lease receivable and accretion of the residual asset.

(b) Return on assets is calculated as profit divided by the lease receivable plus residual asset.

(c) Profit = Lease income of CU28 less depreciation of CU21.67 in each year.

54. The staff think that the ‘receivable and residual’ approach is a better reflection of the lease transaction for financial institution lessors for the following reasons:

- The accounting reflects the pricing of the contract and how the lessor manages its leasing business. The lessor recognises interest income (profit) that shows a constant rate of return on its investment in the leased asset (which is 6.4%).
- Recognising the receivable and residual asset separately provides users with better information about the risks to which the lessor is exposed, ie credit risk on the receivable and asset risk on the residual.
- A financial institution lessor typically never actually receives physical possession of the underlying asset—it is delivered directly from the

manufacturer to the lessee. It would appear less useful to imply that the equipment is part of the lessor's property, plant and equipment and available for the lessor's use when the lessor cannot use or generate economic benefits from use of the asset (other than via the lease contract) until the end of the lease term—ie, the lessee controls the use of the asset during the lease term.

Manufacturer/dealer lessors

55. A manufacturer lessor enters into a lease contract for two reasons—firstly, to earn manufacturing profit on the leased asset in a manner similar to how it would if it sold the asset; and secondly, to earn interest income by transferring control of the use of the asset to the lessee at lease commencement but getting paid for that use over the lease term. The lessor would price the contract by calculating what it would expect to receive for the asset if it were to sell the asset. Then, similarly to a financial institution lessor, it would estimate the residual value of the asset at the end of the lease term, and apply an interest rate that it would like to achieve on its investment in the leased asset (which is the interest rate implicit in the lease).
56. When pricing the contract, a manufacturer lessor might be influenced to a lesser or greater extent by market factors, depending on the nature and availability of the underlying asset in the market. The manufacturer might also price contracts differently depending on the extent of other services provided within the contract. Nonetheless, even when the contract contains service elements that will be delivered over time, the lessor has still transferred the right to control the use of the underlying asset to the lessee at lease commencement, just as it would if it had sold the asset but still had remaining services to provide. The Boards have tentatively decided that the lessor would allocate a portion of the overall payments made by the lessee to the lease component of the contract in a similar manner to a seller in a multiple element revenue contract. Non-lease components would be accounted for separately.

57. Using the example in paragraph 39 of this paper to illustrate, the manufacturer lessor would recognise the lease component of a contract as follows:

Yr	Receivable and residual approach			Return on assets (d)	Current operating lease accounting		Return on assets
	Lease Receivable	Residual asset (a)	Profit (b)		Underlying asset	Profit (e)	
0	74	38	12		100	-	
1	51	40	7	6.4%	85	13	15.0%
2	26	43	6	6.4%	70	13	17.7%
3	-	46	5	6.4%	55	13	21.4%
			<u>(c) 30</u>			<u>39</u>	

(a) The residual asset is initially measured on an allocated cost basis (see paragraph 46 of this paper for details of the calculation).

(b) The year 0 profit of CU12 represents profit on the ROU asset transferred to the lessee recognised at lease commencement, subject to that profit being reasonably assured. The manufacturer lessor is likely to present revenue of CU74 and cost of sales of CU62 (resulting in profit of CU12) at lease commencement. The profit recognised in years 1, 2 and 3 represents interest income on the lease receivable and accretion of the residual asset.

(c) Profit recognised under the 'receivable and residual' approach over the lease term of CU30 is lower than under current operating lease accounting of CU39. This is because any profit on the residual asset is *not* recognised until the leased asset is sold or released at the end of the lease term. Under current operating lease accounting, profit on the residual asset is often recognised over the lease term by depreciating to the leased asset's estimated residual value at the end of the lease term (in this example, the estimated residual value at the end of the lease term is CU55).

(d) Return on assets is calculated as profit divided by the lease receivable plus residual asset.

(e) Lease income of CU28 less depreciation of CU15 in each year.

58. Again, the staff think that the 'receivable and residual' model is a better reflection of the lease transaction for manufacturer/dealer lessors for the following reasons:

- (a) The profit recognition reflects the pricing of the contract and how the lessor manages its business, because the manufacturer lessor recognises two income streams as follows:

- (i) Revenue and cost of sales resulting in the recognition of manufacturing profit on the ROU asset at lease commencement if it is reasonably assured. This is consistent with the manufacturer's selling business, ie the manufacturer will present lease and sales transactions in a similar manner, arguably providing better information to users of financial statements. Those supporting the single lessor model think that it is appropriate for the manufacturer lessor to recognise manufacturing profit on the ROU asset (subject to that

profit being reasonably assured) because, having transferred the right to control the use of the underlying asset to the lessee, the lessor has performed with respect to that ROU in exchange for a receivable. (See paragraphs 59-80 of this paper for further discussion about the timing of profit recognition.)

- (ii) Interest income (profit) over the lease term that shows a constant rate of return on its investment in the leased asset (which is 6.4%).
- (b) Recognising the receivable and residual asset separately provides users with better information about the risks to which the lessor is exposed, ie credit risk on the receivable and asset risk on the residual.
- (c) It would appear less useful to imply that the equipment is part of the lessor's property, plant and equipment and available for the lessor's use when the lessor cannot use or generate economic benefits from use of the asset (other than via the lease contract) until the end of the lease term—ie, the lessee controls the use throughout the lease term.

When should a lessor recognise profit on a lease contract?

59. At the joint board meeting in June 2011, the boards discussed two approaches to recognising profit on a lease contract under the 'receivable and residual' approach:

- (a) **Approach 1:** if the carrying amount of the underlying asset is lower than its fair value at lease commencement, the lessor would recognise profit on the ROU transferred to the lessee at lease commencement, subject to that profit being reasonably assured. The lessor would also recognise interest income on the lease receivable, and would accrete the residual asset using the rate charged in the lease, over the lease term.
- (b) **Approach 2:** profit would not be recognised at lease commencement but would be recognised over the lease term unless the entire underlying asset was, in effect, 'sold' to the lessee (ie unless the lease

contract transferred substantially all the risks and rewards of ownership of the underlying asset to the lessee). When substantially all the risks and rewards of ownership of the underlying asset have *not* been transferred to the lessee, the lessor would initially measure the residual asset as the difference between the carrying amount of the underlying and the lease receivable. The lessor would then accrete the residual asset over the lease term, using a constant rate of return, to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation.

60. The following table illustrates the leased asset and income recognised by a manufacturer lessor under both **Approaches 1 and 2**, and also under current operating lease accounting, using the example in paragraph 39 of this paper:

Yr	Approach 1				Approach 2			
	Lease Receivable	Residual asset	Profit	Return on assets	Lease Receivable	Residual asset	Profit	Return on assets
0	74	38	^(a) 12		^(b) 74	26	-	
1	51	40	7	6.4%	51	33	12	12.2%
2	26	43	6	6.4%	26	43	13	15.2%
3		46	5	6.4%		55	14	20.3%
			<u>30</u>				<u>39</u>	
Current operating lease accounting								
Yr	Underlying asset	Profit	Return on assets					
0	100	-						
1	85	13	15.0%					
2	70	13	17.7%					
3	55	13	21.4%					
		<u>39</u>						

(a) The year 0 profit represents profit recognised at lease commencement, assuming that the profit is reasonably assured.

(b) The profit of CU12 not recognised at lease commencement is netted against the residual asset. Therefore the residual asset is initially measured at CU26 (CU38 less CU12) under Approach 2. That profit of CU12 is then recognised over the lease term.

Approach 1

61. Under **Approach 1**, if the fair value of the underlying asset is higher than its carrying amount at lease commencement, a lessor would recognise profit on

the ROU transferred to the lessee at that date to the extent that the lessor is reasonably assured that the profit would not be reversed in the future. This is consistent with the revenue recognition project, which requires a seller to recognise as revenue the amount of the transaction price allocated to satisfied performance obligations unless the entity is not reasonably assured to receive that amount.

62. Those supporting **Approach 1** think that it is appropriate for the lessor to recognise profit (if there is any such profit) on the ROU asset that has been transferred to the lessee if that profit is reasonably assured. This is because, at lease commencement, the lessor has performed by making the underlying asset available for use by the lessee and, in exchange, has a lease receivable. With respect to the ROU, the lessor is not obliged, and is unable, to do anything further to the underlying asset during the lease term unless the lessee defaults on payment—ie, the lessee has quiet enjoyment of the underlying asset during the lease term. (Any services provided by the lessor to the lessee are accounted for separately.)
63. If, at lease commencement, the lessor is viewed as having obtained a lease receivable in exchange for delivering the ROU asset to the lessee (and has no obligation in relation to that ROU asset, the lessor has earned that profit on the ROU asset and should recognise it if it is reasonably assured.

Reasonably assured

64. If the profit is not reasonably assured, under **Approach 1**, the lessor would *not* recognise any profit at lease commencement, but would apply the accounting set out under **Approach 2**, recognising profit on the ROU asset over the lease term. The lessor would initially measure the residual asset as the difference between the carrying amount of the underlying asset and the lease receivable and subsequently accrete the residual asset, using a constant rate of return, to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation.
65. The profit on the ROU asset transferred would *not* be reasonably assured in any of the following situations:

- (a) If there is uncertainty about the estimated residual value at the end of the lease term, to the extent that the lessor is not reasonably assured that the estimated residual value will not fall below the residual asset allocated cost carrying amount. Consequently, in the example in paragraph 39 of this paper, the lessor should *not* recognise profit of CU12 on the ROU asset if the lessor was not reasonably assured that the estimated residual value at the end of the lease term (the present value of which is CU46 at lease commencement) would not fall below the allocated cost carrying amount of the residual asset of CU38. The staff recommend including guidance similar to that in the revenue recognition standard that would state that a lessor would assess if it is reasonably assured of its estimate of the residual value on the basis of the experience or other persuasive evidence that the entity has with similar types of contracts, assuming that that experience is predictive of the outcome of the lease contract in question. The lessor could also be reasonably assured of the profit on the ROU asset if it has a residual value guarantee.
- (b) If there is uncertainty about the allocation of payments made by the lessee to lease and non-lease components. If a contract contains both lease and non-lease components, the lessor allocates a portion of the total payments made by the lessee to the lease component on the basis of the revenue recognition guidance for allocating the transaction price in a revenue contract to separate performance obligations. The lessor should not recognise profit on the ROU asset transferred to the lessee if the lessor is not reasonably assured that the allocation of payments to the lease component of a contract depicts the amount that the lessor expects to be entitled in exchange for the ROU transferred to the lessee.
- (c) If there is uncertainty about the fair value of the underlying asset at lease commencement. This might be the case for some leases of a portion of a larger asset (eg the lease of one floor of a corporate head

office building) if the pricing of the contract is not based on the value of the asset at lease commencement.

66. If the Boards support **Approach 1**, the staff would include guidance in the leases standard describing those situations for which profit might *not* be reasonably assured.

Arguments for and against Approach 1

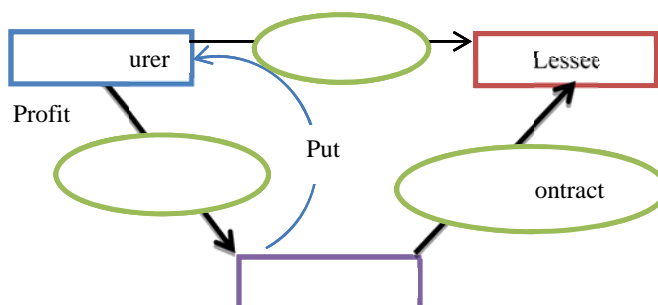
67. Some view recognising any manufacturing/dealer profit at lease commencement as ‘front-loading’ profit recognition. However, it is important to note that the increase in value of the asset that a manufacturer lessor would recognise at lease commencement has already been created at the time of manufacture. The recognition in profit or loss of that value already created is, in fact, delayed until the lessor enters into a transaction that then crystallises some or all of that value, ie a lease or sales transaction.
68. Under current operating lease accounting, a lessor often recognises all of the manufacturing profit on the entire leased asset over the lease term, thus recognising all of the value created at the time of manufacture by the end of the lease term. This is because many operating lessors depreciate leased assets over the lease term to the estimated residual value of those leased assets at the end of the lease term. This is illustrated in paragraph 60 of this paper. Under **Approach 1**, the lessor recognises total profit over the lease term of CU30. Under current operating lease accounting and under **Approach 2**, the lessor recognises total profit over the lease term of CU39. The difference of CU9 represents the manufacturing profit on the residual asset that is not recognised under **Approach 1** until the underlying asset is sold or re-leased at the end of the initial lease term. All of the manufacturing profit of CU20 (CU120-CU100) is recognised over the lease term under current operating lease accounting and under **Approach 2**.
69. Others have questioned whether **Approach 1** would be consistent with the timing of recognition of profit on other assets, such as financial assets. Under US GAAP, profit is recognised on a financial asset only when the transferor no longer retains control of the financial asset. Under IFRS, profit is recognised on an entire financial asset if the transferor either no longer retains control or

has transferred substantially all the risks and rewards associated with the financial asset. If the transferor has not transferred control or substantially all the risks and rewards associated with the financial asset, profit is *not* recognised to the extent that the transferor retains continuing involvement with the financial asset.

70. Those supporting **Approach 1** do not think that such an approach is inconsistent with the requirements regarding the recognition of profit on financial assets. The timing of recognition of profit under **Approach 1** is very similar to the recognition of profit on financial assets under IFRS—profit is *not* recognised on both financial assets and leased assets to the extent that the transferor/lessor retains continuing involvement. The lessor retains continuing involvement in the residual asset and does not recognise profit on the residual asset until the end of the lease term. In addition, under US GAAP, profit is recognised on financial assets when control is transferred; while profit on the ROU asset is also recognised under **Approach 1** only when control of the use of the underlying asset has been transferred to the lessee.
71. Those supporting **Approach 1** would also highlight that applying **Approach 2** might result in transactions that are economically similar being accounted for differently and, thus, might encourage transactions to be structured to achieve a particular outcome. Consider the following example:
- (a) If a lessee leased an asset directly from a manufacturer lessor, under **Approach 2** the manufacturer lessor would be prevented from recognising any manufacturing profit on the leased asset at lease commencement if substantially all the risks and rewards of ownership of the asset were not transferred to the lessee. This is case even if the lessor has considerable experience in estimating residual values on similar contracts, and there is an active second-hand market for the asset.



- (b) Alternatively if the manufacturer decided to sell the asset to a financial institution lessor, who in turn leased the asset to the lessee, the manufacturer would recognise full manufacturing profit on the underlying asset, even if the financial institution had the right to put the asset back to the manufacturer at the end of the lease term (as long as the put did not create a significant economic incentive to exercise at the time of sale).



- (c) In the second scenario in (b) above, the financial institution (bank) lessor would recognise the residual asset at an amount that is, or close to, fair value under both **Approaches 1 and 2**. This is because the cost and fair value of the underlying asset at lease commencement would be the same. Using the example in paragraph 39 of this paper, the financial institution lessor would initially measure the residual asset at CU46. Although CU46 is higher than the allocated cost amount of CU38 that the manufacturer would recognise if it leased the asset directly to the lessee, the financial institution lessor would *not* be required to immediately impair the residual asset on entering into the lease transaction (assuming that the contract is priced on an arm's length basis). Nonetheless, in the first scenario in (a) above, under **Approach 2** the manufacturer lessor is prevented from recognising profit on the ROU asset transferred, even though it would initially measure exactly the same residual asset at CU38 (CU6 less than a financial institution lessor would). **Approach 2** would force the lessor to initially measure the residual asset at an even lower amount of CU26 even if the lessor was reasonably assured that the estimated

residual value of the asset at the end of the lease term would be close to CU55.

72. Finally, those supporting **Approach 1** note the following:

- (a) Estimating the value of the underlying asset at the end of the lease term is essential to many lessors' businesses, because it is a fundamental piece of the pricing of a lease contract. Those lessors hold the view that they can reliably estimate residual values, particularly when there is a liquid second-hand or secondary lease market.
- (b) The residual asset will be subject to impairment testing if the expected amount to be received at the end of the lease term falls below the carrying amount.
- (c) The residual asset is initially measured as an allocation of the previous carrying amount of the underlying asset. Consequently, the measurement of the residual asset already includes a 'buffer' because it is measured on an allocated cost basis, and not at fair value.
- (d) The Boards' tentative decisions regarding lease term and variable lease payments means that the lessor will assign less value to the lease receivable at lease commencement and more to the residual asset than proposed in the ED. This results in lower manufacturing profit being recognised at lease commencement than under the proposals in the ED.

Applying the 'receivable and residual' approach when the receivable is greater than the carrying amount of the underlying asset

73. At the June 2011 Board meeting, some Board members questioned how the 'receivable and residual' approach would be applied when the lease receivable is greater than the carrying amount of the underlying asset.

Approach 1

74. If the Boards apply **Approach 1** and the lease receivable is greater than the carrying amount of the underlying asset, the lessor will simply recognise profit on the ROU asset exactly as it would if the receivable were not greater than the carrying amount of the underlying asset, as long as the profit is reasonably assured.
75. In the event that it is not possible to calculate the fair value of the underlying asset either at lease commencement or at the end of the lease term, and the lease receivable is greater than the carrying amount of the underlying asset, supporters of **Approach 1** recommend initially measuring the residual asset at zero. The lessor would then recognise as profit any difference between the lease receivable and the previous carrying amount of the underlying asset. Consistently with the accounting under **Approach 2**, the residual asset would then be accreted over the lease term, using a constant rate of return, to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation.
76. To illustrate, the example in paragraph 39 of this paper is used, except that the carrying amount of the underlying asset will be CU50 at lease commencement. It is also assumed that it is not possible to calculate the fair value of the underlying asset accurately. In such a situation, under **Approach 1**, the lessor would recognise the following:

Yr	Lease Receivable	Residual asset	Leased asset ^(a)	Profit ^(b)
0	74	0	74	24
1	51	3	54	8
2	26	9	35	9
3	-	25	25	18
				<u>59</u>

(a) Leased asset = lease receivable plus residual asset

(b) Lease receivable of CU74 less carrying amount of CU50 recognised at lease commencement.

77. Those supporting **Approach 1** think that it is appropriate to recognise profit of CU24 at lease commencement in such a situation. That profit is reasonably assured—the residual asset cannot be worth *less* than zero at the end of the lease term. The profit could be characterised as representing, at least to some extent, ‘over-depreciation’ of the underlying asset in previous periods.

Approach 2

78. Under **Approach 2**, if the receivable is greater than the carrying amount of the asset, profit would not be recognised at lease commencement if substantially all the risks and rewards of ownership of the underlying asset were not transferred to the lessee. If this is the case, the lessor would recognise a negative residual asset at lease commencement, which would then be accreted over the lease term to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation.
79. Using the same example as above in paragraph 76 of this paper, the lessor would recognise the following under **Approach 2**:

Yr	Lease Receivable	Residual asset	Leased asset ^(a)	Profit
0	74	(24)	50	-
1	51	(8)	43	21
2	26	9	35	20
3	-	25	25	18
				<u>59</u>

(a) Leased asset = lease receivable and residual asset

80. The staff supporting **Approach 1** do not think that it is meaningful to recognise a negative asset (in this example, (CU24)) that is then accreted to a positive asset (CU25) over the lease term.

Question 2 for the Boards—profit recognition under a ‘receivable and residual’ approach

If the Boards support a single lessor accounting model, the staff recommend (for the reasons noted in paragraphs 67-80 of this paper) that, at lease commencement, a lessor should recognise profit on the ROU asset transferred to the lessee *if* that profit is reasonable assured (**Approach 1**).

Do the Boards agree?

Investment property/real estate lessors

Comments from respondents

81. Some respondents from IFRS jurisdictions suggested that the proposed scope exclusion in the IASB's *Leases* exposure draft for investment property measured at fair value should be extended to all investment property accounted for in accordance with IAS 40, regardless of whether the cost model or the fair

value model is applied. This is because the fair value of investment property is generally available either in the measurement of the investment property (for the fair value model) or through disclosure (for the cost model).

82. Other respondents and outreach participants from both IFRS and US GAAP jurisdictions commented on the differences between the scope of IAS 40 and the FASB's tentative decisions on the scope of its *Investment Properties* project. These respondents and participants questioned whether these potential scope differences would lead to:
- (a) comparability concerns between which real estate lessors are within, or outside of, the scope of the final leases standard; and
 - (b) more US GAAP real estate lessors being required to apply the lessor accounting model rather than a fair value measurement model.
83. Specific concerns were raised by lessors of multi-tenanted real estate who were concerned that they might be required to apply a lessor accounting approach similar to the 'receivable and residual' model described in this paper. Many of those lessors and their users expressed a preference for being able to apply a fair value measurement model instead.

Applying the 'receivable and residual' approach to investment property / real estate

84. Paragraphs 18-22 of this paper describe the economics of an investment property / real estate lease. Although those supporting the 'receivable and residual' approach think that, in theory, the same lessor accounting approach could be applied to all leases (including investment property leases), they agree that measuring those investment properties at fair value provides better information to users of financial statements.
85. The reason that the 'receivable and residual' approach provides less useful information than measuring those properties at fair value is because the residual asset is measured on an allocated cost basis. Any model that measures an appreciating asset at cost rather than fair value has the potential to produce information that is not useful. However, the 'receivable and residual' approach is no less meaningful than depreciating an appreciating asset, which would be

the alternative if using current operating lease accounting. Indeed, if the lease is for an entire investment property, more clearly presenting the lessor's lease receivable would arguably provide better information than simply recognising the entire investment property at depreciated cost.

86. Nonetheless, applying the 'receivable and residual' approach to multi-tenant leased assets (eg shopping malls; commercial office buildings; parking lots; telecommunications towers) could be extremely cumbersome and costly. In order to apply the approach to such multi-tenant leased assets, the lessor would need either to calculate the fair value of each portion of the larger asset being leased separately or, if that were not possible, to allocate the overall cost of the larger asset to each portion being leased separately. As an example, a lessor of a shopping mall can have over 500 different lease contracts with different tenants at any one time.
87. The scope of the IASB's investment property standard, IAS 40, and the staff recommendation in paragraph 25 of this paper mean that an investment property lessor applying IFRSs would not be required to apply the 'receivable and residual' approach to its investment property lease contracts. Such a lessor could choose to apply the fair value model. Consequently, the complexities described in paragraph 86 above regarding multi-tenant investment property assets would not arise.
88. The staff do not recommend excluding leases of investment property measured using the cost model in IAS 40 from the scope of the lessor accounting requirements. This is because such an approach would treat leases of investment property measured at cost differently from leases of other assets measured at cost from the lessor's perspective. This might raise questions about why the Boards have concluded that such transactions should be treated the same as all other lease transactions from the lessee's perspective.
89. However, the scope of the FASB's investment property project is different from the scope of IAS 40. The staff recommendation in paragraph 25 of this paper means that only lessors that meet the definition of an investment property entity would be excluded from the lessor accounting model. Thus, for example, an insurance company or a bank that has a commercial real estate

lease portfolio is likely to be required to apply the ‘receivable and residual’ approach, if the Boards were to support the single lessor accounting model for all leases.

90. If the Boards were to provide a scope exception for investment properties, the FASB may want to further consider this issue within its Investment Properties project.

Applying the ‘receivable and residual’ approach to leases of portions of a larger asset

91. Some have raised concerns about how the ‘receivable and residual’ approach would be applied to a lease of a portion of a larger asset, particularly when the lessor may lease different portions of one larger asset to multiple lessees. The staff have not identified multi-tenant leased asset examples that would not meet the definition of investment property (IAS 40) or real estate (US GAAP), and those concerns about multi-tenant investment property/real estate leases are discussed above in paragraphs 84-90 of this paper.
92. However, the owner of a corporate head office building might lease, for example, a floor of its head office that it is not currently using. In that case, the lessor is likely to measure the head office building at cost because the head office building is unlikely to meet the definition of investment property in IAS 40 and in the FASB’s *Investment Properties* project. Consequently, the lessor would be required to apply the ‘receivable and residual’ approach to the leased floor, if the Boards support the single lessor accounting model.
93. The staff think that the ‘receivable and residual’ approach would work in such a situation—it is just that the profit on the ROU asset transferred to the lessee may not be reasonably assured. If the profit is not reasonably assured, it would be recognised over the lease term as illustrated below in paragraph 95. However, if the leased asset is a portion of a larger asset (such as one floor of a head office building), the lessor would need to allocate a portion of the carrying amount of the entire building to the portion leased.
94. Those supporting the single lessor accounting model do not expect such an allocation of carrying amount being a difficult exercise for the lessor. In order

to lease that portion of the building, the lessor must know, for example, the size of the space leased. The relative size of the space leased compared to the size of floor space available for use in the entire building would be one way in which the lessor could allocate the carrying amount of the building. The staff would recommend including guidance in the leases standard stating that, when leasing a portion of a larger asset (and assuming that profit on the ROU asset transferred is not reasonably assured), the lessor would allocate a portion of the carrying amount of the larger asset to the portion leased on a basis that best reflects how the lease contract has been priced.

95. To illustrate, assume that the carrying amount (depreciated cost) of a head office building with a 60 year life is CU90,000 (the property originally cost CU100,000). The owner enters into a 3-year lease contract of one floor of the building—lease payments total CU3,000 over the lease term (the present value of those lease payments is CU2,600) The floor leased represents 20 per cent of the floor space available for use in the building.

Yr	Receivable and residual Approach					Current operating lease accounting		
	Lease receivable	Residual asset (portion)	Head office building	Interest/ lease income	Deprec	Head office building	Lease income	Deprec
0	2,600	15,400	72,000	-	-	90,000	-	-
1	1,796	15,915	70,667	711	1,334	88,333	1,000	1,667
2	930	16,449	69,333	668	1,333	86,667	1,000	1,666
3	0	17,000	68,000	621	1,333	85,000	1,000	1,666
				<u>2,000</u>	<u>4,000</u>		<u>3,000</u>	<u>5,000</u>

96. Those supporting the single lessor accounting model think that the ‘receivable and residual’ approach results in better information. This is because the head office building included within property, plant and equipment, and the corresponding depreciation charge, relates only to the portion of the head office used by the owner for its business. The portion that is leased (and not used by the owner for its own purposes) is accounted for separately in the same way as any other leased asset would be. This more accurately reflects how the building is being used.

Staff recommendations for lessor accounting

97. Having considered and determined how the single lessor accounting model would be applied if the Boards were to support the ‘receivable and residual’ approach, the Boards must decide whether that single lessor accounting model is an improvement when compared to the current dual lessor accounting approach.
98. Some staff support the single lessor accounting model set out in this paper (the ‘receivable and residual’ approach). Those staff think that this approach is more consistent with the lessee accounting model developed and is a better reflection of the economics of many lease transactions (see paragraphs 40-58 of this paper). In addition, those staff prefer an approach that removes the need to distinguish between different types of leases for accounting purposes. Those staff also think that *not* changing the lessor accounting model at the same time as significant changes are being made to the lessee accounting model may lead to criticisms about the project being incomplete—some have expressed the view that the lessor accounting model becomes ‘broken’ if lessee accounting is changed as proposed.
99. Other staff members support retaining current lessor accounting, which retains the distinction between finance and operating leases. However, those staff would propose aligning lessor accounting with the tentative decisions reached to date, ie the scope decisions, definition of a lease, accounting for variable lease payments, etc. Those staff members place more weight on feedback from constituents who think that current accounting guidance for lessors provides useful information without having to incur the additional costs associated with applying the single lessor accounting model. In addition, those staff think that it is appropriate for a lessor to recognise the underlying asset on its statement of financial position unless it has transferred substantially all the risks and rewards of ownership of the underlying asset to the lessee.
100. Those staff also note that the main objective of the leases project was to ensure that a lessee recognises the rights and obligations arising from a lease contract, which it does not recognise under current operating lease accounting

requirements. A lessor already recognises the underlying asset on its statement of financial position. Changing lessor accounting could be viewed as being less critical because any proposed change to the lessor accounting model would simply recharacterise that underlying asset as two assets.

Question 3 for the Boards—lessor accounting

Some staff recommend the single lessor accounting model set out in this paper (the 'receivable and residual' approach) for all leases except those that are short-term or leases of investment property measured at fair value.

Other staff recommend retaining current lessor accounting, but would align lessor accounting with the tentative decisions reached to date, ie the scope decisions, definition of a lease, accounting for variable lease payments, etc.

Which approach do the Boards support?