Objective and background

1. The objective of this memo is to analyze initial and subsequent measurement, and presentation, of assets and liabilities recognized by a lessor.

2. At the May 2011 joint Board meeting, the Boards tentatively decided that, for all leases, a lessee should subsequently measure its right-of-use (ROU) asset based on the proposals in the ED. That is, a lessee should amortize its ROU asset on a straight line basis unless another systematic method of amortization more appropriately depicts the usage of the asset. This decision means that there is a single lessee accounting model.

3. At the same meeting, the Boards instructed the staff to explore possible lessor accounting approaches. Specifically, the staff were asked to consider whether it would be appropriate to have a single lessor accounting model and, if so, what that model would be.

4. This memo therefore explores what the lessor accounting model would be if there was only one lessor accounting model, and discusses whether and how such a model could be applied to all lease contracts. The alternative to such an approach is to retain the current operating and finance lessor accounting models, distinguishing between leases that transfer substantially all the risks and rewards of ownership of the underlying asset to the lessee, and those that do not. The Boards already discussed this alternative to retain the current lessor accounting models at the May 2011 joint board meeting and reached

tentative decisions on those models in the event that the Boards decide not to proceed with the single lessor accounting model discussed in this memo. Thus, this memo does not discuss current operating and finance lessor accounting extensively. Rather, the current operating and finance lessor accounting models are discussed only in the context of contrasting those models with the single lessor accounting model set out in this memo.

5. This memo should be read in conjunction with IASB agenda papers 1F, 1G, and 1I/ FASB memos 160, 161 and 163, which were discussed at the Boards' joint meeting in April 2011, and IASB agenda papers 2E and 2F / FASB memos 172 and 173, which were discussed at the Boards' joint meeting in May 2011. Those memos provide a summary of the proposals in the Exposure Draft, *Leases* (ED), further background on lessor accounting, an analysis of comment letters and other feedback and, as noted above, a discussion of the current lessor accounting models. That information has not been repeated in full in this memo.

6. Throughout this memo, 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, consistent with the Boards' tentative decision regarding non-lease components of a contract, the lessor would separate those non-lease components from the lease component. The lessor would then account for those non-lease components in accordance with other applicable standards.

7. The memo is structured as follows:

   (a) Staff recommendations

   (b) Lessor accounting—a single lessor accounting model

   (c) Current lessor accounting model

   (d) Presentation on the statement of financial position, in profit or loss and on the cash flow statement

   (e) Impairment

8. Appendix A to this memo (see separate excel file) includes a number of examples to illustrate the application of the lessor accounting model discussed in this memo, and to contrast the accounting with current lessor accounting.

Staff recommendations—lessor accounting

9. Some staff recommend that a lessor should recognize a lease receivable and a residual asset for all leases (except short-term leases and investment property measured at fair value). Under this approach:

   (a) Except as noted in paragraph 9(b) and (c) below, a lessor should:

      (i) initially measure the lease receivable at the present value of lease payments discounted using the rate charged in the lease, and subsequently measure it at amortized cost using the effective interest method.

      (ii) initially measure the residual asset on an allocated cost basis, 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.

      (iii) consequently, recognize a profit at lease commencement for any difference between the previous carrying amount of the underlying asset, and the sum of the lease receivable and the residual asset recognized. Any profit would relate to the right-of-use transferred to the lessee and not to the entire underlying asset.

      (iv) recognize interest income on the receivable and the residual asset over the lease term.

   (b) for leases where the fair value of the underlying asset is not reliably measurable (eg when the underlying asset is a portion of a larger asset), a lessor should apply the approach set out in paragraph 9(a) 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 on a constant effective yield basis, to an amount that is

equivalent to what the underlying asset's carrying amount would have been had it been subject to depreciation. Profit would generally not be recognized at lease commencement for such leases.

(c) for short-term leases and leases of investment property that is measured at fair value, a lessor should apply current operating lease accounting (investment property measured at fair value is discussed in a separate staff memo).

10. Other staff recommend that:

(a) for leases where the lessor has transferred substantially all the risks and rewards of ownership of the underlying asset to the lessee, a lessor should apply current finance lease accounting. Therefore, a lessor should apply the approach set out in paragraph 9(a) except that the lessor would initially measure the residual asset at the present value of the estimated residual value of the underlying asset at the end of the lease term, discount that amount using the rate charged in the lease, and subsequently accrete the residual asset to the amount initially estimated. Consequently, the lessor would recognize a profit at lease commencement for any difference between the previous carrying amount of the underlying asset, and the sum of the lease receivable and the residual asset recognized. Any profit would relate to the entire underlying asset and not just the right-of-use transferred to the lessee.

(b) for leases where the lessor has not transferred substantially all the risks and rewards of ownership of the underlying asset to the lessee, a lessor should apply current operating lease accounting. Therefore, a lessor should:

(i) recognize the underlying asset and depreciate it over the lease term (or the estimated useful life if the lessor intends to hold the asset for its useful life).

(ii) not recognize a lease receivable or profit at lease commencement.

(iii) recognize lease income over the lease term, typically on a straight-line basis.

11. If the Boards support the 'receivable and residual' approach recommended in paragraph 9 of this memo, the staff recommend that a lessor should:

    (a) present the lease receivable (including any residual value guarantee) and the residual asset separately either on the statement of financial position (SFP) or in the notes.

    (b) if the lessor defers any 'day 1 profit' at lease commencement, present that deferred profit together with the residual asset.

    (c) in profit or loss, present revenue and cost of sales at lease commencement if the lessor's business model uses leases as an alternative means of realizing value from goods it would otherwise sell.

    (d) test the lease receivable (including the residual value guarantee) for impairment in accordance with the impairment guidance for financial assets.

    (e) test the residual asset for impairment in accordance with the impairment guidance for non-financial assets.

Lessor accounting—a single lessor accounting model

12. This section of the memo is set out as follows:

    (a) Paragraphs 13-17 discuss whether and why there should be a single lessor accounting model.

    (b) Paragraphs 18-28 describe what the single lessor accounting model would be, including what assets the lessor would recognize, how those assets would be measured and, consequently, the timing and nature of income recognized by the lessor.

(c) Paragraphs 29-33 discuss whether it is appropriate to recognize 'day 1' profit, irrespective of the extent of transfer of risks and rewards of ownership of the underlying asset to the lessee.

(d) Paragraphs 34-35 set out advantages and disadvantages of the single lessor accounting model.

(e) Finally, paragraphs 36-41 discuss when a lessor should be allowed to apply an alternative accounting model and what that model would be.

Why should there be a single lessor accounting model?

13. A lease is defined as a contract in which the right to use a specified 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.

14. At lease commencement, the lessee receives the right to use the underlying asset, which it recognizes as an asset (a right-of-use (ROU) asset). At the same time, the lessee recognizes a liability to make lease payments, which is accounted for similar to a loan in that the lessee measures the liability at amortized cost and recognizes 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.

15. Because the lessee recognizes a ROU asset and a liability to make lease payments at lease commencement, it follows that the lessor has transferred that ROU to the lessee at that date and would then recognize the rights that it has upon entering into the lease contract—ie, a right to receive lease payments (a lease receivable) and a right to the underlying asset at the end of the lease term (a residual asset).

16. Those who support a single lessor accounting model think that, irrespective of the extent of risks and rewards of ownership of the underlying asset transferred to the lessee, a lessor should recognize those two rights upon entering into a

lease contract (with some exceptions discussed in paragraphs 36-41 of this memo). This is consistent with the boards' conclusions on lessee accounting that, irrespective of the extent of risks and rewards of ownership transferred, the lessee should always recognize a ROU asset (with the exception of short-term leases). In their view, it would be inappropriate to conclude that when a lessor has transferred substantially all of the risks and rewards of ownership of an asset and has only a small residual, the lessor has a receivable and a residual asset that it recognizes. However, when the lessor has not transferred substantially all of the risks and rewards of ownership of an asset and has a larger residual, the lessor does *not* have a receivable and a residual asset that it recognizes.

17. In contrast, those who support retaining the current lessor accounting approach would argue that the lessor retains not only title to, but control of, the underlying asset that is the subject of a lease unless substantially all of the risks and rewards of ownership have been transferred to the lessee. When the lessor has not transferred substantially all of the risks and rewards of ownership of an asset to the lessee, the lessor has given the lessee the right to use the asset, but retains control of that underlying asset. The lessor would then recognize income from providing the ROU over the period that the lessee has the right to use the underlying asset. If the lessor transfers substantially all of the risks and rewards of ownership of an asset to the lessee, then it is appropriate to account for the transaction as if the lessor had sold the entire underlying asset. In that case, the lessor would recognize a lease receivable and a residual asset (although the residual asset would be relatively insignificant when compared to the receivable component).

What assets does the lessor have upon entering into a lease and how should they be measured?

18. At lease commencement, a 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).

19. The lessor initially measures the lease receivable at the present value of the lease payments, discounted using the rate charged in the lease, and subsequently measures it at amortized 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.

20. 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 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 staff think that there are two ways that the residual asset could be initially measured:

(a) **Approach 1** (the 'receivable and residual—allocated cost' approach)**:** initially measure the residual asset as an allocation of the previous carrying amount of the underlying asset, 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, different from the ED, the residual asset would be accreted over the lease term using the rate charged in the lease. Using the example in Appendix A2 to this memo, the residual asset is initially measured as follows:

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

$$\text{CU8,750} - \text{CU8,750} \times \frac{\text{CU8,137}}{\text{CU10,000}} = \text{CU 1,630}$$

(b) **Approach 2** (the 'receivable and residual' approach)**:** initially measure the residual asset at the present value of the estimated residual value of the underlying asset at the end of the lease term, discounted using the rate charged in the lease. The residual asset would again be accreted over the lease term, using the rate charged in

the lease, to the amount initially estimated. This is the same as current finance lease accounting.

21. If the fair value of the underlying asset and its carrying amount in the financial statements of the lessor are the same, both **Approach 1** and **Approach 2** produce the same accounting at lease commencement and throughout the lease term. This is typically the case for a financial institution lessor, which purchases the underlying asset at the same time as the asset is delivered to the lessee. For example, using the example in Appendix A1 to this memo, the carrying amount and fair value of the underlying asset is CU 10,000. Under both **Approaches 1 and 2** described above, the residual asset is initially measured as CU 1,863.

22. **Approaches 1 and 2** produce different residual asset amounts and, consequently, different 'day 1 profit' figures when the fair value of the underlying asset is different from its carrying amount in the lessor's financial statements at lease commencement. This is typically the case for manufacturer/dealer lessors.

23. Appendix A2 to this memo illustrates the different amounts recognized under both **Approaches 1 and 2** discussed above, and current operating lease accounting as follows:

	Approach 1				Approach 2			Current operating lease accounting		
Yr	Leased asset *	Net income	Return on assets		Leased asset *	Net income	Return on assets	Underlying asset	Net income	Return on assets
0	9,767	1,017		**	10,000	1,250		8,750	0	
1	8,597	977	10.0%		8,853	1,000	10.0%	7,600	997	11.4%
2	7,310	860	10.0%		7,592	886	10.0%	6,450	997	13.1%
3	5,894	731	10.0%		6,204	759	10.0%	5,300	997	15.5%
4	4,337	589	10.0%		4,678	620	10.0%	4,150	996	18.8%
5	2,625	434	10.0%		3,000	468	10.0%	3,000	996	24.0%
		4,608				4,983			4,983	

* Leased asset = lease receivable plus residual asset

** The year 0 net income represent 'day 1 profit' recognized at lease commencement.

24. **Approach 2,** in effect, treats the residual asset as a new asset that is initially measured at an amount that approximates fair value. **Approach 2** reflects how many lease contracts are priced, eg car and equipment leases. The lessor prices the contract by estimating the residual value of the underlying asset at the end

of the lease term, and then factors in a specified return that it would like to achieve on its investment in the leased asset (which, in the example above, is 10%). The amount the lessor charges in periodic lease payments is a function of those inputs. Supporters of **Approach 2** would highlight the fact that the total income recognized by the lessor over the lease term is the same as recognized under current operating lease accounting, assuming that the lessor depreciates the underlying asset to its estimated residual value over the lease term, which we understand is often the case in practice. However, they would argue that the income recognition pattern better reflects the economics of the transaction because the lessor would present interest income over the lease term at a constant rate of return on the leased asset. **Approach 2** also arguably provides better information for users because the residual asset is measured at an amount that is close to its fair value.

25. **Approach 1** results in the recognition of 'day 1 profit' only on the ROU asset transferred to the lessee, whereas **Approach 2** recognizes all of the manufacturing/dealer profit on the underlying asset at lease commencement. Under **Approach 1**, any manufacturing profit relating to the residual asset is recognized by the lessor only when the underlying asset is sold or re-leased at the end of the lease term. Again, referring to the example in Appendix A2 and the table after paragraph 23 above, the lessor recognizes profit at commencement of the initial lease of CU 1,017 under **Approach 1** representing profit on the ROU asset transferred to the lessee. The profit of CU 1,017 is 81% of the full manufacturing profit of CU 1,250 because the amount that the lessee pays for the ROU asset transferred is 81% of the underlying asset's fair value (ie the present value of lease payments of CU 8,137 represents 81% of the fair value of the underlying asset). Under **Approach 2**, profit of CU 1,250 is recognized at lease commencement.

26. Those supporting **Approach 1** think that the approach reflects the fact that the lessor has not 'sold' all of the underlying asset at lease commencement and, therefore, should not recognize all of the profit relating to that underlying asset (if there is any profit margin). **Approach 1** also address some of the concerns regarding 'day 1 profit' recognition if a single lessor accounting model were applied to all leases (see paragraph 29-33 of this memo for further discussion

of those concerns). There is a risk under **Approach 2** that a manufacturer/dealer could initially enter into a very short-term lease and recognize all of the manufacturing profit at commencement of that initial lease. Under **Approach 1**, if the lease term is for a small proportion of the useful life of the underlying asset, a manufacturer lessor would recognize manufacturing profit relating only to the portion of the underlying asset consumed during the lease term.

Accretion of the residual asset

27. The Boards tentatively decided at the May 2011 joint board meeting that, if the Boards were to decide to support a single lessor accounting model, the residual asset should be accreted over the lease term. As noted above, this approach reflects how lease contracts are priced. The lessor does not charge the lessee interest only on the value of the ROU asset transferred to the lessee. Rather, the lessor charges the lessee interest on the entire cost of the underlying asset to ensure that the lessor obtains a return that will cover the costs of funding the purchase or construction of the asset. If the residual asset were not accreted over the lease term, the residual asset value would be artificially low and the lessor would hold back and recognize a larger profit when that underlying asset is sold or re-leased at the end of the lease term. The initial measurement of the residual asset effectively embeds a time value of money element that should be unwound over the lease term.

28. To illustrate, and again using the example in Appendix A2, under the 'receivable and residual—allocated cost' approach, the residual asset is accreted from CU 1,630 to CU 2,625 over the 5-year initial lease term. This results in the lessor recognizing a manufacturing profit margin of 12.5% at lease commencement (CU 1,017 / CU 8,137) and interest income during the lease term, representing a constant 10% rate of return on the leased asset. If the carrying amount of the residual asset were 'frozen' at lease commencement, the lessor would recognize a manufacturing profit margin of 46% on the residual asset at the end of the lease term when the underlying asset were sold or re-leased (CU 1,370 / CU 3,000), and a decreasing rate of return on the leased asset during the 5 year initial lease term (eg in year 2,

interest income of CU 680 (a return of 8%); in year 5, interest income of CU 195 (a return of 5.4%)). Put another way, the result of not accreting the residual asset is the eventual recognition of a large gain upon selling the residual at the end of the lease term, even in cases where the residual value is exactly the same as the amount estimated in the pricing of the lease.

Is it appropriate for the lessor to recognize any 'day 1 profit' at lease commencement?

29. If the fair value of the underlying asset is higher than its carrying amount at lease commencement, those supporting a single lessor accounting model think it is appropriate to recognize profit on the ROU asset that has been transferred to the lessee. Consistent with the revenue recognition project, the lessor has performed by making the underlying asset available to the lessee—at lease commencement, the lessee has obtained control of the ROU asset. With respect to the ROU, the lessor is not obliged, and is unable, to do anything further to the 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.

Concerns about recognizing profit at lease commencement

30. Some have expressed concern about the lessor recognizing any profit at lease commencement when the lessor has not transferred substantially all of the risks and rewards of ownership of the underlying asset to the lessee (ie, when there is a significant residual asset). We understand that the concern is that too much profit may be recognized at lease commencement if the estimate of the residual value of the underlying asset is not a reliable prediction of what the underlying asset will be worth at the end of the lease term. This concern arises because of the link between the calculation of the profit on the ROU asset and the estimated residual value of the underlying asset.

31. Using the example in Appendix A2 to illustrate, under the 'receivable and residual—allocated cost' approach, cost of sales (which determines the profit

on the ROU asset) at commencement of the initial lease term is calculated as follows:

$$8{,}750 \times \frac{8{,}137}{10{,}000} = 7{,}120$$

The fair value of the underlying asset of CU 10,000 used to calculate cost of sales is the sum of the present value of the lease receivable (CU 8,137) and the present value of the estimated residual asset at the end of the lease term (present value of CU 3,000 = CU 1,863). Furthermore, the rate charged in the lease is the result of assumptions about the current and residual value of the underlying asset. Thus, for many leases, the calculation of the profit on the ROU asset is influenced by the estimated residual value of the underlying asset at the end of the lease term (paragraph 33 below discusses this in further detail).

32. Because of those concerns, some would suggest that a lessor should always defer profit on lease contracts that do not transfer substantially all of the risks and rewards of ownership of the underlying asset to the lessee.

Addressing those concerns

33. Those supporting a single lessor accounting model do not think that such an approach to profit recognition is necessary for all current operating leases for the following reasons:

    (a) Lessors, particularly equipment lessors, are often able to obtain or calculate reliable residual value estimates. Reliably estimating the value of the underlying asset at the end of the lease term is essential to their leasing business.

    (b) The residual asset will be subject to impairment testing in the event that the carrying amount becomes higher than the estimated residual value.

    (c) 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

recognized at lease commencement than under the proposals in the ED.

(d) Under **Approach 1** described in paragraph 20(a) of this memo, the residual asset is initially measured as an allocation of the previous carrying amount of the underlying asset. Therefore, there is only a risk of 'too much' profit being recognized at lease commencement in the following situations:

(i) the residual asset value is expected to fall below the amount initially allocated to the residual asset. In the example in Appendix A2, day 1 profit of CU 1,017 would only be considered to be overstated if the residual asset value were to fall below CU 1,630. Note that the estimate at lease commencement is CU 3,000, so the market for the asset would need to be significantly depressed in order for it to fall below CU 1,630 by the end of the lease term. Under **Approach 2**, there is no such 'buffer' built into the measurement of the residual asset because it is measured at its estimated value rather than on an allocated cost basis.

(ii) the lessor concludes at lease commencement that the lessee has a significant economic incentive to exercise a purchase or extension option, which eventually is *not* exercised. Because a 'significant economic incentive' is considered to be a high threshold, we think it would be rare that a lessor would conclude that such an incentive exists at lease commencement that would not lead to the eventual exercise of the extension or purchase option by the lessee.

(e) Because the pricing of many lease contracts is based on estimating the value of the underlying asset at the end of the lease term, if the lessor overestimates the residual asset when pricing the lease contract, the 'day 1 profit' is *lower* than it would have been if the estimate had been accurate. This is illustrated in Appendix A3. In Scenario 2 of Appendix A3, the estimated residual value of the underlying asset is increased by CU 500. In that case, day 1 profit would decrease by CU

39. The lessor prices the contract to recover less of the asset value during the lease term, which results in lower day 1 profit, because the lessor expects the residual value to be higher at the end of the lease term.

(f) In contrast, if the lessor underestimates the residual asset when pricing the lease contract, the 'day 1 profit' is *higher* than it would have been if the estimate had been accurate. Nonetheless, that higher day 1 profit reflects that the lessor has priced the contract to recover more of the asset value during the lease term because it did not think that the residual asset would be worth as much at the end of the lease term. This is also illustrated in Appendix A3. In Scenario 1 of Appendix A3, if the residual estimate is reduced by CU 500, then the day 1 profit increases by CU 39.

(g) It is also important to note that, that under current operating lease accounting, a manufacturer lessor would often recognize more profit during the initial lease term than under **Approach 1**. 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. In that case, the operating lessor takes all of the manufacturing/dealer profit on the leased asset over the lease term, including any profit on the residual asset. This is illustrated in Appendix A2 and in the table after paragraph 23 of this memo. Under **Approach 1**, the lessor would recognize total income over the lease term of CU 4,608. Under current operating lease accounting, the lessor recognizes total income over the lease term of CU 4,983. The difference of CU 375 represents the manufacturing profit on the residual asset that is not recognized 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 CU1,250 is recognized over the lease term under the current operating lease accounting approach and under **Approach 2**.

(h) The staff would also recommend including guidance that would prevent a lessor from recognising profit at lease commencement to the

extent that the estimated residual value of the underlying asset at the end of the lease term was highly uncertain such that the residual value could fall below the amount allocated to the residual asset at lease commencement. This would be consistent with the forthcoming revenue recognition standard that will include guidance preventing the recognition of revenue when the amount of revenue is not reasonably assured.

Advantages of a single lessor accounting model

34. The recognition of a lease receivable and a residual asset by all lessors (with some limited exceptions noted in paragraphs 36-41 of this memo) has the following advantages:

    (a) Those staff supporting a single lessor accounting model think that the approach is consistent with both the revenue recognition proposals and the lessee accounting model for the reasons noted in paragraphs 13-16, and 29 of this memo.

    (b) It removes the complexity in determining whether a lease is finance or operating, and thus should lead to more comparable information. Having two lessor accounting models means that very similar transactions can be accounted for in very different ways.

    (c) It provides users with information that better reflects the economics of the underlying transaction. Many lessors price contracts by estimating the residual value of the underlying asset at the end of the lease term, and pricing the contract such that they get a constant return on the leased asset over the lease term. This accounting model would reflect those economics. This is particularly the case for financial institution lessors, which typically do not obtain physical possession of assets that they lease. A financial institution lessor obtains legal title of the underlying asset but that asset is delivered directly to the lessee and, at the end of the lease term, is sold immediately to a third party. For such financial institution lessors, it would appear to be confusing to account for those assets as property, plant and equipment

and record depreciation expense, which implies that those assets are owned and used by the financial institution. This is illustrated in Appendix A1 to this memo.

(d) The equipment leasing industry support the single lessor accounting model set out in this memo in the light of the changes proposed for lessee accounting. 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.

Disadvantages of a single lessor accounting model

35. However, there are some disadvantages of this approach:

(a) Some would argue that this approach does not necessarily reflect the economics of some lease transactions where the pricing is driven primarily by market or regulatory factors, rather than being priced by estimating the residual asset and calculating a return on the underlying asset (for example, some real estate contracts). The single lessor approach requires fair value information about the underlying asset at lease commencement. In some instances when the underlying asset is a portion of a larger asset and the lease is not priced on the basis of the fair value of that portion, it could be difficult to accurately calculate the fair value of the underlying asset.

(b) Particularly when the lease term is for a short portion of the useful life of the underlying asset, some would argue that it is more appropriate for the lessor to treat the underlying asset as its asset, and recognize any lease income derived from giving the lessee use of the asset over the lease term. They do not think that derecognising a portion of the underlying asset in such cases is either cost efficient or an accurate reflection of the transaction.

(c) For some assets (namely, investment properties), users have informed us that fair value information about the whole underlying asset provides useful information.

(d) Most real estate lessors do not think that this single lessor accounting model would work well for their leasing activity. Most would prefer applying current operating lease accounting, and measuring the underlying investment property at fair value.

(e) There is additional complexity if lease payments are reassessed during the lease term (eg if the lessee is deemed to have a significant economic incentive to extend a lease), although this is not expected to occur frequently.

When should a lessor be allowed to apply an alternative accounting model and what would that model be?

Investment property measured at fair value

36. As noted above, investment property analysts have informed us that fair value information about investment properties provides useful information and total rental income is an important measure of the return on investment property. For those reasons, if a lessor applies the fair value model in IAS 40 *Investment Properties* or measures its investment properties at fair value in accordance with any potential future US GAAP guidance for investment property entities, that lessor should apply the current operating lease model to its lease contracts. (Investment property measured at fair value is discussed in a separate staff memo.)

Fair value of the underlying asset is unreliable

37. Some have suggested that, for the reasons noted in paragraph 35 of this memo, lessors of real estate leases should not be required to apply the single lessor accounting model set out in this memo. However, when the underlying asset is an entire investment property, we think that the model could be applied equally to real estate as to any other underlying asset. Fair value information for an entire investment property would usually be available or could be calculated (IAS 40 assumes that fair value information is available for all investment properties and the FASB investment property project will require fair value measurement for investment property. Note however that a floor of a building

would not meet the definition of investment property under the FASB proposals). The estimated residual values for investment property may be somewhat more volatile than for other shorter-lived assets. However, given that investment property residual values often remain static or increase over a lease term, it is less likely that an investment property residual asset recognized by the lessor would be impaired during the lease term.

38. Nonetheless, when the underlying asset is a portion of a larger asset, fair value information may either be difficult to obtain or unreliable. For example, when the underlying asset is a floor of a building, some have suggested that it may be difficult to allocate a portion of the common areas to each individual floor that is leased to different tenants or allocate items such as taxes that are calculated on the entire building. In addition, when one building is leased out to multiple tenants for relatively short lease terms, it may be particularly onerous to continuously estimate the fair value of each floor of the building. Other examples include a lease of a portion of a specified telecommunications tower or cable, the pricing of which is determined on a basis that does not require the estimation of the value of the portion of the tower or cable. In such cases, we think there are two possible ways that a lessor could account for those lease contracts:

    (a) **Approach A:** apply current operating lease accounting.

    (b) **Approach B:** apply a modified 'receivable and residual' approach that would avoid calculating the fair value of the underlying asset, both at lease commencement and at the end of the lease.

39. Both of those approaches are illustrated in Appendix A4 to this memo. Under the 'modified receivable and residual' approach, the lessor would recognize a lease receivable and a residual asset, as is the case under the proposed single lessor accounting model. However, the residual asset would be initially measured as the difference between the present value of the lease receivable and the carrying amount of the underlying asset, with no 'day 1 profit' recognition (unless the value of the lease receivable was greater than the carrying amount of the underlying asset—the residual asset cannot have a negative carrying value). The residual asset would then be accreted at a

constant rate to the amount that the underlying asset would be carried at if it were depreciated over its expected useful life. The accretion rate on the residual asset would be higher than the rate in the lease in order to recognize the day 1 profit that has been deferred. Under such a modified approach, the lessor would recognize total income during the lease term that is equal to the total income that it would recognize if it applied current operating lease accounting.

40. Using the example in Appendix A4 to illustrate, a lessor would recognize the following income over the lease term under current operating lease accounting and the 'modified receivable and residual' approach:

	Curent operating lease accounting		**'Modified receivable and residual' approach**			
Year	**Underlying asset**	**Net income**	**Lease receivable**	**Residual**	**Total leased asset**	**Net income**
0	700,000		281,742	418,258	700,000	
1	682,500	47,500	230,711	451,416	682,127	47,127
2	665,000	47,500	177,150	487,202	664,352	47,225
3	647,500	47,500	120,933	525,825	646,758	47,406
4	630,000	47,500	61,929	567,510	629,439	47,681
5	612,500	47,500		612,500	612,500	48,061
		237,500				237,500

41. This memo does not discuss short-term lease contracts, ie those with a maximum lease term of less than 12 months, because the boards have already decided that lessors can apply current operating lease accounting to such contracts. The staff think that such an approach works well for such short-term contracts, but the cost of applying the proposed lessor model 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.

Current lessor accounting model

42. Some staff recommend retaining the current lessor accounting model 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 Boards already discussed and made tentative decisions regarding finance lease accounting at the May 2011 joint board meeting.

(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.

(c) The principle and indicators used to distinguish between operating and finance leases would be based on those in IAS 17 as discussed and decided at the May 2011 joint board meeting.

43. The advantages of such an approach is as follows:

(a) Many respondents to the ED expressed the view that current lessor accounting is not 'broken'. Comments from users of financial statements would suggest that they are not unhappy with the information that they receive from lessors' financial statements, with the exception of residual asset information. This lack of information could be bridged by requiring lessors to disclose additional residual asset information, whilst retaining the current lessor accounting model.

(b) Preparers and others are familiar with the accounting model and, thus, such an approach would not require any significant system or other changes for lessors.

(c) This approach is supported by those who think that a lessor should retain the underlying asset on its statement of financial position (SFP) unless it transfers substantially all of the risks and rewards of ownership of the underlying asset to the lessee.

(d) The main objective of the leases project was to ensure that a lessee recognizes the rights and obligations arising from a lease contract, which it does not recognize under current operating lease accounting requirements. A lessor already recognizes the underlying asset on its SFP. Changing lessor accounting is viewed by some as being less

critical because any proposed change to the lessor accounting model would simply recharacterise that underlying asset as two assets.

44. The disadvantages are:

    (a) Some think that current lessor accounting is inconsistent with the lessee accounting model developed because it 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 one lessee accounting model.

    (b) Having two lessor accounting approaches necessitates retaining the complexity associated with the 'substantially all the risks and rewards' line that is included in current leases standards. It also means that lease contracts that are similar in almost all respects could be accounted for in a very different manner.

    (c) Current operating lease accounting does not reflect the economics of many lease transactions that are priced to ensure that the lessor receives a return on its investment in the underlying asset, taking into account the estimated residual value of the underlying asset at the end of the lease term.

Staff recommendation—lessor accounting

45. Some staff members support the single lessor accounting model set out in this memo. Those staff members think that this approach is more consistent with the lessee accounting model developed. In addition, those staff prefer an approach that removes the need to distinguish between different types of leases for accounting purposes.

46. Under such an approach, there are arguments in support of both initially measuring the residual asset on an allocated cost basis (**Approach 1** discussed in paragraphs 20-26 of this memo) and initially measuring the residual asset at the present value of the estimated residual value at the end of the lease term

(**Approach 2** discussed in paragraphs 20-26 of this memo). **Approach 2** is the best reflection of how many leases are priced and by measuring the residual at its estimated value at the end of the lease term, it arguably provides better information to users of financial statements. Alternatively, **Approach 1** could be viewed as more accurately reflecting that a lessor has not 'sold' all of an underlying asset when it enters into a lease contract and therefore should not recognize all of the manufacturing profit associated with that asset at lease commencement, if any such manufacturing profit exists.

47. If the Boards support a single lessor accounting model, on balance, those staff recommend **Approach 1**—initially measuring the residual asset on an allocated cost basis. In addition, those staff support **Approach B**—the 'modified receivable and residual' approach if the fair value of the underlying asset is not reliably measurable.

48. Other staff members support retaining current lessor accounting, which retains the distinction between finance and operating leases. Those staff members place more weight on feedback from constituents that current accounting guidance for lessors provides useful information without significant costs. In addition, those staff think it is appropriate for a lessor to recognize the underlying asset on its SFP unless it has transferred substantially all the risks and rewards of ownership of the underlying asset to the lessee.

Question 1—Lessor accounting
Which approach do the Boards prefer?

Presentation on the SFP, in profit or loss and on the cash flow statement

Statement of financial position

49. If the Boards were to support the single lessor accounting model set out in this memo, the staff recommend presenting the lease receivable and the residual asset separately either on the SFP or in the notes, as two amounts under the heading 'leased assets'. A lessor would decide whether to present those two

amounts separately on the SFP using the guidance in other Standards stating that an entity should present items separately when that information is relevant to an understanding of the entity's financial position.

50. The advantages of presenting the lease receivable and the residual asset separately are as follows:

    (a) Users would have more prominent information about the value of the residual asset and the lease receivable. We think this is beneficial because it more clearly depicts the different nature of the risks to which the lessor is exposed—ie, credit risk for the lease receivable and asset risk for the residual asset. Because residual value guarantees primarily expose the lessor to credit risk rather than asset risk, we recommend that such guarantees are presented as part of the lease receivable (assuming that those residual value guarantees have substance and are not only effective in exceptional circumstances). In addition, we understand that residual value guarantees are often priced in relation to the lease receivable. Thus, presenting any residual value guarantee and the lease receivable together would appear to be more appropriate. Accordingly, for presentation purposes, the residual asset would represent only the unguaranteed portion of the residual asset.

    (b) The lease receivable and the residual asset together represent the lessor's investment in one leased asset and, as such, we think it is useful to present those two amounts separately but adjacent to one another. Presenting the residual asset within property, plant and equipment would not be appropriate for financial institution lessors who often obtain only legal title to the asset. Therefore, we do not recommend presenting the lease receivable and the residual asset within property, plant and equipment, nor do we recommend (for IASB only) allowing lessors to apply the revaluation model described in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets* to the residual asset.

51. If the lessor defers 'day 1 profit' because that profit is highly uncertain (as discussed in paragraph 33 of this memo), any deferred profit should be netted

against the residual asset on the SFP. If profit is deferred, it is only because the fair value of the underlying asset at lease commencement and/or the estimated residual asset value is highly uncertain (it is not because there is uncertainty about the recovery of the lease receivable). Therefore it would appear appropriate to present the residual asset and any deferred profit together in such situations.

Profit or loss

52. If the boards were to support the single lessor accounting model set out in this memo, the lessor has (possibly) two different income streams:

    (a) A 'day 1 profit' relating to the ROU asset transferred to the lessee.

    (b) Interest income relating to the lease receivable and the residual asset recognized over the lease term.

53. Regarding the 'day 1 profit' and consistent with the proposals in the leases ED, the staff recommend that a lessor should present revenue and cost of sales if the lessor's business model uses leases as an alternative means of realizing value from the goods it would otherwise sell. This would typically be the case for manufacturer and dealer lessors. If the lessor's business model does not use leases in that way, the lessor should recognize any 'day 1 profit' as a gain in profit or loss.

Cash flow statement

54. Consistent with the proposals in the leases ED, the staff recommend that a lessor should classify cash receipts from lease payments as operating activities in the statement of cash flows. This is because most lessors are in the business of leasing assets—it is a core operating activity of the lessor.

Question 2: Presentation
If the Boards support the single lessor accounting model set out in this memo, the staff recommend the following: - A lessor should present the lease receivable (including any residual value guarantee) and the residual asset separately either on the SFP or in the notes, as two amounts under the heading 'leased assets'.

- If the lessor defers any 'day 1 profit' at lease commencement, the lessor should present that deferred profit together with the residual asset.

- In profit or loss, a lessor should present revenue and cost of sales at lease commencement if the lessor's business model uses leases as an alternative means of realizing value from goods it would otherwise sell.

Do the Boards agree with the staff recommendations?

Impairment

55. The following paragraphs discuss impairment assuming that the Boards support the single lessor accounting model set out in this memo.

56. As discussed in paragraph 50 above, the lessor is primarily exposed to credit risk from the lease receivable (including any residual value guarantee). As such, we think it is appropriate to test the lease receivable for impairment using the impairment guidance for financial assets.

57. In contrast and because the lessor is primarily exposed to asset risk from the residual asset (excluding any residual value guarantee), we think it is appropriate to test the residual asset for impairment using the impairment guidance for non-financial assets. However, from a practical perspective when the unguaranteed residual asset is small, the lessor might simply apply the impairment guidance for financial assets to the entire leased asset.

58. Regarding US GAAP, the staff recommend carrying forward impairment guidance relating to finances leases from current US GAAP literature. According to Topic 840 *Leases*, a decrease in the estimated residual value of an underlying asset is accounted for differently in finance leases and operating leases. A lessor in a finance lease is required to assess if the estimate of the residual asset has decreased at least annually. The lessor assesses the unguaranteed residual asset for impairment separately from the remainder of the leased asset (ie, separately from the lease receivable (including any residual value guarantee)). If the estimated residual value has decreased, and that decrease is determined to be 'other than temporary', then the lessor records the decrease immediately as a loss.

59. A lessor in an operating lease is required to assess if the underlying asset is impaired when indicators of impairment exist. The staff note that, in performing this test, the residual asset estimate is just one of many estimates in the impairment calculation. That is, a decrease in the residual estimate, even if it were determined to be 'other than temporary', does not always result in the recognition of an impairment loss.

Question 3: Impairment

If the Boards support the single lessor accounting model set out in this memo, the staff recommends the following:

- A lessor should test the lease receivable (including any residual value guarantee) for impairment in accordance with the impairment guidance for financial assets.

- A lessor should test the residual asset for impairment in accordance with the impairment guidance for non-financial assets. For US GAAP, this would incorporate carrying forward the current impairment guidance for finance leases.

Do the Boards agree with the staff recommendations?