Project **Leases**

Topic **Lessor accounting: Finance leases – measurement and presentation**

Purpose

1. The purpose of this paper is to discuss initial and subsequent measurement, as well as presentation, of assets recognised by a lessor for leases where substantially all the risks and rewards incidental to ownership of an underlying asset are transferred by the lessor to the lessee (referred to as finance leases).
2. This paper should be read in conjunction with IASB agenda papers 1K and 1L/ FASB memos 165 and 166 discussed at the boards' joint education session in April 2011. Those papers provide background and comment letter analysis for the issues analysed in this paper, which have not been repeated in this paper.
3. This paper does not consider whether and when a lessor reassesses the discount rate or the lease term, nor does it consider the accounting for variable lease payments (which are, or have been, discussed in other board papers).
4. This paper also does not discuss impairment and possible revaluation of a lessor's assets. At future meetings, the staff will bring papers discussing those issues.

Structure of this paper

5. This paper is organised as follows:

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

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

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

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

(a) Summary of staff recommendations

(b) Analysis and staff recommendations for each of the following topics:

(i) The underlying asset (paragraphs 8 to 25)

(ii) The lease receivable (paragraphs 26 to 34)

(iii) The residual asset (paragraphs 35 to 66)

(iv) The presentation of the lease receivable and the residual asset (paragraphs 67 to 84)

Summary of staff recommendations

6. The staff recommendations take into account the boards' tentative decision at the April 2011 joint board meeting to retain two approaches for lessor accounting, which are based on the transfer of risks and rewards incidental to ownership of the underlying asset, similar to the distinction between finance and operating leases in IAS 17 *Leases*.

7. The staff recommend that:

(a) at the date of commencement of a finance lease, a lessor should:

(i) account for the underlying asset by derecognising the entire carrying amount of the underlying asset.

(ii) recognise a lease receivable at the present value of lease payments, discounted using the rate the lessor charges the lessee (plus any initial direct costs incurred by the lessor). Some staff, however, recommend that a lessor should initially measure some lease receivables at fair value (see paragraphs 26-30 of this paper).

(iii) recognise a residual asset, measured at the present value of the estimated residual value of the underlying asset at the end of the lease, discounted using the rate the lessor charges the lessee.

(b) and subsequently, a lessor should:

(i) measure the lease receivable at amortised cost using the effective interest method. Some staff, however, recommend that a lessor should subsequently measure some lease receivables at fair value (see paragraphs 33 and 34 of this paper).

(ii) measure the residual asset by accreting the residual asset using the rate lessor charges the lessee.

(c) in relation to presentation, a lessor should present the lease receivable and the residual asset together as one amount in the statement of financial position as an investment in leased assets. The lessor should also disclose in the notes to the financial statements, the portion of that investment in leased assets that relates to the residual asset.

The underlying asset

8. Regarding the underlying asset, the staff have considered only derecognition of part, or all, of the carrying amount of the underlying asset as possible approaches for lessors of finance leases because there was limited support in comment letters for finance lessors to continue to recognise the entire underlying asset.

9. This section therefore considers two approaches:

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

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

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

10. Under Approach A, at the date of commencement of a finance lease, a lessor derecognises the entire carrying amount of the underlying asset and recognises a lease receivable and any residual asset. This approach of derecognising the entire carrying amount of the underlying asset is consistent with the direct

financing and sales-type lease approaches in US GAAP and the approach used for finance leases in IFRSs.

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

12. Approach A views the lessor as transferring a right-of-use asset to the lessee and satisfying its performance obligation with respect to the right-of-use asset at commencement of the lease. This would result in the lessor recognising all revenue that is not attributable to the financing component of the lease arrangement upon delivery of the underlying asset.

13. Paragraphs 14 and 15 below note the advantages and disadvantages of derecognising the entire carrying amount of the underlying asset. Those advantages and disadvantages assume that, if the lessor derecognises the entire carrying amount of the underlying asset, its right to the residual asset would be a new asset that is initially measured either at fair value or at the present value of the expected residual asset at the end of the lease term. In other words, if the lessor derecognises the entire underlying asset, it would *not* measure its right to the underlying asset at the end of the lease term as an allocation of the carrying amount of the underlying asset.

14. The advantages of derecognising the entire carrying amount of the underlying asset are that:

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

    (b) it improves comparability of the profit or loss recognised by lessors that either sell or lease assets (often with purchase options) for what some might view as economically similar transactions (assuming that those lessors present revenue and cost of sales on finance lease contracts). This

is how the profit or loss on those transactions is accounted for today for finance/capital leases.

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

15. The disadvantages of this approach are:

(a) if the carrying amount of the underlying asset is different from its fair value, a lessor might recognise a day-one gain with respect to the whole underlying asset, rather than just the portion of the asset transferred to the lessee (assuming that the residual asset is not measured as an allocation of the carrying amount of the underlying asset). This is typically the case for manufacturer/dealers. Therefore, in such cases, Approach A arguably does not faithfully depict the transfer of benefits from the lessor to the lessee, where the lessor has transferred only the right of use to the lessee, and not the whole asset.

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

Approach B: Derecognise a portion of the carrying amount of the underlying asset

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

17. Consistent with how some view the boards' tentative decision on lessee accounting according to which a lessee acquires a right to use the underlying asset, the lessor derecognises that portion of the underlying asset representing the right to use the underlying asset for a period of time. In return, the lessor obtains a right to receive lease payments and retains an interest in the residual asset representing the lessor's retained rights to the underlying asset.

18. Approach B views the lessor as having performed by providing a right to use the underlying asset at commencement of the lease. The lessor could therefore

recognise a gain upon delivery of the underlying asset if there is a difference between the present value of the lease payments and the portion of the underlying asset derecognised.

19. Paragraphs 20 and 21 below note the advantages and disadvantages of derecognising a portion of the carrying amount of the underlying asset. Those advantages and disadvantages assume that, if the lessor derecognises only a portion of the carrying amount of the underlying asset, the lessor would initially measure its retained interest in the underlying asset as an allocation of the carrying amount of the underlying asset.

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

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

    (b) any day-one gain recognised for the portion of the underlying asset transferred arguably more faithfully depicts the transfer of benefits from the lessor to the lessee, where the lessor has transferred only the right of use to the lessee, and not the whole asset.

21. The disadvantages are:

    (a) it could be considered overly complex, particularly if reassessments are required, eg for lease term or possibly in relation to variable lease payments. Therefore, some might question whether any improvements over current GAAP would be sufficient to justify the additional costs.

    (b) in some cases, the present value of lease payments is not a good proxy for the fair value of the right-of-use asset. Assuming that the lessor measures the residual asset as an allocation of the carrying amount of the underlying asset, this may result in more or less value being allocated to the residual asset than its fair value.

    (c) it adds complexity to sublease accounting when determining how much of the asset the lessor should derecognise.

Staff recommendation – underlying asset

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

23. However, because this recommendation applies only to leases that transfer significant risks and rewards associated with the underlying asset to the lessee, those staff question the benefits of applying Approach B instead of Approach A (derecognise the entire carrying amount of the underlying asset) from a cost benefit perspective. This is because:

    (a) the effect of applying Approach B instead of Approach A would be limited to situations in which a lessor recognises day-one profit in applying current IFRSs/US GAAP. In other words, the choice of approach is irrelevant for lessors that purchase the underlying asset at its fair value and immediately lease it, thus realising no day-one gains. These types of lessors are typically financial institutions.

    (b) even for lessors who realise day-one gains (such as manufacturers or dealers), the effect of applying Approach B would be unlikely to result in a significant difference compared with applying Approach A (ie current practice) because any profit on the residual asset would be relatively insignificant.

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

24. Those staff therefore think the costs of applying Approach B outweigh the benefits and thus recommend Approach A—derecognise the entire carrying amount of the underlying asset.

25. Other staff also recommend that a finance lessor should derecognise the entire carrying amount of the underlying asset but for different reasons. Those staff prefer to incorporate the 'whole asset' approach, similar to the tentative decisions in the accounting for sale and leaseback transactions. Those staff think that a physical asset cannot be componentised and therefore, under a derecognition approach to lessor accounting, the entire carrying amount of the underlying asset should be derecognised. In addition, based on feedback received in the comment letters and outreach activities, many respondents think that current lessor accounting is not 'broken'. Because applying a partial derecognition approach would add complexity to the existing lessor model, particularly in the case of reassessment or subleases, those staff recommend a full derecognition approach to the underlying asset, which is similar to existing lease guidance for lessors with finance/capital leases.

Question 1: Underlying asset
The staff recommend that, at the date of commencement of a finance lease, a lessor should derecognise the entire carrying amount of the underlying asset. Do the boards agree with staff recommendation? Why or why not?

The lease receivable

26. The ED proposes that a lessor initially measures all lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor. After the date of commencement of the lease, the ED proposes that a lessor should measure the right to receive lease payments at amortised cost using the effective interest method, unless it becomes impaired. The majority of the respondents to the ED and participants in outreach agreed with the boards' proposals in the ED with respect to the initial and subsequent measurement of the lessor's lease receivable.

27. However, a few respondents disagreed and thought that measurement of the lease receivable should follow the requirements in the financial instruments standard.

> … [we are] concerned that the measurement of the lease receivable by a lessor is not consistent with the measurement model of IAS 39/IFRS 9, as effectively the lease receivable is a loan and should be accounted for consistently with other financial assets. [CL783]

28. Some staff think that the suggestion has merit. For example, some lease receivables can and have been securitised (we note that many finance lessors are financial institutions) and it may be appropriate for those lease receivables to be measured at fair value. This is consistent with the requirements in IFRS 9 *Financial Instruments* and the FASB's tentative decisions (made in January 2011) in developing their financial instruments standard that requires entities to measure specified financial assets at fair value.

29. Thus, some staff recommend that, if the lessor's business model or business strategy is either (a) not to hold those assets to collect contractual cash flows or (b) to hold them for trading, the lessor should measure those financial assets at fair value through profit or loss. These staff think that requiring a lessor to measure those lease receivables at fair value through profit or loss would more faithfully reflect the economics of the transaction and is less cumbersome and costly for those lessors. This approach would also measure lease receivables consistently with other financial assets.

30. Some constituents from the insurance industry suggested that the Boards should permit lease receivables to be measured at fair value as an option to avoid accounting mismatches (eg some insurance liabilities, which are measured on a current measurement basis, are backed by lease receivables). IFRS 9 allows entities to fair value their financial assets to eliminate measurement mismatches and US GAAP also allows eligible assets to be elected for fair value measurement (although, currently, lease receivables are not eligible assets). The staff notes that insurance liabilities would not be measured at fair value, according to boards' tentative decisions, but they are measured using a current

measurement basis, which is closer to fair value than amortised cost. Therefore, fair value measurement of lease receivables would arguably minimise the measurement mismatch, if not eliminate it completely.

Staff recommendation—lease receivables

Initial measurement

31. Some staff recommend that a lessor should initially measure all lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee, plus any initial direct costs incurred by the lessor (as proposed in the ED).

32. Other staff have been persuaded by arguments that lease receivables are like other financial assets and should be measured consistently, which includes fair value measurement in some circumstances. Those staff therefore recommend that a lessor should initially measure lease receivables at fair value if the lessor's business model or business strategy is either (a) not to hold those assets to collect contractual cash flows or (b) to hold them for trading (ie initial measurement that is consistent with other financial assets). Those staff also recommend that lessors should be allowed to initially measure lease receivables at fair value if such measurement would significantly reduce measurement mismatches. Otherwise, a lessor should initially measure lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee, plus any initial direct costs incurred by the lessor.

Question 2: Lease receivable – initial measurement
Some staff recommend that a lessor should initially measure all lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee, plus any initial direct costs incurred by the lessor.

> Other staff recommend that a lessor should initially measure lease receivables at fair value if the lessor's business model or business strategy is either (a) not to hold those assets to collect contractual cash flows or (b) to hold them for trading. Otherwise, a lessor should initially measure lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee plus any initial direct costs incurred by the lessor. Those staff also recommend that lessors should be allowed to initially measure lease receivables at fair value if such measurement would significantly reduce measurement mismatches.
>
> Which approach do the boards prefer? Why?

Subsequent measurement

33. Some staff recommend that a lessor should subsequently measure all lease receivables at amortised cost using the effective interest method, as proposed in the ED.

34. Other staff recommend that a lessor should subsequently measure lease receivables at fair value if the lessor's business model or business strategy is either (a) not to hold those assets to collect contractual cash flows or (b) to hold them for trading, for the reasons noted in paragraphs 28 and 29 of this paper (ie subsequent measurement that is consistent with other financial assets). Otherwise, a lessor should subsequently measure lease receivables at amortised cost using the effective interest method. Those staff also recommend that a lessor should be required to subsequently measure lease receivables at fair value if it elected to initially measure lease receivables at fair value to reduce measurement mismatches.

> **Question 3: Lease receivable – subsequent measurement**
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> Some staff recommend that a lessor should subsequently measure all lease receivables at amortised cost using the effective interest method
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> Other staff recommend that a lessor should subsequently measure lease receivables at fair value if the lessor's business model or business strategy is either (a) not to hold those assets to collect contractual cash flows or (b) to hold them for trading. Otherwise, a lessor should subsequently measure lease receivables at amortised

> cost using the effective interest method. Those staff also recommend that a lessor should be required to subsequently measure lease receivables at fair value if it elected to initially measure lease receivables at fair value to reduce measurement mismatches.
>
> Which approach do the boards prefer? Why?

Residual asset

A large part of this paper is devoted to discussing the measurement and presentation of the residual asset in order to provide full analysis for the boards' decisions. However, the staff note that, for finance leases, the value of the residual asset (particularly if unguaranteed) is typically relative insignificant when compared to the lease receivable. If significant, the lease is unlikely to be a finance lease. Consideration of this factor played a major part in reaching the staff recommendations in this paper.

35. In measuring its residual asset, the lessor should consider the following factors:

    (a) The condition of the underlying asset will have changed by the end of the lease. The asset will be older; it may even be obsolete. Its condition will depend on the nature and length of use of the asset by the lessee.

    (b) The lessor is unable to access the benefits associated with the residual asset until the end of the lease. Therefore, the measurement of the residual asset should reflect the fact that the lessor may not be able to obtain cash flows from the residual asset until some point in the future (ie the valuation of the residual asset should reflect the time value of money).

    (c) The residual asset could comprise a guaranteed amount provided by either a lessee or a third party, and an unguaranteed amount. The measurement of the lease receivable incorporates any residual value guaranteed by the lessee (based on the boards' tentative decision on residual value guarantees in February 2011). The lease receivable does not incorporate third party guarantees because the boards tentatively decided that they would not be considered to be lease payments.

Initial measurement

36. There are two approaches to consider for initial measurement of the residual asset:

    (a) Approach A: Allocate a portion of the carrying amount of the underlying asset to the residual asset (the approach proposed in the ED).

    (b) Approach B: 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 the lessor charges the lessee.

37. The staff note that, if the lessor's underlying asset is carried at or close to fair value at the commencement of the lease, then both of the approaches produce a similar answer. This is typically the case for financial institutions that act as finance lessors.

38. Therefore, the decision regarding the initial measurement of the residual asset would affect a lessor only if the carrying amount of the underlying asset does not equal its fair value at the date of commencement of the lease. For finance leases, this would typically be the case only for manufacturers and dealers.

Approach A: Allocate a portion of the carrying amount of the underlying asset to the residual asset

39. In the ED, the boards proposed that under the derecognition approach a lessor initially measures the residual asset by allocating a portion of the carrying amount of the underlying asset at the date of inception of the lease. The amount allocated to the residual asset by the lessor is as follows:

    Carrying amount of the underlying asset less:

$$\frac{\text{Fair value of lease receivable} \times \text{Carrying amount of the underlying asset}}{\text{Fair value of the underlying asset}}$$

40. Most respondents agreed with the ED proposal for initial measurement of the residual asset.

41. Approach A may provide the most faithful depiction of the economics of the lease transaction. This is because the lessor would recognise profit only on the

portion of the underlying asset transferred to the lessee in the form of the right of use. The lessor would not recognise profit on the residual asset that is initially measured on the basis of the previous carrying amount of the underlying asset. The example below illustrates this approach.

> Entity A produced a machine that has a carrying amount of CU80 with a useful life of ten years. The fair value of the machine is CU100. The estimated residual value of the machine in 9 years is CU25. The present value of that estimated residual value is CU20. Entity A leases the machine for nine years for lease payments with a present value of CU80.
>
> Assuming Entity A derecognises the entire carrying amount of the machine at the date of commencement of the lease, the entries are:
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> | | | |
> |---|---|---|
> | DR Receivable | 80 | |
> | DR Residual asset | 16 (80 – (80 x 80/100)) | |
> | DR Cost of sales | 64 (80 x 80/100) | |
> | CR Machine | | 80 |
> | CR Revenue | | 80 |
>
> In this example, Entity A initially measures the residual asset as an allocation of the carrying amount of the machine of CU80, which is less than the machine's fair value of CU100. Hence, the carrying amount of the residual asset (CU16) is less than the present value of the estimated residual value of the underlying asset at the end of the lease (CU20). As a result, under Approach A, Entity A recognises revenue of CU80 and a profit of CU16. The profit of CU16 represents profit on the right of use transferred to the lessee, but does not include any profit relating to the residual asset because the residual asset is initially measured on the basis of the previous carrying amount of the machine.

42. Under Approach A, the initial measurement of the residual asset is linked to the previous carrying amount of the underlying asset. In the staff's view, Approach A would not be appropriate if the boards support Approach A in Question 1 of this paper relating to the underlying asset, ie an approach for which the lessor treats the underlying asset as sold and derecognises the entire carrying amount of the underlying asset (discussed in paragraphs 10-15 of this paper). Initially measuring the residual asset at an amount that is closer to fair value would be more consistent with Approach A in Question 1 of this paper.

43. Initially measuring the residual asset as an allocation of the carrying amount of the underlying asset makes more sense when coupled with Approach B in Question 1 of this paper relating to the underlying asset (discussed in paragraphs 16-21 of this paper). According to that approach, a lessor derecognises only a portion of the carrying amount of the underlying asset (and, thus, only a portion of the underlying asset is treated as sold). Thus, in that case, it would appear logical to retain the measurement of the residual asset that is not 'sold' as part of the initial measurement of the residual asset.

Approach B: Measure the residual asset at the present value of the estimated residual value of the underlying asset at the end of the lease term

44. Under Approach B, the lessor initially measures the residual asset at the present value of the estimated residual value of the underlying asset at the end of the lease, discounted using the rate the lessor charges the lessee (which, for the lessor, would generally be the rate implicit in the lease). Therefore, in the example set out after paragraph 41 of this paper, the lessor would initially measure the residual asset at CU20. As a result, the lessor would recognise revenue of CU100 and profit of CU20 at the date of commencement of the lease.

45. Using the rate the lessor charges the lessee to discount the estimated residual value of the underlying asset at the end of the lease term results in a measure of the residual asset that is similar to, although may not be exactly the same as, the residual asset's fair value at the date of commencement. Approach B is also consistent with the staff recommendation regarding the initial measurement of the lease receivable—to initially measure the lease receivable at the present value of lease payments, discounted using the rate the lessor charges the lessee.

46. Initial measurement of the residual asset at fair value would be consistent with how many other assets are initially measured (eg financial assets, also PPE because the cost of PPE is typically fair value at initial measurement). However, the staff considered and rejected initially measuring the residual asset at fair value because we do not think the benefit of requiring fair value measurement would outweigh the costs of calculating such a measure. This is because fair valuing the residual asset would involve not only estimating the residual value at

the end of the lease term, but also applying a discount rate to the residual asset when calculating its fair value that is likely to be different from the rate the lessor charges the lessee in the lease. Measuring the residual asset at fair value would only be appropriate if the lessor also initially measured the lease receivable at fair value.

Staff recommendation

47. The staff recommend Approach B—that a lessor should 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 the lessor charges the lessee. This amount is considered a good proxy for fair value at the commencement of the lease and, at the same time, is less complex to measure than fair value. In addition, the staff think that Approach B to initially measuring the residual asset is consistent with:

    (a) the staff recommendation relating to the underlying asset set out in paragraphs 23-25 of this paper—ie a lessor should derecognise the entire carrying amount of the underlying asset and, then, initially measure the residual asset (as a new asset) at a value that approximates fair value.

    (b) the majority staff recommendation relating to initially measuring the lease receivable set out in paragraphs 31 and 32 of this paper—ie a lessor should initially measure lease receivables at the present value of lease payments, discounted using the rate the lessor charges the lessee.

Question 4: Residual asset – initial measurement
The staff recommend that a lessor should 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 the lessor charges the lessee. Do the boards agree with staff recommendation? Why or why not?

Subsequent measurement

48. A lessor could subsequently measure the residual asset in any of the following ways:

    (a) Approach A: 'Freeze' the initial carrying amount of the residual asset except for impairment (the approach proposed in the ED).

    (b) Approach B: Accrete or unwind the carrying amount of the residual asset over the lease term.

    (c) Approach C: Remeasure the residual asset to fair value.

Approach A – 'Freeze' the initial carrying amount of the residual asset

49. According to the proposals in the ED, the residual asset is an allocation of the previous carrying amount of the underlying asset and the lessor does not subsequently remeasure that carrying amount unless the asset is impaired. Therefore, in the example set out after paragraph 41 of this paper (and assuming that the lessor initially measures the residual asset at the present value of the estimated residual value of the underlying asset at the end of the lease term), the lessor would measure the residual asset at CU20 until the end of the lease unless the asset was impaired.

50. For manufacturer/dealer lessors, the carrying amount of the underlying asset would typically be less than its fair value at initial measurement, as shown in the example set out after paragraph 41 of this paper.

51. Under Approach A, when a manufacturer/dealer lessor re-leases or sells the residual asset at the end of the lease, that lessor recognises a larger profit at that time, some of which might be more appropriately recognised over the lease term, rather than at the end of the lease term. This would be the case if the residual asset is initially measured taking into account the time value of money (which would be case under both approaches to initial measurement discussed in paragraphs 36-47 of this paper). A lessor would recognise a larger profit on re-leasing or selling the residual asset at the end of the lease term because, under

Approach A, the subsequent measurement of the residual asset would not unwind that time value of money over the term of the lease.

52. Nonetheless, retaining the proposals in the ED (that is, 'freezing' the value of the residual asset) may be simpler for preparers because the lessor would not change the carrying amount of the residual asset after initial measurement (other than when the asset is impaired).

53. Some think the proposals in the ED are a consistent application of historical cost accounting for property, plant and equipment. However we note that the lessor's *residual asset* as proposed in the ED is different from the concept of *residual value* as defined in existing guidance:

IFRSs – IAS 16 *Property, Plant and Equipment* defines residual value as follows:

> The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. (IAS 16.6)

The glossary in *FASB Accounting Standards Codification*® defines residual value as:

> The estimated fair value of the leased property at the end of the lease term.

54. Both definitions of residual value take into account the time value of money. However, the lessor's subsequent measurement of the residual asset according to the ED does not adjust the carrying amount of the residual asset to take account of the time value of money reflected in the initial measurement of the residual asset. Therefore, we do not think that this approach is consistent with the measurement of property, plant and equipment.

55. In addition, because the staff recommendation for initial measurement of the residual asset set out in paragraphs 44-47 of this paper reflects the time value of money, 'freezing' that initial measurement would understate the residual asset if the Boards agree with the staff recommendation for initial measurement.

Approach B – accrete the residual asset over the lease term

56. Under Approach B, the lessor would unwind or accrete the residual asset over the lease term to reflect the time value of money on the amount initially recognised for the residual asset. Therefore, in the example set out after paragraph 41 of this paper, the residual asset would be accreted from its initial measurement of CU20 to CU25 over the 9 year term of the lease. The lessor would not change the estimated residual value of the underlying asset at the end of the lease (CU25 in the example referred to above) after initial measurement, unless the lessor determines that the residual asset is impaired. The rate the lessor uses to accrete the asset would be the same rate as that used to discount the residual to its present value on initial measurement, ie the rate the lessor charges the lessee.

57. The entries to accrete the value of the residual asset are:

    DR Residual asset

    CR Interest income

58. Some might hold the view that a lessor should only accrete the portion of the residual asset that is guaranteed at the end of the lease. This would treat the guaranteed amount as akin to a financial asset (and the unguaranteed amount not)—accreting the guaranteed amount would be consistent with the accounting for other financial assets. However, the staff think that the residual asset at the end of the lease should equal the residual value as defined in IFRSs and US GAAP (see paragraph 53 of this paper for the definition of residual value). Consequently, we recommend that the lessor accretes the entire (guaranteed and unguaranteed) amount over the lease term.

59. The advantages of accreting the residual asset are:

    (a) the residual asset continues to be measured on a historical-cost basis, which is comparable with other long-term tangible assets that are measured on a cost basis.

    (b) it is less onerous to apply than Approach C, which requires the lessor to remeasure the residual asset to fair value.

(c) it is consistent with how the lease was typically priced and with current finance lease accounting.

(d) it avoids delaying recognition of potentially large gains (that arise solely from the time value of money) when the lessor re-leases or sells the underlying asset at the end of the lease.

60. The disadvantages of accreting the residual asset are:

(a) because it does not take into account changes in the discount rate or cash flows expected from the underlying asset, it arguably provides less useful information than fair valuing the residual asset (Approach C).

(b) when applied to assets that appreciate over the lease term (eg land), the result is not consistent with historical cost measurement (because the measurement of the residual at the end of the lease term would be higher than the initial measurement of the underlying asset). This is an issue for US GAAP, which does not permit the revaluation of tangible assets. However, it is worth noting that most assets that are the subject of a finance lease would depreciate over the lease term.

(c) the residual would be more sensitive to impairment, possibly giving rise to more frequent impairment testing, which might be burdensome.

Approach C – fair value the residual asset

61. Under Approach C, the lessor would remeasure the residual asset to fair value and recognise any gains and losses in profit or loss. The entries would be:

DR/CR Residual asset

DR/CR Gains/losses on remeasurement

62. The advantages of remeasuring the residual asset to fair value are that:

(a) it provides more relevant information to users of financial statements (the lessor's residual asset reflects current expectations about the residual asset). This is because the fair value would not only take into account the

time value of money of the residual asset, it would also consider other sources of changes to the value of the residual asset.

(b) the lessor does not have to consider impairment separately (but it is still taken into account when determining fair value).

(c) many lessors already monitor the estimated residual value of leased assets particularly in situations in which their interest in the residual is significant or guaranteed. If the lessor's interest in the residual is not material, it would not have to apply this requirement. Consequently, the approach might not be as burdensome as some might consider it to be.

63. The disadvantages are that:

(a) it is inconsistent with the accounting for property, plant and equipment that is measured on a historical cost basis, and thus decreases comparability with such assets.

(b) it is also inconsistent with IAS 16 for property, plant and equipment that is revalued. This is because a lessor would recognise the fair value adjustment relating to the residual asset in profit or loss and not in other comprehensive income as is the case when applying the revaluation approach in IAS 16.

(c) fair value may be difficult to determine in some jurisdictions.

(d) measuring residual assets at fair value may be practicable for small numbers of large assets that have high individual values. Measuring residual assets at fair value, however, is likely to be extremely onerous for lessors that have a large number of lower value assets that, in aggregate, are material in value to the lessor.

Staff recommendation

64. The staff recommend Approach B, that a lessor should subsequently measure the residual asset by accreting the residual asset over the lease term using the rate the lessor charges the lessee because it:

(a) ensures that the residual asset is measured on a historical-cost basis. This means that the residual asset at the end of the lease term is equal to the asset's residual value as defined under existing requirements (see paragraph 53 for definitions of residual value in existing requirements). This ensures comparability with other long-term tangible assets that are measured on a cost basis.

(b) is less complex and onerous than fair value measurement.

(c) will not understate the lessor's income or profitability during the period of the lease. Nor will it overstate a lessor's gains when the lessor sells or re-leases the underlying asset in subsequent periods.

65. The staff do not recommend Approach A—to 'freeze' the initial carrying amount of the residual asset-because it does not reflect the underlying economics of the residual asset, nor is it consistent with the staff recommendation regarding the initial measurement of the residual asset.

66. The staff also do not recommend Approach C—to remeasure the residual asset to fair value-because we think that it would potentially be very costly to implement without providing sufficient additional benefit to users.

Question 5: Residual asset – subsequent measurement
The staff recommend that a lessor subsequently measures the residual asset by accreting the residual asset over the lease term using the rate lessor charges the lessee. Do the boards agree with staff recommendation? Why or why not?

Presentation

Nature of the lessor's assets

67. Upon entering into a finance lease, the lessor obtains two rights in exchange for the underlying asset:

(a) the right to receive lease payments (ie the lease receivable); and

(b) the right to return of the underlying asset at the end of lease term (ie the right to the residual asset).

68. The right to receive lease payments is a financial asset because it is a right to receive cash.

69. The residual asset is not a financial asset. Its nature is more akin to the lessee's right-of-use asset.

How should the lessor's assets be presented?

70. The lessor could present those assets in two ways:

    (a) Approach A: Present each of the assets separately in the statement of financial position.

    (b) Approach B: Present both the lease receivable and the residual asset as one amount in the statement of financial position.

Approach A: Present each of the assets separately

71. Under Approach A, the lessor presents separately each of the assets arising from a finance lease in the statement of financial position.

72. The advantage of this approach is that it would provide transparency in the statement of financial position about the different risks that arise from each of the assets, ie credit risk for the lease receivable, and asset risk for the residual asset. Thus, this approach arguably provides the best information for users.

73. Nonetheless, some users have indicated that they would prefer to see all assets arising from one underlying asset presented together in the statement of financial position.

74. In addition, there is a question as to where to present the residual asset. The most appropriate caption under which to present that asset might be property, plant and equipment. However, if the lessor were to present the residual asset as an item of property, plant and equipment, many respondents to the ED did not think such presentation would be useful, particularly for financial institution lessors. This is because financial institution lessors typically do not take

possession of the underlying asset, either before commencement of the lease or after the end of the lease term. Presenting the residual asset as an item of property, plant and equipment would imply that those financial institution lessors intend to either use or re-lease the underlying asset at the end of the lease term, which is usually not the case.

75. Finally, this approach could be more complex if the value of the residual asset changes during the lease term and the lessor is required to remeasure the lease receivable or the residual asset. This is because a change in the value of the residual asset could result in a change to the amounts recognised for both the lease receivable and the residual asset (even though the total amount recognised by the lessor relating to the underlying asset might remain the same).

76. Separate presentation of the residual asset and the lease receivable would arguably provide less useful information to users and possibly be confusing as to the amount of cash flows expected from the residual asset at the end of the lease term. This is illustrated in the following example:

> Assume a lessee provides a residual value guarantee to a lessor to pay the lessor any difference between the amount that the underlying asset is sold for at the end of the lease term and CU400. At the start of the lease, the lessor expects to sell the underlying asset for CU400. Therefore, the lease receivable does not include anything relating to the lessee's residual value guarantee; the present value of CU400 is recognised as a residual asset. Half way through the lease, the lessor expects to sell the underlying asset for CU350 at the end of the lease term. In that case, if the lessor is required to remeasure its lease receivable and residual asset, the lease receivable would then include CU50 discounted to the reporting date, representing the amount that is expected to be paid by the lessee under the residual value guarantee (the boards tentatively decided in February 2011 that lease payments include amounts expected to be paid by the lessee under residual value guarantees). In turn, the residual asset would be remeasured to CU350 discounted to the reporting date.

Approach B: Present all assets together as one amount

77. Under Approach B, the lessor presents together all of its assets relating to the underlying asset that is leased (ie the lessor presents one amount—an investment in lease assets—that includes the lease receivable and the residual asset). This approach is consistent with current practice.

78. This approach is also consistent with the views of those who think that, once the lessor has entered in a finance lease, the entire underlying asset ceases to exist and, from that point forward, the lessor has an investment in the leased asset, the individual pieces of which should be viewed together.

79. For many finance leases, the value of the residual asset is relatively insignificant. Thus, those supporting this view would argue that presenting the residual asset together with the lease receivable would not result in a significant loss of information and would reduce clutter in the financial statements. However, for some leases, the residual asset may be significant, particularly towards the end of the lease term.

80. A disadvantage of this approach is also that it ignores the different nature and risks associated with each of the lessor's rights described in paragraph 72 of this paper. It does not provide transparency of the residual asset in the statement of financial position for which users have repeatedly asked.

Staff recommendation

81. The staff have been persuaded by arguments that most lessors manage assets subject to a lease as investments. They rarely use those underlying assets for their own purposes after the end of lease term, which is particularly the case for finance leases.

82. The staff therefore do not think that presenting a part of this investment (ie the residual asset) as property, plant and equipment would provide useful information to users. Thus the staff recommend Approach B—that a lessor should present all assets together as an investment in leased assets.

83. However, the components of this investment are subject to different risks and timing of cash flows. Therefore, the staff think that disclosure of these components would provide useful information.

84. The staff recommend disclosure in the notes to the financial statements of the portion of the lessor's investment in leased assets that relates to the residual asset.

Question 6: Presentation
The staff recommend that the lessor presents one amount in the statement of financial position—an investment in leased assets that combines its right to receive lease payments and its right to the residual asset, with separate disclosure in the notes to the financial statements of the portion of that investment in leased assets that relates to the residual asset. Do the boards agree with the staff recommendation? Why or why not?