

IASB/FASB Joint Meeting - Week Commencing May 16, 2011

IASB/FASB Education Sessions - Week Commencing May 9, 2011

AP 2F/FASB Memo 173 - Appendix A

Appendix A - Illustration of Approaches -- Lease of a depreciating asset where the fair value exceeds the carrying value at commencement

A lessor has a piece of equipment with a carrying amount of CU30,000,000 and an economic life of 10 years. The equipment's fair value is CU50,000,000. The lessor enters into a 5-year lease of the equipment. The lease calls for annual payments of CU7,000,000 for the first two years and CU8,000,000 for the last three years. The estimated value of the equipment at the end of 5 years is CU25,000,000. The resulting interest rate the lessor charges the lessee in the contract is 6.31%. The present value of the lease payments, discounted at 6.31%, is 31,590,237. This example assumes that the estimated value of the residual asset does not change throughout the lease term.

Lease Terms		
		6.31% Interest Rate
0	(50,000,000)	5 Term in years
1	7,000,000	50,000,000 Asset Fair Value at Inception
2	7,000,000	30,000,000 Asset Carrying Value at Inception
3	8,000,000	25,000,000 Expected Gross Residual Value
4	8,000,000	7,000,000 Annual Payment, Years 1-2
5	33,000,000	8,000,000 Annual Payment, Years 3-5

APPROACH 1

Year	Cash	Lease Receivable	Lease Contract Liability	Net Lease Asset	Underlying Asset	Amortization Revenue	Interest Income	Lease Revenue	Depreciation Expense	Net Income
Rate	6.31%									
0		31,590,237	31,590,237	-	30,000,000					
1	7,000,000	26,583,909	25,983,909	600,000	27,000,000	5,606,328	1,993,672	7,600,000	(3,000,000)	4,600,000
2	7,000,000	21,261,629	20,061,629	1,200,000	24,000,000	5,922,279	1,677,721	7,600,000	(3,000,000)	4,600,000
3	8,000,000	14,603,459	13,803,459	800,000	21,000,000	6,258,170	1,341,830	7,600,000	(3,000,000)	4,600,000
4	8,000,000	7,525,089	7,125,089	400,000	18,000,000	6,678,370	921,630	7,600,000	(3,000,000)	4,600,000
5	8,000,000	-	-	-	15,000,000	7,125,089	474,911	7,600,000	(3,000,000)	4,600,000
TOTAL						31,590,237	6,409,763	38,000,000	(15,000,000)	23,000,000

APPROACH 2

Year	Cash	Deferred Lease Asset	Underlying Asset	Lease Revenue	Depreciation Expense	Net Income
0		-	30,000,000			
1	7,000,000	600,000	27,000,000	7,600,000	(3,000,000)	4,600,000
2	7,000,000	1,200,000	24,000,000	7,600,000	(3,000,000)	4,600,000
3	8,000,000	800,000	21,000,000	7,600,000	(3,000,000)	4,600,000
4	8,000,000	400,000	18,000,000	7,600,000	(3,000,000)	4,600,000
5	8,000,000	-	15,000,000	7,600,000	(3,000,000)	4,600,000
TOTAL				38,000,000	(15,000,000)	23,000,000

APPROACH 3

(note: it is assumed in this example that the lessor is not reasonably assured that the residual value of the underlying asset at the end of the lease term will be higher than its initial carrying amount)

Journal Entry at Lease Commencement

Lease Receivable	31,590,237	
Residual Asset (a)	11,045,858	
Deferred Cost of Goods Sold (b)	18,954,142	
Equipment (inventory)		30,000,000
Deferred Lease Revenue (c)		31,590,237

Calculation Notes:

- (a) = Cost basis of inventory (30,000,000) less Deferred Costs of Goods Sold (18,954,142)
- (b) = Cost basis of inventory (30,000,000) multiplied by Lease Receivable (31,590,237) divided by Underlying's fair value (50,000,000)
- (c) less (b) = Deferred Gain : 12,636,095

Year	Cash	Lease Receivable	Residual Asset	Deferred Gain	Interest Income	Residual Accretion	Amortization of Deferred Gain (d)	Net Income
0		31,590,237	11,045,858	12,636,095				
1	7,000,000	26,583,909	11,742,966	10,726,875	1,993,672	697,108	1,909,220	4,600,000
2	7,000,000	21,261,629	12,484,070	8,545,699	1,677,721	741,103	2,181,176	4,600,000
3	8,000,000	14,603,459	13,271,944	6,075,403	1,341,830	787,874	2,470,296	4,600,000
4	8,000,000	7,525,089	14,109,541	3,234,630	921,630	837,597	2,840,773	4,600,000
5	8,000,000	-	15,000,000	-	474,911	890,459	3,234,630	4,600,000
TOTAL	38,000,000				6,409,763	3,954,142	12,636,095	23,000,000

Cash Received	38,000,000
Change in Asset Cost Basis	(15,000,000) (30,000,000 less 16,915,988)
Lease Revenue	23,000,000

Other Notes:

(d) The amortization of deferred gain could also be presented on a gross basis as Revenue and Cost of Goods Sold.