Project	**Leases**
Topic	**Lessor Accounting – Other-than-finance leases**

Objective

1. The objective of this memo is to analyze initial and subsequent measurement, and presentation, of assets and liabilities recognized by a lessor for other-than-finance leases (ie, leases where substantially all the risks and rewards incidental to ownership of an underlying asset are *not* transferred to the lessee).

2. 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. Those memos provide a summary of the proposals in the Exposure Draft, *Leases* (ED), further background, and an analysis of comment letters and other feedback related to the issues analyzed in this memo. That information has not been repeated in this memo.

3. The structure of this memo is as follows:

    (a) Staff analysis

        (i) Topic I – Statement of financial position (SFP) initial measurement and presentation

        (ii) Topic II – Subsequent measurement – SFP and income statement

        (iii) Topic III – Sale or assignment of lease receivables

    (b) Appendix A – Illustrative example: contrasting the three approaches to lessor accounting for other-than-finance leases

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

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(c) Appendix B –Illustrative example: sale or assignment of lease receivables

(d) Appendix C – Impairment considerations

(e) Appendix D – Recognition of profit under Approach 3.

Topic I – SFP Initial Measurement and Presentation

Possible approaches

4. The staff has analyzed three approaches to the initial measurement and presentation of assets and liabilities recognized by lessors of an other-than-finance (OTF) lease:

    (a) Approach 1 (Performance obligation approach proposed in the ED, amended to net presentation)

    (b) Approach 2 (Current operating lease accounting)

    (c) Approach 3 (Derecognition-based approach).

5. The staff did not analyze the performance obligation approach proposed in the ED (gross presentation) because constituents expressed several concerns about the approach.

6. The following example will be used to illustrate the differences between the three approaches:

Example 1 (see Appendix A to this memo for detailed calculations):

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 five-year lease of the equipment. The lease calls for annual payments of CU7,000,000 for the first 2 years and CU8,000,000 for the last 3 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 percent. The present value of the lease payments, discounted at 6.31 percent, is CU31,590,237. The present value of the estimated value of the equipment at the end of 5 years, discounted at 6.31 percent is CU18,409,763.

This example assumes that the estimated value of the residual asset does not change throughout the lease term.

Approach 1: Recognize a lease receivable and lease liability but present the lease receivable net of the lease liability

7. Under Approach 1, the lessor would recognize a lease receivable and a lease liability at lease commencement, as proposed in the ED. The lease receivable and lease liability would be initially measured consistent with the proposals in the ED. However, the lessor would present the lease receivable net of the lease liability on the SFP. The gross amounts of the lease receivable and lease liability would be disclosed in the footnotes. The underlying asset would be presented separately from other property, plant, and equipment on the SFP.

8. At lease commencement, assuming there are no initial payments of cash to/from the lessor, the lessor's net contract position would be zero. At lease commencement, the lessor's financial statements would be as follows:

Statement of Financial Position:	
Net Lease Contract Asset	-
Underlying Asset	30,000,000
Disclosures:	
Lease Receivable	31,590,237
Lease Liability	(31,590,237)

9. In subsequent periods, a net contract position would be zero in leases in which both of the following exist:

   (a) The pattern of lease payments and the pattern of economic benefit provided to the lessee are equivalent throughout the lease term.

   (b) The pattern of income is on a straight-line basis, resulting in the lease liability amortizing at the same rate as the lease receivable. See Topic II below for further details on subsequent measurement.

10. However, if there are uneven lease payments and/or the pattern of economic benefit is not even throughout the lease term, the lessor would recognize a net lease contract asset or a net lease contract liability. In the example in paragraph 6 of this paper, the payments increase from CU7,000,000 for the first 2 years to CU8,000,000 for the last 3 years. Therefore, at the end of Year 2, the financial statements would be as follows (see Appendix A for details about the calculation of these figures):

Statement of Financial Position:	
Net Lease Contract Asset	1,200,000
Underlying Asset	24,000,000
Disclosures:	
Lease Receivable	21,261,629
Lease Liability	(20,061,629)

11. The accretion of the lease receivable and the extinguishment of the lease liability over the lease term would lead to interest income (on the lease receivable) and lease revenue (as the asset is made available for use by the lessee).

Advantages of Approach 1

12. Approach 1 addresses the concerns of some constituents, who objected to presenting the grossed-up effect on the SFP that results from presenting the underlying asset, the lease receivable, and the performance obligation individually in the SFP as proposed in the ED.

13. Some think that accounting for the underlying asset under Approach 1 is simpler than under Approach 3. This is because depreciating the underlying asset is an easier way, and a good proxy, for measuring the consumption or use of an asset that will be returned to the lessor at the end of the lease term as compared to the recognition and accretion of a residual asset.

14. Unlike Approach 2, Approach 1 depicts the extent to which the lessor's use of the underlying leased asset is restricted by requiring disclosure of the lease liability.

Disadvantages of Approach 1

15. The netting of the lease receivable and lease liability on the SFP presents the lessor's financial position in a way that implies that the lessor has not actually recognized the lease receivable. If one thinks that the lessor ought to recognize a lease receivable and a lease liability, then presenting those amounts net limits the ability of users to assess the future economic benefits available to, and obligations of, the lessor and, hence, hinders an assessment of the lessor's financial strengths and weaknesses. Offsetting obscures the existence of lease

assets and liabilities and thereby reduces users' ability to assess the lessor's liquidity and solvency, its needs for additional financing and to predict how future cash flows will be distributed among those with a claim against the lessor.

16. From a cost benefit perspective, it is questionable whether the costs of applying Approach 1 outweigh any benefits when compared to Approach 2. This is because Approach 1 and Approach 2 result in the lessor recognizing similar amounts on its SFP and in profit or loss for all OTF leases.

17. Some staff members think that additional application guidance regarding impairment would be required under Approach 1. Additional impairment considerations under Approach 1 are discussed in Appendix C to this memo.

Approach 2: Operating lease treatment

18. Approach 2 carries forward current accounting guidance for operating leases under IAS 17, *Leases,* and Topic 840, *Leases*. The lessor would not recognize a lease receivable or a lease liability at lease commencement. Instead, the lessor would recognize a lease receivable only to the extent that it has performed under the terms of the lease but has not yet collected the associated consideration. The lessor would recognize a liability to the extent that the lessee prepays for the use of the asset. The underlying asset would be presented separately from other property, plant, and equipment on the SFP. A lessor would disclose lease receivables on a gross (undiscounted) basis but would not disclose a lease liability.

19. A lessor would account for the lease as follows when applying Approach 2:

    (a) Assume that a lessor invoices a lessee at the end of each month, with the payment due on the tenth day of the following month.

    (b) At the end of the first month, the amount billed becomes unconditional because the lessor has made the underlying asset available for use by the lessee throughout that given month. Therefore, a lessor recognizes a lease receivable for that month.

(c) Conversely, if the lessee pays larger amounts for the lease in earlier periods (or in an extreme case, prepays the entire lease), the lessor records deferred revenue.

(d) The lessor would disclose the minimum lease payments on a gross (undiscounted) basis.

20. Using the example from paragraph 6 of this paper, at lease commencement, assuming there are no initial payments of cash to/from the lessor, the lessor does not record anything on the SFP. At lease commencement, the lessor's financial statements would be as follows (see Appendix A for details of the calculation of these figures):

Statement of Financial Position:	
Underlying Asset	30,000,000
Disclosures:	
Lease Payments	38,000,000

21. At the end of Year 2, the lessor's financial statements would be as follows:

Statement of Financial Position:		
Lease Receivable	1,200,000	
Underlying Asset	24,000,000	(original cost less accum. depreciation)
Disclosures:		
Lease Receivable	24,000,000	(CU8,000,000 x 3 remaining years)

Advantages of Approach 2

22. The performance obligation approach proposed in the ED was considered by most constituents to not be a significant improvement when compared to current guidance for operating leases. Because Approach 2 carries forward existing guidance, lessors that have operating lease portfolios are familiar with the guidance and could apply Approach 2 without additional costs. Moreover, Approach 2 results in a SFP that is substantially the same as Approach 1 but would avoid the cost of having to measure the lease receivable and lease liability on a discounted basis.

23. Users are likewise familiar with current operating lease accounting. Some have expressed a preference for Approach 2 because a lessor would not

recognize an interest-earning asset on its SFP (the lease receivable). Those users prefer to see one lease income amount in the lessor's income statement, rather than lease interest income and other lease revenue. This matter is discussed further in Topic II of this memo.

24. Approach 2 reflects the view that the lessee derives economic benefits from an OTF lease over the term of the lease. The lessor only has unconditional rights to cash to the extent that it has made the economic benefits associated with the leased asset available to the lessee.

25. Some think that accounting for the underlying asset under Approach 2 is simpler than under Approach 3. This is because depreciating the underlying asset is an easier way, and a good proxy, for measuring the consumption or use of an asset that will be returned to the lessor at the end of the lease term as compared to the recognition and accretion of a residual asset.

26. Because Approach 2 would require a lessor in an OTF lease to disclose the lease receivable on a gross (undiscounted) basis, some staff members think this requirement provides adequate transparency regarding the extent to which the lessor's use of the underlying leased assets is restricted.

Disadvantages of Approach 2

27. Some staff members think that Approach 2 is inconsistent with both lessee accounting and revenue recognition because the lessor does not record a lease receivable:

    (a) It is inconsistent with lessee accounting because the lessee in an OTF lease is required to recognize a liability to make lease payments; therefore, the lessor in an OTF lease should be required to record a lease receivable.

    (b) It is inconsistent with revenue recognition if the lessor is considered to have delivered the ROU asset because a lease receivable is not recognized.

Approach 3: Derecognition-based approach

28. At the April 2011 education session, some Board members asked the staff to include a discussion of a derecognition-based approach when addressing the lessor's accounting for OTF leases.

29. Under Approach 3, the lessor of an OTF lease would derecognize the underlying asset, recognize a lease receivable and recognize a residual asset based on the carrying amount of the underlying asset multiplied by the proportionate value of the lease receivable to the underlying asset's fair value at lease commencement. As a consequence, the lessor would not recognize any profit on the residual asset at lease commencement for OTF leases. The rationale for using a proportional cost allocation for the residual asset rather than initially measuring the residual at the present value of its estimated residual value at the end of the lease term is discussed in Appendix D to this memo.

30. In addition, under Approach 3, some question whether a lessor should recognize any gain at lease commencement on OTF leases, which is also discussed in Appendix D to this memo.

31. When compared to the derecognition approach proposed for finance leases in the lessor—finance lease staff memo, there are two possible differences between Approach 3 as described in this memo and the staff recommendations for finance leases:

    (a) as noted in paragraph 29 above, for an OTF lease, the lessor would not recognize any profit on the residual asset until it subsequently sells or re-leases the underlying asset at the end of the lease term. For a finance lease, at lease commencement, a lessor would recognize profit on the residual asset as well as the ROU asset transferred to the lessee.

    (b) if the profit on the ROU asset is not reliably measurable as discussed in Appendix D to this memo, the lessor would not recognize that profit at lease commencement but, instead, would recognize it in a manner that ensures that the lessor would recognize lease income on a straight-line basis over the lease term.

32. Using the example from paragraph 6 of this memo, under Approach 3, the lessor recognizes a lease receivable and a residual asset on its SFP. At lease commencement, the lessor's financial statements would be as follows:

Statement of Financial Position:	
Lease Receivable	31,590,237
Lease Residual	11,045,858
Deferred Profit	(12,636,095)

In this example, it is assumed that the profit on the ROU asset is not reliably measurable and all of that profit on the ROU asset transferred to the lessee is deferred at lease commencement.

33. At the end of Year 2, the financial statements would be as follows (see Appendix A for details of the calculation of these figures):

Statement of Financial Position:	
Lease Receivable	21,261,629
Lease Residual	12,484,070
Deferred Profit	(8,545,699)

34. Those who support Approach 3 think that a lessor has performed when it has delivered the ROU asset to the lessee at lease commencement. Therefore, the underlying asset should be derecognized. They hold the view that there should be only one approach to accounting for a lessor's interest in leased assets on the SFP, but that there should be two approaches for profit and loss recognition. That is, at lease commencement, irrespective of the type of lease, a lessor derecognizes the underlying asset and recognizes a lease receivable and a residual asset. They view this as similar to the approach being proposed for lessee accounting—at lease commencement, a lessee recognizes a ROU asset and a liability to make lease payments, irrespective of the type of lease, but allowing for a different profit and loss recognition profile for certain leases.

35. If the Boards were to support a derecognition-based approach for all leases, with a different pattern of income recognition for some leases, the staff thinks that the leases standard would need to include some parameters on when a lessor of an OTF lease would be permitted to recognize revenue and profit at lease commencement. Concerns have been raised about the recognition of profit on the ROU asset when the profit recognized is dependent on an

estimation of the residual asset value at the end of the lease term. See Appendix D to this memo for further discussion of profit recognition under Approach 3.

Advantages of Approach 3

36. Approach 3 results in consistent accounting for all leases, whether finance or OTF. That is, a lease receivable and a residual asset are recognized. Some staff members believe that derecognition of the underlying asset and recognition of a residual asset more appropriately depicts the usage of the underlying asset during the lease term than depreciation. This is because the lessor is not the entity that directly uses the underlying asset. Instead, the lessor invests in that asset by leasing it, so derecognition and accretion of the residual asset are more meaningful than depreciation expense.

37. Some staff think that Approach 3 is consistent with lessee accounting in that the lessor recognizes a receivable, which is consistent with the lessee recognizing a liability to make lease payments. In addition, many constituents, including several working group members, would argue that Approach 3 is also consistent with the lessee recognizing a ROU asset. They think that, having delivered the ROU asset, the lessor has performed and there is no performance obligation in relation to the ROU asset. In a lease, the lessor is obliged to give the lessee ‘quiet enjoyment’ of the underlying asset. However, those supporting Approach 3 would argue that the lessor does not have a performance obligation to abide by the terms of a lease contract by giving the lessee ‘quiet enjoyment’ of the asset. Any ongoing services performed by the lessor are separate performance obligations, and the Boards have tentatively decided that payments for services are considered separately from payments for the ROU asset.

38. Deferring profit on the transaction when the residual asset value is not reliably measurable would address the concerns of some constituents about profit recognition at lease commencement, which was a concern expressed by some about the proposals in the ED under the derecognition approach.

39. Approach 3 may not work well for real estate leases because the residual value of a real estate asset at the end of the lease term can be higher than its carrying

amount at the beginning of the lease term. In addition, costs of applying Approach 3 might outweigh benefits for short-term leases. Nonetheless, supporters of Approach 3 would argue that:

(a) IAS 40, *Investment Property,* and the FASB's separate project on investment properties could be applied to real estate leases.

(b) The Boards' tentative decision on short-term leases works well for those leases (ie a lessor and lessee would apply the current operating lease model). For those leases, depreciation is a more cost-efficient measure of the consumption of the value of the underlying asset than derecognizing a portion of the underlying asset when the lease is for a very short term (for instance, six months).

Disadvantages of Approach 3

40. Approach 3 is potentially more complex than Approaches 1 and 2 because it requires the lessor to estimate the fair value of the underlying asset at lease inception and the residual value at the end of the lease term. Further, the residual asset would have to be continually monitored for possible impairment and potentially require more frequent reassessment. Approach 3 also raises questions about how the lessor would subsequently measure and present the residual asset, which is discussed in more detail in Appendix D of this memo and in the staff memo on lessor accounting for finance leases. (Nonetheless, it is worth noting that under Approaches 1 and 2, a lessor must also estimate and monitor the residual value of the underlying asset. This is because the lessor must take account of the residual value of the underlying asset when calculating depreciation on that asset, assessing impairment and for disclosure purposes. We understand that, depending on facts and circumstances, some operating (OTF) lessors currently depreciate a leased asset to its estimated residual value at the end of the lease term. Thus, those operating lessors already continuously monitor the residual values of assets in their operating lease portfolio.)

41. Approach 3 might also be difficult when accounting for a lease of a portion of a larger asset because it would require estimation of the current and residual

value of a portion of an asset when the market may only transact at the level of the larger asset.

42. Unlike in Approach 1 in which the lease liability represents the lessor's obligation to provide the economic benefit of the underlying asset to the lessee during the lease term, it may be unclear what any deferred profit represents under Approach 3 and how it should be presented on the SFP.

43. Some staff members do not view the residual asset as a financial asset (an asset that is a terminal cash flow). They think that, in an OTF lease, a lessor's interest in the underlying asset is more like a tangible asset (property, plant, and equipment) and should be accounted for as such. Thus, those staff members think that the underlying asset should not be derecognized.

44. Some think that an underlying asset in an OTF lease cannot be componentized and that, consequently, it would be inappropriate to recognize a residual asset and profit relating to the ROU asset transferred to the lessee upon lease commencement.

45. Approach 3 relies on other accounting standards dealing with the lessor's accounting for real estate leases.

Staff recommendation

46. Some staff support Approach 2 (the current operating lease model). They are persuaded by feedback received from many respondents to the ED, who expressed the view that the current operating lease model for lessors is not 'broken'. They also note that Approach 2 provides users with very similar information to Approach 1 but is more straight-forward to apply.

47. Other staff are attracted to Approach 3 (the derecognition-based approach) for OTF leases. They think that it is preferable to have one basic lessor accounting model, even though the different types of leases might lead to different profit and loss recognition profiles. Those staff place greater weight on the factors noted in paragraphs 36-39 of this memo.

48. The staff do not recommend Approach 1 (the net performance obligation approach). This is because we do not think that the benefits of Approach 1 outweigh the costs of applying Approach 1 when compared to Approach 2.

Question 1
Which of the three lessor accounting approaches do the Boards prefer for an OTF lease?

Topic II – Subsequent Accounting

Lease receivable (Approaches 1 and 3)

49. When the lessor recognizes a lease receivable arising from an OTF lease under Approach 3, the staff recommends that the lessor should subsequently measure that lease receivable consistently with how a lease receivable arising from a finance lease is measured (discussed in the staff memo on lessor accounting for finance leases). Therefore, if the boards decide that a lessor should subsequently measure all lease receivables arising from finance leases at amortized cost (accreted using the rate the lessor charges the lessee), a lessor should also use that measurement basis for OTF leases. Alternatively, if the boards decide that a lessor should subsequently measure some lease receivables arising from finance leases at fair value, then a lessor should also subsequently measure similar lease receivables at fair value if they arise from OTF leases. The staff also recommends that the lessor should subsequently measure the initially unrecorded lease receivable under Approach 1 consistently with how a lessor measures the lease receivable arising from a finance lease.

50. Credit losses on lease receivables would be subject to existing guidance on impairment of financial assets. Impairment considerations are discussed further in Appendix C.

Underlying asset (Approaches 1 and 2)

51. When the lessor does not derecognize the underlying asset (Approaches 1 and 2), the staff recommends that the lessor subsequently measure the underlying

asset at historical cost, net of accumulated depreciation and any impairment/revaluation adjustments. That is consistent with how other tangible and intangible assets are subsequently measured.

Residual asset (Approach 3 only)

52. If the Boards support Approach 3 (the derecognition-based approach), some staff members recommend that the lessor should subsequently measure the residual asset in an OTF lease in a manner similar to its subsequent measurement in a finance lease. That is, the lessor would accrete the residual asset over the lease term, using the rate the lessor charges the lessee. Support for this recommendation is included in the staff memo on lessor accounting for finance leases. However, other staff members think that for OTF leases, it is more appropriate to 'freeze' the initial carrying amount of the residual asset (as was proposed for the derecognition approach in the ED). That is because they think that the residual asset risk is sufficiently high for OTF leases so as to preclude accretion of the residual asset.

53. Appendix D to this memo discusses subsequent measurement and profit recognition under Approach 3 in more detail.

Lease liability (Approach 1 only)

54. In the ED, under the performance obligation approach, the lessor would subsequently measure its lease liability based on the pattern of use of the underlying asset by the lessee. That would often mean that the lessor would recognize a straight-line pattern of income relating to the reduction in value of the lease liability and, at the same time, recognize higher interest income in early years on the lease receivables (together with straight-line depreciation on the underlying asset). Comment letters and other feedback suggested that, for an OTF lease, an income pattern that reflects higher income in earlier periods is not helpful to users of lessor financial statements.

55. If the Boards support Approach 1 (the net performance obligation approach), the staff thinks that it would be more appropriate for the lessor to subsequently measure its initially unrecorded lease liability in a manner that reflects that it

has made the underlying asset available for use by the lessee. In our view, the lessor is meeting its obligation toward the lessee as long as the asset is made available for use by the lessee. Thus, the subsequent measurement of the lease liability should not be linked to the actual amount of benefit that the lessee receives from the use of the underlying asset.

56. Nonetheless, consistent with how the lessee subsequently measures its ROU asset for OTF leases, the staff recommends that a lessor subsequently measures its initially unrecorded lease liability by amortizing the liability so that the lessor recognizes total lease income on a straight-line basis (see Appendix A for an illustration of the subsequent measurement of a lessor's lease liability under Approach 1).

57. The staff notes that this would lead to the recognition of lease income on a straight-line basis that is consistent with Approach 2 (current operating lease accounting).

Profit and loss recognition under each of the approaches

58. The staff recommendations on the subsequent measurement of the lease receivable, the underlying asset, and the lease liability mean that, under Approaches 1 and 2, the lessor would recognize lease income on a straight-line basis.

59. It is worth noting that, in the example in Appendix A, it is assumed that the lessor depreciates the underlying asset over its estimated economic life of 10 years on a straight-line basis under Approaches 1 and 2. Depending on facts and circumstances, the lessor could depreciate the underlying asset over the lease term of 5 years to its estimated residual value of CU25,000,000. If that were the case, the profit recognized by the lessor over the lease term would be CU10,000,000 higher than shown in Appendix A (ie, the lessor would recognize lease profit of CU33,000,000 over the 5-year lease term under Approaches 1 and 2).

60. The statement of financial position and the profit/loss statement under Approach 1 throughout the lease term would be as follows:

Statement of Financial Position:

Year	Lease Receivable	Lease Contract Liability	Net Lease Asset	Underlying Asset
0	31,590,237	31,590,237	-	30,000,000
1	26,583,909	25,983,909	600,000	27,000,000
2	21,261,629	20,061,629	1,200,000	24,000,000
3	14,603,459	13,803,459	800,000	21,000,000
4	7,525,089	7,125,089	400,000	18,000,000
5	-	-	-	15,000,000

Profit & Loss Statement

Year	Amortization Revenue	Interest Income	Lease Revenue	Depreciation Expense	Net Income
1	5,606,328	1,993,672	7,600,000	(3,000,000)	4,600,000
2	5,922,279	1,677,721	7,600,000	(3,000,000)	4,600,000
3	6,258,170	1,341,830	7,600,000	(3,000,000)	4,600,000
4	6,678,370	921,630	7,600,000	(3,000,000)	4,600,000
5	7,125,089	474,911	7,600,000	(3,000,000)	4,600,000

61. The statement of financial position and the profit/loss statement under Approach 2 throughout the lease term would be as follows:

Statement of Financial Position:

Year	Deferred Lease Asset	Underlying Asset
0	-	30,000,000
1	600,000	27,000,000
2	1,200,000	24,000,000
3	800,000	21,000,000
4	400,000	18,000,000
5	-	15,000,000

Profit & Loss Statement

Year	Operating Lease Revenue	Depreciation Expense	Net Income
1	7,600,000	(3,000,000)	4,600,000
2	7,600,000	(3,000,000)	4,600,000
3	7,600,000	(3,000,000)	4,600,000
4	7,600,000	(3,000,000)	4,600,000
5	7,600,000	(3,000,000)	4,600,000
TOTAL	**38,000,000**	**(15,000,000)**	**23,000,000**

62. Under Approach 3, any deferred profit relating to the ROU asset would be recognized over the lease term in a manner that ensures that the lessor recognizes lease income on a straight-line basis over the lease term. The statement of financial position and the profit/loss statement under Approach 3 throughout the lease term would be as follows (assuming that all of the profit relating to the ROU asset is deferred at lease commencement):

Statement of Financial Position:

Year	Lease Receivable	Residual Asset	Deferred Gain
	31,590,237	11,045,858	12,636,095
1	26,583,909	11,742,966	10,726,875
2	21,261,629	12,484,070	8,545,699
3	14,603,459	13,271,944	6,075,403
4	7,525,089	14,109,541	3,234,630
5	-	15,000,000	-

Profit & Loss Statement

Year	Interest Income	Residual Accretion	Amortization of Deferred Gain	Net Income
1	1,993,672	697,108	1,909,220	4,600,000
2	1,677,721	741,103	2,181,176	4,600,000
3	1,341,830	787,874	2,470,296	4,600,000
4	921,630	837,597	2,840,773	4,600,000
5	474,911	890,459	3,234,630	4,600,000
TOTAL	**6,409,763**	**3,954,142**	**12,636,095**	**23,000,000**

Question 2—subsequent measurement
Do the Boards agree with the following staff recommendations: (a) The lessor would subsequently measure the lease receivable arising from an OTF lease in a manner similar to the subsequent measurement of the lease receivable arising from a finance lease (Approach 1 or Approach 3)? (b) The lessor would subsequently measure the underlying asset at its historical cost, net of accumulated depreciation and any impairment/revaluation adjustments (Approach 1 or Approach 2)? (c) If the Boards support Approach 1, the lessor would amortize the initially unrecorded lease liability in a manner that results in straight-line lease income? (d) If the Boards support Approach 3: (1) The lessor would subsequently measure the residual asset by accreting the residual using the rate that the lessor charges the lessee? (2) If the lessor defers any profit on the ROU asset, the lessor would recognize that profit in a manner that ensures that the lessor recognizes lease income on a straight-line basis over the lease term?

Topic III – Sale or Assignment of Lease Receivables

63. At the April 2011 education session, some Board members asked the staff to consider the effect of the sale or assignment of lease receivables when discussing which approach the lessor should apply to OTF leases. The staff has considered that effect under each of the approaches discussed in this memo.

64. Under current accounting in both U.S. GAAP and IFRSs, the sale of a lease receivable can be treated as a sales transaction if the receivable is recognized by the lessor. Because a lessor does not recognize a lease receivable for current operating leases, the lessor does not account for the sale or assignment of the lease receivable as a sale. The transaction is instead accounted for as a secured borrowing, and the borrowing is secured by the assignment of future lease rentals.

65. That has the following implications for each of the three approaches discussed in this memo:

    (a) Under Approaches 1 and 3, the lessor recognizes a lease receivable (although the lessor does not initially record the lease receivable under Approach 1). Therefore, if the lessor sells or transfers the lease receivable and the transfer meets the criteria for sale accounting under the applicable guidance in U.S. GAAP and IFRSs, the lessor would recognize a gain/loss at the time of the transaction. The lessor would derecognize the initially unrecorded lease receivable under Approach 1 and the lease receivable under Approach 3, therefore recognizing no further interest income in future periods. Under Approach 1, the lessor would amortize the initially unrecorded lease liability as originally scheduled. See Appendix B for an illustration.

    (b) Under Approach 2, a transaction in which the lessor pledges future lease rental payments in exchange for consideration would not be considered a "sale" for accounting purposes. The lessor would recognize the transaction as a secured borrowing. The lessor would continue to recognize lease revenue, which would be offset by interest expense on the secured borrowing. See Appendix B for an illustration.

66. The staff thinks that it is appropriate to account for the transaction under Approach 2 as a secured borrowing. The lessor does not recognize a lease receivable and, therefore, the receivable cannot be "sold". That is consistent with current operating lease accounting, as noted above.

67. However, the staff also considered whether the Boards should preclude sale accounting under Approach 1 or Approach 3. Many leases that are operating leases under current guidance are likely to be classified as OTF leases in prospective guidance. This means that transactions that are currently accounted for as secured borrowing could be considered to be sales transactions if the Boards support either Approach 1 or Approach 3, unless the Boards specifically preclude sale accounting for lease receivables in OTF leases.

68. The staff can see no justification for precluding sale treatment. The premise underlying Approaches 1 and 3 is that the lease receivable under an OTF lease is the same as the lease receivable under a finance lease. If a lease receivable under a finance lease can be sold, then a lessor should also be able to sell the lease receivable under an OTF lease.

69. The staff recognizes that this also has an impact on transition. If the Boards decide to apply the provisions of the proposed leases standard on a retrospective basis, then borrowings currently secured by future rentals from operating leases could retrospectively qualify for sale treatment. If that is the case, the lessor would be required to recognize a gain/loss and unwind the impact of having accounted for the transaction as a secured borrowing. That could make transition unduly complex. If the Boards were to require retrospective application of the final lease standard, the staff would recommend that secured borrowing transactions be grandfathered. The staff will address this matter, if necessary, as part of the transition considerations for this project.

Question 3

Do the Boards agree that:

(a) lease receivables, if recognized, should be eligible for sale treatment under applicable guidance (Approaches 1 and 3)?

(b) an assignment or sale of lease rentals should be accounted for as a secured borrowing if the lessor does not recognize a lease receivable (Approach 2)?

Appendix C: Impairment Considerations

C1. If a lessee's creditworthiness deteriorates, the lessor may need to impair its lease assets. Under Approach 1, it is unclear whether the lessor would impair the underlying asset, the lease receivable or both because the lease receivable cash flows also support the carrying value of the underlying asset. If a credit impairment is recorded against the lease receivable, it may be appropriate to make a corresponding reduction to the lease liability. This is because the lessor is unlikely to be obliged to continue to provide its asset to the lessee if the lessee defaults on its lease payments. Nonetheless, in some jurisdictions, we understand that the lessor may still have a legal obligation to continue to provide the leased asset to the lessee even when the lessee defaults on its lease payments.

C2. Under Approach 1, it is unclear if the lessor would also impair the underlying leased asset by the amount of the credit impairment. The amount of impairment calculated under current guidance could result in a situation in which the receivable is impaired but the underlying asset is not. For example, under U.S. GAAP, an entity may determine that the underlying asset is not impaired because the undiscounted cash flow expected from that asset exceeded its carrying value.

C3. Under Approach 2, a credit impairment would be factored into the impairment assessment required of the underlying asset when applying the current property, plant, and equipment impairment guidance in U.S. GAAP and IFRSs. Existing guidance would be sufficient to provide the recognition and measurement accounting for the impairment of lease assets. Under Approach 3, impairment guidance for OTF leases would be the same as for finance leases. If the Boards decide on Approach 2 or Approach 3, the staff thinks that no further discussion of impairment for OTF leases would be necessary.

C4. However, some staff members think that further application guidance is needed if the Boards support Approach 1. This is because when applying the impairment guidance and, in particular, the guidance relating to cash generating units, it is unclear whether and how the underlying asset, the lease receivable and the lease liability would be grouped.

Appendix D – Recognition of Profit under Approach 3

D1. As noted in paragraphs 28-35 of this memo, under Approach 3 (the derecognition-based approach), a lessor would derecognize the underlying asset that is the subject of an OTF lease and recognize a lease receivable and a residual asset. The staff recommends that, for OTF leases, the lessor would initially measure the residual asset as an allocation of the previous carrying amount of the underlying asset, as proposed under the derecognition approach in the ED, as follows:

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

D2. This method of measuring the residual asset would mean that the lessor would not recognize any profit on the residual asset at lease commencement or during the lease term, which is different from the staff recommendation regarding the lessor's accounting for finance leases. It is also different from how some operating lessors recognize profit under current guidance—depending on facts and circumstances, some operating lessors recognize profit on the residual asset over the lease term by depreciating the underlying asset to its estimated residual value at the end of the lease term.

D3. Even if the Boards were to decide that a lessor should accrete the residual asset using the rate the lessor charges the lessee, the lessor would recognize interest income on the residual asset only to reflect the time value of money, but would not recognize any profit element on the residual asset. This is illustrated in Appendix A of this memo—the residual asset is accreted under Approach 3 to CU15,000,000 by the end of the lease term, which is an allocation of the previous carrying amount of the underlying asset of CU30,000,000. The measurement of the residual asset during the lease term does not include any profit element relating to the residual asset.

D4. The staff thinks that this difference between the lessor's accounting for finance and OTF leases is justified because, for an OTF lease, the staff does not think it

would be appropriate for the lessor to recognize any profit on the residual asset at lease commencement. If the lessor should recognize any profit for OTF leases at lease commencement, that profit should relate only to the ROU asset transferred to the lessee and not to the residual asset that has not been sold or transferred. For OTF leases, it is more appropriate that any profit on the residual asset is recognized by the lessor when it sells or releases the underlying asset at the end of the lease term.

D5. However, if the Boards were to support a derecognition-based approach for all leases (including OTF leases), the staff thinks that the final leases standard would need to include some parameters or a threshold on when a lessor would be permitted to recognize revenue and profit on the ROU asset at lease commencement for OTF leases.

D6. This is because concerns have been raised about the recognition of profit on the ROU asset at lease commencement when the profit recognized is dependent on an estimation of the residual asset value at the end of the lease term. There is likely to be relatively little uncertainty about the revenue figure, which is derived from the lease receivable (particularly because the Boards' tentative decisions on lease term and variable lease payments reduce the amount of uncertainty about the lease receivable). However, there could be substantial uncertainty on whether the portion of the carrying amount of the underlying asset derecognized and recognized as cost of sales is the "correct" amount. If the value of the residual asset at the end of the lease term were to fall below the amount allocated to the residual asset at lease commencement, the result might be that the lessor would recognize profit on the transfer of the ROU asset that, in effect, might have to be reversed in later periods. The bigger and more volatile the residual value, the greater the sensitivity of the profit recognized to possible future movements in that residual value.

D7. The Boards may decide that it would be appropriate for a lessor to recognize revenue and profit at lease commencement only when the lessor is reasonably or virtually certain that the residual value of the underlying asset at the end of the lease term would not fall below the amount allocated to the residual asset at lease commencement. Revenue recognition guidance could be used to help set that threshold—for instance, a lessor might only be permitted to recognize

profit on the ROU asset transferred at lease commencement if there is adequate data available about residual asset values, which might depend on, for example, the liquidity and volatility of second-hand asset markets or the length of the lease term.

D8. Therefore, using the example set out in Appendix A to this memo, if the lessor were reasonably certain that the residual value of the underlying asset at the end of the lease term would not fall below CU11,045,858, the lessor would recognize a gain on the ROU asset at lease commencement of CU12,636,095. Otherwise, the lessor would defer the profit of CU12,636,095 and recognize it over the lease term.

D9. If the lessor is not reasonably certain that the residual value of the underlying asset at the end of the lease term would be more than its initial carrying amount at lease commencement, the lessor could defer profit on the ROU asset in two ways:

(a) As shown in Appendix A, the lessor could derecognize the underlying asset, recognize a lease receivable and residual asset, and defer any profit relating to the ROU asset by recognizing a liability at lease commencement. That profit would then be recognised in profit or loss over the lease term.

(b) Alternatively, the lessor could apply current operating lease accounting. In that case, the lessor would not derecognize the underlying asset.