STAFF PAPER

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FASB | IASB Meeting

Project	**Leases**
Paper topic	Transition - secured borrowings

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Purpose

1. The purpose of this paper is to provide information regarding transition accounting for secured borrowings. At the joint meeting of the Boards on October 19, 2011, the Boards requested the staff prepare additional analysis regarding this topic beyond the information included in Agenda Paper 2J/Board Memo 214, paragraphs 27 through 29.

Background

2. Under existing IFRSs and U.S. GAAP, the transfer of lease receivables may be recognized as sales transactions if the receivables had been recognized by the lessor and if the sale recognition criteria are met. Because a lessor does not recognize lease receivables associated with operating leases under current leases guidance, the operating lessor cannot account for the subsequent transfer of such operating lease receivables as sales. Instead, those transactions are accounted for as secured borrowings. The borrowings are secured by the assignment of future lease payments. The operating lessor recognizes the cash proceeds from the lender and a corresponding financial liability to the lender. As lessees make lease

payments, the operating lessor remits the payments to the lender (unless the lessees make payments directly to lender), reduces the balance of the financial liability to the lender, and recognizes lease income.

3. Based on the Boards' tentative decisions to date regarding transition accounting, a lessor would recognize a lease receivable for the remaining lease payments associated with leases (that were classified as operating leases) at the earliest comparative period presented. If these lease receivables were previously transferred to a lender and accounted for as a secured borrowing (as described in paragraph 2 of this memo), a lessor will need to consider the impact of such transaction on recognizing lease receivables at transition.

Staff analysis and recommendations

4. Under existing IFRSs and U.S. GAAP, the transaction would continue to be accounted for as a secured borrowing. Because lease receivables were not recognized at the time of the transfer, analyzing whether sale criteria were met was not necessary under operating lease accounting. . Therefore, the lease receivable would be recognized at transition under the new leases standard and would be presented as lease receivables pledged to lenders (or similarly named account), which is the presentation for receivables recognized on the statement of financial position for secured borrowings.

5. The staff prepared the following example to assist the Boards in assessing the accounting under existing IFRSs and U.S. GAAP.

Example of accounting for secured borrowings at transition

- Prior to the effective date of the new leases standard, a lessor transferred CU 500 of lease receivables associated with operating leases to a lender.
- At the time of the transfer, the lessor did not recognize the lease receivables on its statement of financial position under existing IFRSs and U.S. GAAP

guidance for operating leases. Consequently, the lessor did not assess whether the transfer would have qualified for sale treatment and thus accounted for the transaction as a secured borrowing under IFRSs and U.S. GAAP. The lessor continued to recognize the underlying asset on its statement of financial position.

- The lessor recognized cash proceeds from the lender of CU 500 (this example ignores financing fees and other reductions the lender may require) and a note payable to the lender of CU 500.
- At the earliest comparative period presented upon transition to the new leases standard, the lessor had collected CU 300 of lease payments from lessees, which were remitted to the lender. Therefore, the balance of the note payable to the lender was CU 200 at that time.
- At the earliest comparative period presented, the lessor would recognize the remaining lease payments as receivables on the statement of financial position in accordance with the transition guidance for the new leases standard for operating leases. The present value of the remaining lease payments of CU 200 is CU 167. The lease receivables of CU 167 would be presented as lease receivables pledged to the lender because the receivables were associated with the secured borrowing. A residual asset would also be recognized and the underlying asset would be derecognized; any net difference in the changes in recognized lease assets and liabilities would be recognized in opening retained earnings.
- Over the remaining lease term, the lessor would adjust (i) the lease receivables pledged to the lender for interest income as earned and payments as collected and (ii) the note payable to the lender for payments remitted to the lender. At the end of the lease term, the balance in the two accounts would be CU 0.
- The following table is a summary of the note payable and lease receivables balances at the earliest comparative period and each year thereafter until the end of the lease term.

			Lease receivables recognized			
Date	Event	Note payable to lender	Beginning of period	Interest income	Payments	End of period
January 20X1	Date of earliest comparative period - lease receivables recognized, note payable not adjusted as a result of transition	200	167			
Year ending 20X1	Each remaining year of lease term - lessor collects CU 50 of annual lease payments and recognizes interest income on the receivables	150	167	13	(50)	130
Year ending 20X2		100	130	10	(50)	90
Year ending 20X3		50	90	7	(50)	47
Year ending 20X4		-	47	3	(50)	-

6. Under existing IFRSs and U.S. GAAP (as described in paragraphs 4 and 5), the staff think no additional transition guidance is necessary for secured borrowings because existing guidance for secured borrowings and the transition approach for operating leases in the new leases standard is sufficient.

7. The staff considered whether existing IFRSs and U.S. GAAP for transfers should be amended such that a lessor would be *required* to evaluate, as of the date of transfer, whether the sale criteria were met (considering that a receivable would be recognized on transition of the new leases standard), and if the criteria were met, the lessor would derecognize the lease receivables at transition. Any resulting gain or loss from derecognition would be recognized in opening retained earnings if the transaction occurred before the earliest comparative period. The staff recommend that a reconsideration of whether the sale criteria were met not be required because it may increase transition complexity and costs. Under existing IFRSs and U.S. GAAP, the evaluation would occur at the date of the transfer. It may be complex and costly for a lessor to complete this evaluation several years after the transfer occured. For example, a lessor may be required to obtain a legal opinion regarding the transaction at the transfer date. The Boards could consider permitting evaluation of the transaction at the earliest comparative period or at the effective date to address this issue, but that would represent a potentially significant departure from exiting IFRSs and U.S. GAAP on derecognition of financial assets.

8. The staff also considered whether existing IFRSs and U.S. GAAP for transfers should be amended such that a lessor would be *permitted* to evaluate, as of the date of transfer, whether the sale criteria were met (considering that a receivable

would be recognized on transition of the new leases standard), and if the criteria were met, the lessor would derecognize the lease receivables at transition. Any resulting gain or loss from derecognition would be recognized in opening retained earnings if the transaction occurred before the earliest comparative period. The staff recommend that a reconsideration of whether the sale criteria were met be permitted because some transfers of lease receivables would have qualified for sale recognition at the time of the transaction if lease receivables had been recognized on the statement of financial position for the following reasons:

(a) The staff think some lessors would elect to apply the transfer accounting retrospectively to increase comparability between the periods before and after the effective date.

(b) Some staff think it would be punitive to preclude a lessor from recognizing the transfer (when the only reason the sale was not recognized at the time of the transfer was there were no financial assets to derecongize) because financial assets (lease receivables) would be recognized on transition to the new leases standard.

(c) Other staff note that this recommendation is consistent with the Boards' previous tentative decision to permit lessors to take a fully retrospective approach to transition to the new leases standard.

(d) The staff note that the sale recognition criteria under IFRSs and U.S. GAAP are different, and therefore, similar transactions may be accounted for differently at transition depending on an entity's reporting framework. Because this difference between IFRSs and U.S. GAAP would continue after the effective date of the new leases standard, the staff do not believe this would be a reason to preclude retrospective application.

Question 1 – Transition for secured borrowings

Do the Boards agree with the staff recommendations that:

a. No additional transition guidance is necessary for secured borrowings under existing IFRSs and U.S. GAAP, and

b. A reconsideration of whether or not the sale recognition criteria were met at the date of transfer should be permitted, but not required?