# STAFF PAPER

FASB | IASB Meeting

**Week commencing 17 October 2011**

FASB Education Session week commencing 10 October 2011

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| **Project** | **Leases** |
| Paper topic | Fair value requirement for lease receivables and transfers of lease receivables |



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## Purpose

1. This paper:
    a. addresses the boards' request that the staff analyse further whether a lessor should be required to measure the right to receive lease payments at fair value through profit or loss, if that right was held for the purpose of sale; and
    b. discusses the application of existing derecognition requirements to the right to receive lease payments (herein, referred to as the 'lease receivable').
2. This paper contains three sections, each with a question for the boards:
    a. Section A asks whether there should be a fair value requirement for lease receivables that are held for the purpose of sale.
    b. Section B asks, if there is not a fair value requirement, how existing derecognition literature should address the gains or losses that can arise from transferring a lease receivable.
    c. Section C asks what disclosure requirements should apply to transferred lease receivables.

3. If the boards do not agree with the staff recommendation in Section A the boards should ignore Section B and only consider Section C of this paper. If the boards agree with Section A, then the entire paper is relevant.
4. This paper focuses on scenarios where the transfer of the lease receivable gives rise to derecognition. The provisions in IFRS 9 *Financial Instruments* and Topic 860 *Transfers and Servicing* should apply to all the other scenarios where there is no derecognition because the transfer fails to meet the derecognition criteria. Hence, such a discussion is not part of this paper.

## Summary of staff recommendations

5. The staff recommend that a lessor:
    a. should not measure a lease receivable at fair value, even if part or all of that receivable is held for the purpose of sale;
    b. should apply existing derecognition requirements (in IFRS 9 or Topic 860) to lease receivables, but that the allocation of the carrying amount should be done on the basis of the fair value of the lease receivable excluding option elements and variable lease payments that are not transferred; and
    c. should apply the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* and Topic 860 for transferred lease receivables.

## Background

6. When redeliberating the proposals in the *Leases* exposure draft ('the ED') during joint board meetings in 2011, the boards confirmed that a lessor should initially measure the lease receivable at the present value of future lease payments. The boards also tentatively decided to limit the inclusion of variable lease payments, or lease payments associated with extension or purchase options, in the lease receivable. The boards tentatively decided that only lease payments associated with options for which the lessee has a significant economic incentive to exercise should be included in the lease receivable.

7. The boards also tentatively decided that, if a lessee has a significant economic incentive to exercise extension or purchase options, the lease payments associated with those extension or purchase options would not be measured at fair value. Instead, they would be measured as the present value of those future lease payments. This means that once it is determined that there is a significant economic incentive to exercise an option, the lease payments associated with that option would be measured ignoring any possibility of non-exercise of the option.
8. At the September 2011 joint board meeting, the boards tentatively decided that a lessor:
    a. should subsequently measure the lease receivable at amortised cost using the effective interest rate method;
    b. should assess the lease receivable for impairment using the existing financial instrument impairment guidance in IAS 39 *Financial Instruments – Recognition and Measurement* and Topic 825 *Financial Instruments*; and
    c. should not have an option to measure the right to receive lease payments at fair value.
9. At the same meeting, the boards requested that the staff analyse further whether a lessor should measure the right to receive lease payments at fair value if that right were held for the purpose of sale. At that meeting, the staff did not recommend such a fair value requirement.
10. There is currently no such requirement for fair value measurement in either IFRSs or US GAAP specifically designed for lease receivables held for the purpose of sale.

## Feedback summary

11. The ED did not ask a specific question about fair value measurement of the lease receivable. Consequently, no comments were received on this topic.

12. The staff has performed some outreach since the September 2011 board meeting to gain a better understanding of existing lease receivable transfers. A summary of our findings is as follows:
    a. Both manufacturer/dealer and financial institution lessors securitise their lease receivables, depending on the funding strategy of the lessor.
    b. The securitisations of lease receivables usually involve the securitisation of only the *fixed non-cancellable* portions of lease receivables; securitisation of variable lease payments and options is much less common.
    c. The majority of feedback received indicated that, if they are securitised, most lease receivables are securitised between a few months to one year of their origination, but can be securitised at any point along the lease receivable's life. The staff also understands that in some cases, securitisation structures can be designed so that securitisation occurs later in the lease receivable's life.
13. Although the above points were common themes expressed by constituents in the limited outreach performed, the staff understand that the timing and reasons for securitisation can vary depending on the nature of the underlying asset, lessor's business model, and the securitisation structure itself.

## Section A—Inclusion of a fair value requirement for lease receivables held for the purpose of sale

14. During the September board meeting, some board members expressed concern about gains or losses on sale that would occur if a lease receivable was measured at amortised cost and then transferred. Fair value measurement for these lease receivables would clearly eliminate these gains or losses on sale (assuming transfer occurs at fair value) because the asset being transferred would be recognised at fair value. When the lease receivable is measured at amortised cost, these gains or losses would arise either because of external factors (for example, changes in interest rates or credit deterioration) or because of inclusion or exclusion of items

from the lease receivable at measurement bases that are not fair value (for example, options and variable lease payments).

15. Measuring lease receivables at fair value when held for the purpose of sale would be consistent with the principles of both IFRS 9 and the FASB's 'Accounting for Financial Instruments' ('AFI') project. Both boards decided within those projects that fair value provides more relevant information for financial instruments held in such business models.
16. However, a fair value requirement for leases held for the purpose of sale has many disadvantages:
    a. There would be two measurement bases for lease receivables in the leases standard.
    b. The boards would also need to choose between measuring at fair value just the portion of the receivable being transferred, or all cash flows included in the lease receivable, including those from variable lease payments and options that meet the recognition criteria under the leases standard. This issue becomes relevant, for example, when a lease contract contains an extension option and the potential lease payments from that extension period are not expected to be transferred. Both alternatives have significant disadvantages; fair valuing just part of the cash flows would require splitting a lease receivable into two parts, while fair valuing all of the cash flows would involve fair valuing cash flows (such as options or variable lease payments) that the lessor would never expect to sell and would be inconsistent with the boards' previous tentative decisions regarding measurement of options and variable lease payments.
    c. If the fair value requirement was a 'held for sale' requirement, it would not be perfectly consistent with IFRS 9 or the AFI project; both sets of guidance contain a wider 'business model' or 'business strategy' fair value requirement. Moreover, the 'business model' requirement in IFRS 9 and the 'business strategy' requirement in the AFI project are not identical. The boards would have to choose between the converged guidance in the

leases standard and guidance that is consistent with the financial instruments guidance.

d. It will also introduce opportunities for structuring if different portions of the lease receivable are measured using different bases. For example if the portion that is considered certain is measured at fair value, and the uncertain portion (option) at amortised cost, then entities may structure the contracts to achieve a desired accounting result and might place more emphasis on the optional component of the lease receivable.

e. Fair value measurement would be inconsistent with the boards' decision against following a financial instrument approach for the lease receivable. The boards have tentatively decided to measure all lease receivables at amortised cost.

17. For all the reasons outlined in paragraph 16, the staff does not recommend requiring lease receivables held for the purpose of sale to be measured at fair value through profit or loss.

| **Question 1** |
|---|
| Do the boards agree that a lessor should not measure lease receivables at fair value, even those that are held for the purpose of sale? |

## Section B—Applicability of the derecognition guidance in IFRS 9 and Topic 860 to transfer of lease receivables

18. If the boards decide that there should not be a fair value requirement for lease receivables that are held for the purpose of sale, the staff think that they should consider the applicability of the derecognition guidance in IFRS 9 and Topic 860 to lease receivables. As discussed previously, at the September 2011 joint board meeting some board members raised concerns about the applicability of this guidance, especially as it relates to the recognition of gains or losses upon transfer.

19. A loan or receivable is measured at fair value upon initial recognition under IFRS 9 and at transaction price under US GAAP. However, for the leases project, the boards have tentatively decided to require that the lease receivable be initially measured at the present value of the future lease payments, including the lease payments associated with potential extension or purchase options if a lessee has a significant economic incentive to exercise those options (ie those options are deeply in the money at the origination date). This approach creates the issue of measuring some elements of a lease receivable on a basis that is different from fair value even on initial recognition. The carrying amount of lease receivables that do not contain options or variable lease payments should be close to fair value on initial recognition. However, the portion of a lease receivable relating to options may differ from fair value even on initial recognition.
20. Following the derecognition guidance in IFRS 9 and Topic 860 can distort gains and losses on the sale of lease receivables. This would happen if a lease receivable contains an option and just part of that receivable (not including the option) is sold. If the guidance in IFRS 9 and Topic 860 is applied, the previous carrying amount of the larger financial asset is allocated between the part that continues to be recognised and the part that is sold *based on the relative fair values of those parts at the date of the transfer*. This guidance is reproduced in Appendix A.
21. The issue is best illustrated with an example:

Assume that an entity holds a lease receivable with the following terms and conditions[1]:

| **Lease Receivable** | | |
|---|---|---|
| Term | 14 | years |
| Extension Option | 1 | year |
| Rent | 100 | CU per year |
| Option for which lessee has a significant economic incentive to exercise | 100 | CU |
| Lease Receivable $T_0$ | **1,500** | **CU** |

Assume that one year after origination, the lease receivable is sold for CU 1100 under the following terms and conditions:

| | | |
|---|---|---|
| Sale of 12 years of cash flows | CU | |
| (retain 1 year + extension option) | | |
| Value of Transfer (A) | 1,100 | Due to an increase in interest rates |
| Carrying amount of Asset (B) | 1,400 | |
| FV of Asset including option (C) | 1,250 | |
| FV of Asset excluding option (F) | 1,200 | |

If the guidance in IFRS 9 and Topic 860 is followed, the lessor would make the following allocation to determine the amount of the receivable to derecognise and the amount of loss to recognise:

| **Description** | | |
|---|---|---|
| **% of the Asset (D) = (A)/(C)** | 88.0% | |
| | | |
| **Amount derecognised (E) = (D)*(B)** | 1,232 | **CU** |
| | | |
| **Loss Recognised = (A – E)** | **-132** | **CU** |

[1] This example assumes a flat term structure of interest rates and no discounting. It also assumes that the extension option is deeply in the money and therefore will be considered as part of the initial measurement of the lease receivable.

22. If the guidance in IFRS 9 and Topic 860 is applied in the manner illustrated above there are two effects that will distort the calculation of the gain or loss of the transfer:
    a. the percentage of the item to be derecognised will take into account cash flows that are not subject to sale; and
    b. the portion derecognised will be based on comparing the fair value of the portion sold with the fair value of the entire receivable. However, the carrying amount of the receivable is comprised of two components, including the option component that is measured on a non-fair value basis, ignoring the probability of exercise of options.
23. This means that if only the cash flows for the certain portions of the lease are derecognised, the gain or loss recognised is distorted by the carrying amount of the extension options. This concern was raised by some board members at the last meeting.

*Is there a genuine gain or loss upon transfer of lease receivables that needs to be recognised?*

24. The staff note that the discussion as to whether a gain or loss upon a transfer exists is not really the point to be addressed. A gain or loss will always exist provided there is a difference between the consideration received for the transfer and the carrying amount of the asset subject to the transfer. This occurs routinely on the derecognition of items measured at amortised cost. In our view the question to be addressed should not be *whether* gains or losses should be recognised but rather on what basis to determine the proportion of the carrying amount of the lease receivable to be derecognised when the lease receivable is not transferred in its entirety.
25. If the receivable is transferred in its entirety the gain or loss should be calculated based on the fair value of the entire instrument as it is realised upon sale and encompasses the fixed and the optional element of the lease. Therefore it is appropriate to recognise it in profit or loss. However, if the receivable being transferred only relates to the non-cancellable fixed part of the lease receivable, we

recommend that any option elements or variable lease payments not transferred should be *excluded* from the calculation of the gain or loss upon sale to avoid the distortion highlighted in the example above. This will ensure that:

a. the elements used to calculate the gain or loss upon sale are comparable; and
b. the realised gain/loss reflects the nature of the cash flows being transferred.

26. The outcomes of this recommendation are illustrated in Appendix B using the same illustrative example described after paragraph 20.
27. We are of the view that a gain or loss should always be recognised upon sale to reflect the difference between the consideration received and the carrying amount of the referable portion of the lease receivable derecognised. We also consider that the derecognition guidance in IFRS 9 and Topic 860 should clarify that, for the purpose of calculating the gain or loss upon sale of a lease receivable, an entity should consider whether the option elements or variable lease payments within the lease receivable are being transferred. If they are being transferred then the guidance in IFRS 9 and Topic 860 remains appropriate. If the option elements or variable lease payments are not being transferred the relative portion of the asset being transferred should be calculated by reference to the fair value of the lease receivable excluding the fair value of the option elements or variable lease payments not transferred.
28. The staff notes that two of the illustrations in Appendix B are based on fact patterns in which the entire lease receivable, including an extension option, is securitised and derecognised. Based on the information we have obtained to date, it is very unusual for the uncertain cash flows from extension options and variable lease payments to be sold as part of a securitisation. However, it is possible.

### *Staff recommendation*

29. As a result of the analysis in paragraphs 24 to 27, the staff recommend that:

    a. lease receivables are included in the scope of IFRS 9 and Topic 860 for derecognition purposes; and

b. the boards clarify that, when lease receivables subject to transfer contain option elements or variable lease payments that are not transferred, the allocation of the carrying amount for the purpose of derecognition is done on the basis of the fair value of the lease receivable excluding the option elements or variable lease payments not transferred. In all other scenarios the derecognition requirements in IFRS 9 and Topic 860 would apply.

| **Question 2** |
|---|
| Do the boards agree that the derecognition guidance in IFRS 9 and Topic 860 should apply to lease receivables, but allocation should be done only on the basis described in paragraph 29(b)? |

## Section C—Disclosure of gains or losses arising on transfer

30. The staff note that the disclosure of the gains or losses arising from the transfer of lease receivables is important for transparency. In our view the disclosures currently in IFRS 7 and Topic 860 covering derecognition provide a good understanding of the entities' transfer activities and therefore should be used to provide a more comprehensive view of the activities involving transfers of lease receivables. This will, in our view, imply that this transferred lease receivables will also be covered by IFRS 7 and Topic 860 derecognition disclosures.

| **Question 3** |
|---|
| Do the boards agree that the disclosures for transferred lease receivables should follow the disclosure requirements of IFRS 7 and Topic 860? |

## Appendix A – Guidance in IFRS 9 and Topic 860

A1. IFRS 9, paragraph 3.2.13, provides the following guidance for transferring part of a financial asset:

> If the transferred asset is part of a larger financial asset […] and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair value of those parts on the date of the transfer.

A2. Topic 860, paragraph 860-20-40-1A, provides the following guidance for transferring part of a financial asset :

> Upon completion of a transfer of a participating interest […] the transferor (seller) shall:
>
> a) Allocate the previous carrying amount of the entire financial asset between both of the following on the basis of their relative fair values at the date of the transfer:
>
> 1. The participating interests sold
> 2. The participating interest that continues to be held by the transferor.

## Appendix B – Application of staff recommendation to transfers of part, or all, of a lease receivable with optional elements

B1. Assume that the fact pattern in paragraph 21 still applies. Applying the staff recommendation, derecognition would be performed on the basis of the fair value of the lease receivable excluding the fair value of the option not transferred. This would be applied as follows:

| | | |
|---|---|---|
| | **CU** | |
| **Value of Transfer (A)** | **1,100** | |
| **Carrying amount of Asset for purposes of derecognition (G)** | **1,300** | **13 years of rent—excluding option** |
| **FV of Asset (F)** | **1,200** | **Excluding option** |
| **% of the Asset to derecognise H = (A)/(F)** | 92% | |
| | | |
| **Amount derecognised I = (H) * (G)** | **1,192** | |
| | | |
| **Loss Recognised J = (A) – (I)** | -92 | |

B2. Assume that the fact pattern in paragraph 21 still applies, except that the asset is transferred in its entirety. Applying the staff recommendation, derecognition would be performed considering the fair value of the entire lease receivable, including the fair value of the option transferred. This would be applied as follows:

| | | |
|---|---|---|
| | **CU** | |
| **Value of Transfer (A)** | **1,250** | |
| **Carrying amount of Asset (B)** | **1,400** | **14 years of rent—including option** |
| **FV of Asset (C)** | **1,250** | **Including option** |
| **% of the Asset to derecognise H = (C)/(A)** | 100% | |
| | | |
| **Amount derecognised I = (H) * (G)** | **1,250** | |
| | | |
| **Loss Recognised J = (A) – (I)** | -150 | |

B3. Assume that the fact pattern in paragraph 21 still applies, except that the lease receivable, including the extension option, is transferred in its entirety immediately (instead of one year into the lease contract). The staff recommendation would be applied as follows:

| **Lease Receivable** | | | |
|---|---|---|---|
| Lease Receivable $T_0$ | | **1,500** | **CU** |
| Fair value of the lease receivable at $T_0$ (also consideration received on transfer at $T_0$) | | **1,490** | **CU** |
| Gain or loss on transfer | - | **(10)** | |

B4. The staff notes that the loss incurred under this example represents the difference between the measurement bases between the leases standard and fair value. However because this example assumes an immediate or almost immediate transfer it reflects the uncertainty that exists in the exercise of the option at the time of the transfer (close to the inception of the lease). For an option for which the lessee has a significant economic incentive to exercise, the loss upon transfer is likely to be minor as the purchaser will have to compensate the seller for something whose occurrence is highly likely, potentially virtually certain. For both the examples in paragraphs B2 and B3, we are of the view that the loss recognised represents a crystallised loss (resulting from a market transaction) that should be recognised. This is because the transfers of lease receivables will occur under normal market practices and therefore the purchaser of the loans will only be willing to pay for an option element if there are reasonable expectations that it will be exercised. As a result there is no room for abuse.