Staff Paper

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***Education Session and Small Group Meetings week of October 10, 2011***

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Project **Leases**

Topic **Lessor accounting**

## Objective

1. At the July 2011 joint meeting the Boards discussed and reached tentative decisions regarding the lessor accounting model that would require lessors to apply a 'receivable and residual' approach to all leases, except short-term leases and leases of investment property measured at fair value. Since that meeting, the staff has requested input through outreach activities with several constituents regarding the receivable and residual approach. The objective of this paper is to report the feedback received in outreach performed by the staff on the lessor accounting model and to recommend modifications to the Boards' decisions based on that feedback.

## Background

2. In the July 2011 joint meeting, the Boards tentatively decided the following:

   The Boards tentatively decided that a lessor should apply a 'receivable and residual' accounting approach as follows:


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- The lessor would recognize a right to receive lease payments and a residual asset at the date of the commencement of the lease.

- The lessor would initially measure the right to receive lease payments at the sum of the present value of the lease payments, discounted using the rate the lessor charges the lessee.

- If profit on the right-of-use asset transferred to the lessee is reasonably assured, the lessor would initially measure the residual asset as an allocation of the carrying amount of the underlying asset and would subsequently measure the residual asset by accreting it over the lease term using the rate the lessor charges the lessee. Consequently, the lessor would recognize profit at the date of the commencement of the lease. The profit would be measured as the difference between (a) the carrying amount of the underlying asset and (b) the sum of the initial measurement of the right to receive lease payments and the residual asset. Profit is reasonably assured when all of the three following conditions are met; the lessor can reliably:
    - determine the payments that related to the lease component of the contract,
    - measure the fair value of the underlying asset at lease commencement, and
    - estimate the residual value of the underlying asset at the end of the lease term.

- If profit on the right-of-use asset transferred to the lessee is not reasonably assured because all three of the above criteria are not met, the lessor would initially measure the residual asset as the difference between the carrying amount of the underlying asset and the right to receive lease payments. The lessor would subsequently accrete the residual asset, using a constant rate of return, to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if the underlying asset had been subject to depreciation. Consequently the lessor would not recognize profit at lease commencement and instead would recognize profit over the lease term.

- If the right to receive lease payments is greater than the carrying amount of the underlying asset at the date of the commencement of the lease (even when profit is not reasonably assured), the lessor would recognize, as a minimum, the difference between those two amounts as profit at that date.

The Boards also tentatively decided that the following should be excluded from the scope of the "receivable and residual" approach to lessor accounting:

- Leases of investment property measured at fair value
- Short-term leases.

For those excluded leases, a lessor should (1) continue to recognize and depreciate the underlying asset and (2) recognize lease income over the lease term on a systematic basis.

## Summary of outreach

3. Since the July 2011 joint meeting, the staff reached out to various constituents (including the joint working group that includes lessors, users and auditors) to discuss the proposed 'receivable and residual' accounting approach.

4. Overall, there was support for the 'receivable and residual' approach, in particular the recognition of a lease receivable by the lessor. Many thought that the 'receivable and residual' approach was an improvement over the current lessor model that exists in current IFRS and U.S. GAAP. Those citing improvement generally discussed the recognition of the lease receivable by the lessor as consistent with the lessee's recognition of a lease liability. Additionally, respondents identified that the 'receivable and residual' accounting approach strengthened the conceptual basis for the lessee right-of-use accounting model.

5. Many expressed concern with the reasonably assured criteria drafted by the staff (refer to Appendix B). Those that expressed concern cited the difference in reasonably assured between leases and revenue recognition, the auditability of the criteria, and the perceived 'option' to elect reasonably assured or not reasonably assured and the ensuing structuring opportunities. Additionally, respondents noted that the reasonably assured criteria increase the complexity of the lessor accounting model. Despite the concerns expressed with the reasonably assured criteria, some respondents continue to believe that different profit recognition patterns are appropriate and think that the Boards should modify the criteria to either a business model view based on the nature of the business activities or express which types of contracts should defer profit through examples.

6. Additionally, nearly all feedback received expressed concern regarding the different total profit that would be recognized depending on whether profit is or is not reasonably assured, including:

   (a) a concern for the structuring opportunities that this difference in total profit could lead to because a company could use the subjectiveness

of the reasonably assured criteria to decide how much and when to recognize profit in lease transactions;

(b) the subjective nature of the required assessment of reasonably assured.

7. Many requested more clarity as to what transactions the boards anticipated being in the 'not reasonably assured' model, with many suggesting that if the essence of a lessor's leasing business is estimating and monitoring the residual value of leased assets, then the profit on such leasing transactions would be expected to be considered to be reasonably assured.

8. Real estate lessors expressed significant concerns with the proposed model and, in particular, the use of the 'receivable and residual' approach for multi-tenant properties (when those properties are not measured at fair value). In particular, those respondents expressed the view that:

(a) The model does not represent the economics of a real estate lease;

(b) Significant operational challenges principally in moving in and out of the 'receivable and residual' approach for a floor of a building when one year such asset is under lease ('receivable and residual' approach) while the next year the property was vacant (depreciable PP&E asset);

(c) Requiring an impairment assessment at a significantly lower unit of account (a portion of time for a floor of a building) is time consuming and significantly increases the cost;

(d) Challenges in determining the fair value of a floor of a building for which market observable transactions may not be available.

9. Equipment lessors recommended that the residual asset should be initially measured at the present value of the estimated residual value of the underlying asset for a number of reasons:

(a) This method would reflect how equipment lessors price their lease contracts and thus would accurately reflect the economics of such lease transactions.

(b) In order to apply the 'receivable and residual' approach, the lessor needs to be able to reliably estimate the residual value of the underlying at the end of the lease term in order to calculate the interest

rate implicit in the lease. Consequently, it appears counterintuitive to use that amount to calculate the discount rate and not measure the residual asset on the same basis.

(c) Measuring the residual asset on an allocated cost basis may force a change to the business model of captive lessors (that is, a financing lessor subsidiary within a manufacturing group). A manufacturer may use third party lessors or otherwise reach an agreement with another manufacturer to use each other's captive for lease transactions because, in that scenario, the manufacturer will recognize full manufacturing profit on selling the asset to the third party lessor.

(d) Concerns about profit recognition at lease commencement can be addressed by impairment. If excess income is recognized at lease commencement, this would lead to almost immediate impairment of the residual asset (assuming that the impairment model applied had a discounted cash flow approach).

10. Other feedback received regarding the initial and subsequent measurement of the residual asset included the following:

(a) Recognizing a need to define the nature of the residual asset including, what impairment model should be used, when and how such an asset should be derecognized, how the asset should be subsequently measured (accreted) and what the value of the residual asset at the end of the lease term represents.

(b) Whether there should be different methods to calculate the residual asset depending on whether or not profit is reasonably assured (for example, different discount rates)

(c) Whether to differentiate the 'unearned income' (if applicable when the cost is less than fair value) from the recognized residual asset to provide greater transparency to profit recognition rather than embedding profit deferred in an asset otherwise measured at cost.

11. Finally, a respondent questioned the symmetry between the lessee and lessor accounting, expressing a view that the lessee is accounting for the right-of-use asset while it appears that the 'receivable and residual' model

is accounting for the entire asset. This respondent noted that derecognition of the *entire* underlying asset and recognizing interest earned on the *entire* asset in the 'receivable and residual' approach is, in their view, inconsistent with a ROU model.

## Staff analysis and recommendations

### *Residual Asset*

*Nature of the residual asset*

12. If the Boards were to agree on the nature of the residual asset, the staff thinks it would be easier to come to an agreement on the appropriate initial and subsequent measurement of the residual asset. To-date, the Boards have decided that the residual asset:
    (a) should not be measured at fair value but on an allocated cost basis,
    (b) should be impaired using non-financial asset guidance (IAS 36) and specifically under US GAAP using the tangible asset impairment model (Topic 360) and
    (c) should not be presented within PP&E, but together with the lease receivable as an investment in leased assets.
13. The staff think that the residual asset should be considered either:
    (a) A tangible asset (similar to property, plant and equipment), and while out on lease, encumbered by a lease contract. Supporters of this view think that the existence of a lease contact does not change the nature of the asset. The lessor retains title to the asset throughout the lease and only when sold is the asset derecognized and reclassified into another asset. This view is reflected in Approach C discussed in paragraphs 33-43 of this memo.
    (b) An asset that is unique and different from both a tangible asset and a financial asset and therefore should not be constrained by current accounting for such defined assets. The residual is a right to receive a tangible asset at some point in the future (for which the lessor does

not control the use during the lease term)—it is not the same as a tangible asset that the lessor controls the use of before lease commencement. This asset is like the residual asset accounted for today in capital/finance leases in U.S. GAAP and IFRS. This view is reflected in Approaches A and B discussed in paragraphs 20-28 and paragraphs 29-32, respectively, in this memo.

(c) A financial asset, principally when a residual value guarantee is obtained in a lease contract. In these cases, typically when the lessor sells the asset at the end of the lease, the lessor's rights to the underlying asset have been transformed into a final cash payment or a financial asset based on the expected future cash flows to be received either from re-lease or from sale of the underlying asset.

***'Receivable and Residual' Approach***

14. As noted above, there were significant concerns raised during outreach about whether or not the reasonably assured criteria should be retained in the lessor accounting model, about different amounts of profit being measured based on the reasonably assured criteria, and inconsistencies in the proposed 'receivable and residual' approach.

15. The 'reasonably assured' criteria are written as a threshold that a lessor must meet in order to be able to recognize profit on the ROU asset at lease commencement. Anywhere that we set a threshold creates the possibility, in practice, that an entity can choose whether or not to meet that threshold. Most respondents that we spoke to stated that lessors should be able to prove that profit is reasonably assured on *all* lease contracts, unless it is an onerous contract. They held this view because assessing and monitoring the residual value of a leased asset is an essential part of many lessor's leasing business. Even when the pricing of a lease contract is not directly priced by estimating the residual (and is influenced more by market prices), many expressed the view that it would be surprising if most lessors did not have a relatively good idea of the value of the leased asset at the end of the lease term. Therefore, the subjective nature of assessing profit as reasonably assured or not would be a 'choice' based on whether or not a

lessor wanted to prove the amount of profit in a transaction in order to recognize profit at lease commencement. Respondents were uncomfortable with the subjective nature of this determination and the ability to structure transactions to achieve certain results. Auditors also noted that it would be difficult to insist that a client treat a lease contract as being reasonably assured if the lessor client in question was arguing that it could not reliably estimate the residual value of the underlying asset.

16. In addition, concerns were raised about the comparability of one lessor that assessed profit as being reasonably assured to another lessor that did not identify evidence to support the assertion that profit was reasonably assured: is one entity's accounting an error? Some noted that this assessment of whether profit is reasonably assured introduces a day 1 assessment of lease contracts, and different subsequent accounting, that we might have hoped to have removed by moving to a single lessor accounting model. This is because there are two different calculations that are performed to initially measure the residual asset depending on whether or not profit is reasonably assured. Most feedback suggested that there should be only one way to measure the residual asset at lease commencement.

17. Because of those concerns, as well as the other feedback received on the proposed lessor model, the staff thinks that the Boards should have one model for calculating the residual asset at lease commencement. This would result in one measurement of any profit on the lease transaction at lease commencement. Whether all or some of that profit should be recognized at lease commencement, over the lease term, or deferred until the end of the lease term will be discussed in the next section of this paper.

18. Therefore, the staff has put forward three approaches to the accounting for the residual asset based on the feedback received in outreach activities. All three approaches would have a different way to calculate the residual asset, and therefore would result in a different measurement of any profit at lease commencement. In all three approaches, however, the lessor would measure profit at lease commencement if the carrying amount of the underlying asset is less than the sum of (1) the initial measurement of the lease receivable and (2) the initial measurement of the residual asset.

19. For all three approaches, a lessor would initially and subsequently measure the lease receivable as the Boards have tentatively decided (that is, initially measured at the present value of the lease payments discounted using the rate the lessor charges the lessee, and subsequently measured at amortized cost applying an effective interest method).

*Approach A: Measure the residual asset based on depreciated cost basis*

20. Under Approach A, a lessor would initially measure the residual asset by determining what the future depreciated carrying amount of the underlying asset would be at the end of the lease term if the underlying asset were not subject to lease accounting, discounted using the rate the lessor charges the lessee. That initial value would then be accreted over the lease term using the rate the lessor charges the lessee.

21. The change from the Boards' tentative decisions on lessor accounting relates to the initial measurement of the residual asset and thereby potentially profit recognition. Rather than calculating an allocated cost-based measurement for the residual asset at lease commencement using the prescribed formula (CU36 – refer to Appendix A) and then subsequently accreting the residual over the lease term, this approach would determine a measurement of the residual asset using property, plant and equipment guidance (that is, depreciated cost) at the end of the lease term and discount that amount back to lease commencement. (If the lessor's business is to sell the asset at the end of the initial lease term, the residual would be initially measured at CU43 using the example in Appendix A. If the lessor's business is to retain ownership of the asset for a longer term, leasing it out again over the life of the asset, the residual would be initially measured at CU39 using the example in Appendix A.)

22. The basis used to measure the residual asset at the end of the lease term is consistent with IAS 16 and Topic 360. Although, according to this model, the residual is a unique asset that is different from property, plant and equipment during the lease term (in that the lessor, by definition, does not control the use of that underlying asset), the staff think that this approach is

appropriate because, at the end of the lease term when returned to the lessor, the residual asset typically becomes property, plant and equipment.

23. This model results in profit measurement at lease commencement of CU20 (when the value expected at the end of the lease is CU55 and the lessor plans to sell the asset at the end of the lease term) as the carrying amount of the underlying asset (CU100) is less than the sum of (1) the initial measurement of the residual asset (CU43) and (2) the initial measurement of the receivable (CU77). Refer to Appendix A for a comparison of the approaches. Approach A is more aggressive with respect to the timing of profit recognition than the current 'receivable and residual' approach agreed to by the Boards at the July 2011 meeting:

   (a) when the lessor's business is to sell leased assets at the end the initial lease term (profit measurement of CU20 under Approach A is higher than the July 2011 tentative decisions that measured CU13 when profit is reasonably assured).

   (b) if the Boards agree that this approach is applied to all lease contracts. If this is the case, there is no need to include a 'reasonably assured' assessment, and profit would be recognized at lease commencement on all contracts for which the carrying amount of the underlying asset is less than its fair value.

24. In addition, it is worth noting that this model could produce a loss at lease commencement in some scenarios (even when the underlying asset is not impaired), particularly when lease payments include a high proportion of variable lease payments that are not included in the initial measurement of the lease receivable. Consequently, the staff would recommend including guidance that would result in no loss being recognized at lease commencement in situations in which the underlying asset is not impaired. There are two ways that this could be done:

   (a) The discount rate applied to both the lease receivable and the residual asset could be adjusted so that there would be no gain or loss at lease commencement.

(b) Alternatively, the lessor could separately account for the 'deferred loss' and release this to profit or loss over the lease term. This would have the same effect on net assets, but would prevent adjusting the discount rate applied to the lease receivable and the residual asset.

The staff prefers the second alternative to prevent 'tampering' with the discount rate charged by the lessor.

25. Because the residual asset would be initially measured based on the underlying asset's depreciated cost at the end of the lease term, the measurement of the residual asset does not include an element relating to variable lease payments, should they exist. This eliminates the need to provide guidance on whether and how to adjust the carrying amount of the residual asset when variable lease payments are not included in the lease receivable, as discussed in a separate paper.

26. The advantages of this approach are as follows:

(a) It removes the need to include a reasonably assured assessment at lease commencement and thus addresses those concerns raised in paragraphs 15 and 16 of this paper. This is because the residual is measured using inputs that the lessor is required to obtain under current accounting requirements. Consequently, all lessors should have available the inputs required to initially and subsequently measure the residual asset.

(b) It uses one method to initially calculate the residual asset and one method to subsequently measure the residual asset. Thus, it would mean that the lessor accounting model is more of a single model than the current 'receivable and residual' approach that requires a day 1 assessment of whether profit is or is not reasonably assured, and which can lead to different accounting depending on that assessment. This single approach also addresses concerns that a lessor could 'pick and choose' the timing and amount of profit recognition on lease contracts under the current Boards' tentative decisions.

(c) Because it removes the need to assess whether profit is reasonably assured and uses inputs that should be readily available to the lessor, it

is a simplification of the current 'receivable and residual' approach and should be easier to apply. It also removes the need to separately develop guidance for variable lease payments.

(d) The profit measurement that flows from the model (that is, profit at lease commencement if the carrying amount and the sum of (a) the initial measurement of the residual asset and (b) the initial measurement of the receivable are different), and consequently, interest income on the receivable and the residual asset) is easier to explain and understand than is the case under the current 'not reasonably assured' model. This is because, under the 'not reasonably assured' model, the accretion of the residual asset incorporates both deferred profit relating to the transfer of the ROU asset and interest income on the residual. Those amounts would be difficult to separate in a meaningful way when profit is not reasonably assured.

27. Nonetheless, there are some consequences of applying this model that the Boards should consider:

(a) If a lessor's business model is such that it expects to sell the underlying asset at the end of the initial lease term, the lessor would recognize manufacturing profit on the entire underlying asset at lease commencement (full profit). This is because, in such a scenario, IAS 16 and Topic 360 would require such a lessor to depreciate the underlying asset to its estimated residual value over the period the lessor expects to own the asset. If the lessor expects to sell the asset at the end of the initial lease term, the lessor would measure the residual asset at the estimated residual value at the end of the lease term discounted using the rate the lessor charges the lessee. Using the example in Appendix A, the lessor would recognize profit at lease commencement of CU20.

(b) It is important to note, however, that this model would not permit a lessor to recognize full manufacturing profit at lease commencement if the lessor's business is such that it intends to retain ownership of the asset after the end of the lease term and generate income from that

asset by either leasing it again over its useful life or using it in its own business. This is because, in that scenario, a lessor would measure the residual asset at the end of the lease term on the basis that the asset would be depreciated over the period that the lessor expects to own the asset, which would be longer than the initial lease term. Again, using the example in Appendix A, the lessor would initially measure the residual asset as CU39 in this scenario. And so, a lessor would not recognize full manufacturing profit at lease commencement on a 2 year lease of an asset that has a 10 year life unless the lessor expects to sell the asset at the end of that 2 year period.

28. Similar to the current 'receivable and residual' approach, this approach treats the underlying asset that is leased as a separate unit of account. Therefore, if the underlying asset is a portion of a larger asset, the lessor would need to allocate the cost of the larger asset to the portion or portions leased. Some real estate lessors have indicated that this might be difficult when there are multiple leases on one larger asset, and the underlying asset is not measured at fair value.

*Approach B – Fair value proxy approach*

29. Approach B is consistent with current capital/finance lease accounting in U.S. GAAP and IFRS. Approach B views the residual asset as a unique asset (that is neither a tangible asset or a financial asset) and:

(a) Initially measures the residual (CU43 in the example in Appendix A) as the present value of the estimated fair value of the residual at the end of the lease term (CU55 in the example in Appendix A) discounted using the rate the lessor charges the lease,

(b) Subsequently accrete the residual using the rate the lessor charges the lessee to ultimately end the lease contract with a residual asset value consistent with the fair value of the residual (CU55).

(c) Measure profit at lease commencement (CU20) as the difference between the carrying amount of the underlying asset (CU100) and the sum of the (1) initial measurement of the residual asset (CU43) and

(2) the initial measurement of the lease receivable (CU77), and either recognize such profit at lease commencement or defer such profit in specified situations as discussed further below. (Refer to Appendix A)

30. The advantages of this approach are that it:
    (a) is consistent with current finance lease accounting;
    (b) reflects the way in which many lessors price lease contracts (for example, car and equipment lessors).
    (c) is likely to provide better information to users about the value of the residual asset, including the effect of any residual value guarantees. The residual represents the right to the cash flows that the lessor expects to receive at the end of the lease term that will ultimately be realized through sale, residual value guarantees, or re-lease of the underlying asset. Because lessors attribute significant importance to the residual asset and estimating its residual value at the end of the lease term, this information would be useful to users of financial statements.
    (d) better reflects the value of the residual asset when the lessor has a residual value guarantee. Measuring the residual asset on an allocated cost basis might result in the lessor measuring the residual asset at an amount that is lower than what the lessor would receive from a residual value guarantee.

31. This approach always results in *full* manufacturer's profit to be measured upon commencement of a lease contract regardless of the length of the lease. Additionally, this approach could also create a loss at lease commencement due to variable lease payments as described above in Approach A that the staff thinks could also be resolved by either adjusting the discount rate or separately accounting for deferred revenue as described above in paragraph 24.

32. In addition, because all lessors may not be able to reliably determine the fair value of the underlying asset or reliably estimate its residual value, it is likely that this approach could not be applied to all lease contracts. Consequently, this approach would require the development of a model that

measures the residual asset differently in some circumstances and consequently would create different profit recognition patterns for some lease contracts (see paragraphs 45-49 of this memo).

*Approach C – Cost based approach*

33. This approach considers the residual asset to be a tangible asset (Topic 360 or IAS 16 asset). In Approach C the residual retains its nature throughout the lease despite the lessor providing a right-to-use the underlying asset to the lessee. As a result of the lease contract, the lessor has transferred a portion of the value of the underlying asset to the lessee; however it retains ownership and rights to the underlying asset's return at the end of the lease. This approach views a lease as the 'sale' of the right-of-use asset and not the underlying asset in a lease contract.

34. Approach C includes the following decisions:

    (a) Initially measure the residual as an allocation of the previous carrying amount of the underlying asset, CU36. That allocated cost would be calculated based on the proportion of the underlying asset's fair value that is the subject of the lease. (Similar to the calculation in the 2010 ED and the July 2011 tentative decisions.)

    (b) Subsequently measure the residual asset like other tangible assets, cost basis subject to impairment testing and do not accrete the asset.

    (c) Measure profit at lease commencement (CU13) as the difference between the carrying amount of the underlying asset (CU100) and the sum of the (1) initial measurement of the residual asset (CU36) and (2) the initial measurement of the lease receivable (CU77), and either recognize such profit at lease commencement or defer such profit in specified situations.

35. The Boards decided at the July 2011 joint Board meetings that a lessor should initially measure the residual asset as an allocation of the previous carrying amount of the underlying asset. That allocated cost would be calculated based on the proportion of the underlying asset's fair value that

is the subject of the lease. The residual asset would be initially measured as follows:

Cost of underlying– (Cost x PV of lease payments*/FV of underlying)

* The staff has changed the description of the numerator in this calculation to 'Present value of lease payments' measured at lease commencement. Note in prior memos the staff has used the 'lease receivable' as the numerator in this equation; however, the staff notes that the recognized receivable may not include any upfront payments (prepaid rents) that should be taken into account in the allocation methodology.

36. The Boards supported this cost allocation approach for the following reasons:

    (a) Measuring the residual asset on an allocated cost basis more accurately reflects that a lessor has not 'sold' all of the underlying asset when it enters into a lease contract and recognizes profit only on the ROU asset transferred to the lessee and *not* on the residual asset until the end of the lease term.

    (b) Measuring the residual asset at fair value, or at a proxy for fair value, would, in effect, result in remeasuring the entire underlying asset to fair value at lease commencement with resulting gains recognized in profit or loss, irrespective of the length of the lease. In the absence of a lease contract, an entity would not be permitted to measure such an underlying asset, which would be a tangible asset, at fair value under US GAAP or, although permitted under IFRS, the entity would recognize any fair value movements in other comprehensive income (with the exception of investment property).

37. If the Boards continue to prefer the above initial measurement, some staff members do not think that subsequent measurement whereby the residual asset is accreted is conceptually supportable. These staff members think that by selecting a cost-based initial measurement as outlined above, the recognized tangible asset should be consistent with other owned PP&E and inventory neither of which accrete into income under either U.S. GAAP or IFRS. By allowing accretion on this type of 'special' asset the staff thinks that there could be a potential incentive to arrange a transaction as a lease

(rather than a sale) in order to achieve a preferred profit recognition pattern. While profit recognition criteria and thresholds may be applied as discussed further below, some staff members think that those criteria/thresholds will not fix the conceptual challenge with accreting an otherwise cost-based tangible asset, if the boards view the residual asset as a tangible asset (that is simply encumbered by a right-of-use).

38. Additionally, these staff members note that in lease contracts whereby the rate implicit in the lease is unavailable and a lessor uses another rate (for example, yield on the property or the lessee's incremental borrowing rate) when the residual asset is accreted, the profit deferred by the calculation in paragraph 35 may be recognized through the lease term even when deferred at lease commencement.

39. The main advantage of this approach is that it addresses many of the Boards' concerns about profit recognition at lease commencement because it ensures that any manufacturing profit relating to the residual asset is not recognized at lease commencement.

40. Nonetheless, because the residual asset is neither accreted nor measured based on the estimated residual value of the underlying asset, this approach would not reflect the economics of equipment leasing.

41. Despite the potential conceptual concerns above, as outlined to the Boards in previous memos, the feedback principally from those equipment lessors that supported the derecognition approach disagreed with the 2010 ED's conclusion not to allow accretion of the residual. These equipment lessors that supported a derecognition method refer to the economics of their transactions whereby the lessor is charging the lessee for the use of the entire asset (requiring financing of the entire asset not the right-of-use) to cover its investment in the lease contract as support for why the residual should be accreted.

42. This approach, including no accretion, would also typically result in a measurement of the underlying asset at the end of the lease term that is much lower than exactly the same tangible asset that had not been leased. As illustrated in Appendix A, if the underlying asset had not been subject to

a lease or if the lessor used current lease accounting, the asset would be measured at the end of the lease term either at CU50 or CU55, depending on the business model of the lessor and whether the lease was an operating or finance leases. According to this approach, the underlying asset would be measured at the end of the lease term at CU36.

43. Finally, because the initial measurement of the residual asset is calculated based on the fair value of the underlying asset, this approach may not be able to be applied to all lease contracts because, for example, when the underlying asset is a portion of a larger physical asset, it may be difficult or excessively costly to determine the fair value of that portion leased. Consequently, like Approach B, this approach would require the development of a model that measures the residual asset differently in some circumstances and consequently would create different profit recognition patterns for some lease contracts (see paragraphs 45-49 of this memo).

*Accretion of the residual asset under Approaches A and B*

44. All staff members think that if the initial measurement of the residual asset is the present value of some future value (expected depreciated value (Approach A) or fair value proxy (Approach B)) then that amount recognized should be accreted. As a result of the subsequent accretion, the measurement of the residual asset at the end of the lease would be an amount that is understood (the value the lessor expects to realize upon sale or release of the underlying asset) and supportable.

| **Question 1 – Residual asset accounting** |
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| A) How do the Boards want to initially measure the residual asset (Approach A – depreciated cost basis, Approach B – fair value proxy, or Approach C – cost based approach)? |
| B) How do the Boards want to subsequently measure the residual asset (accrete or do not accrete)? |

***Profit Recognition***

45. If the boards support either Approach B or Approach C regarding the measurement of the residual, as noted above, the staff think it is necessary

to develop a different measurement basis for the residual in some situations and thus create two different profit recognition pattern models. This is not required if the boards support Approach A. Consequently, this section applies only if the boards decided to support Approaches B or C regarding the measurement of the residual.

46. There was feedback that indicated that different profit recognition patterns are necessary for different lease transactions and therefore some criteria to differentiate between the two recognition methods should be retained. However, most did not suggest retaining the reasonably assured criteria to assess this distinction. Many expressed views that current lessor accounting, with its dual approach, appropriately aligned with more entities' business models. These respondents prefer a dual approach which would allow for entities that use leasing as an alternative to selling to recognize profit upon lease commencement, while entities that provide value over the lease term and view leasing more like providing a service to recognize profit over the lease term.

47. Those who thought that different profit recognition patterns should be retained suggested that the Boards clarify when and what types of contracts do not meet the criteria for profit recognition at lease commencement. They also suggested that the Boards provide examples to illustrate when profit should or should not be recognized at lease commencement. They questioned whether the Boards had in mind that the types of lease contracts where profit would be deferred would generally be restricted to some real estate (market-based leases), leases of portions of underlying assets and leases with significant variable lease payments. Most respondents expressed the view that in situations when estimating and monitoring the residual value of leased assets at the end of the lease term is the essence of a lessor's leasing business, and this is how the lessor prices its lease contracts, the Boards should make clear that lease contracts written by such lessors would be expected to achieve profit recognition at lease commencement.

*Staff recommendation*

48. The staff thinks Approach A outlined above which bases the residual asset on the depreciation policy of the lessor could allow all lease contracts within the scope of the 'receivable and residual' approach to be accounted for consistently and without a need for criteria to distinguish when profit should not be recognized at lease commencement.

49. The majority of staff was persuaded by comments received about the complexity that the inclusion of a reasonably assured assessment creates and recommends changing the 'receivable and residual' approach to include the decisions in Approach A above. Nonetheless, if the Boards disagree with this recommendation and decide to retain criteria to distinguish between profit recognition patterns at lease commencement, the staff recommends clarifying in which situations the Boards think profit should not be recognized at lease commencement.

**Question 2 – Profit recognition**

A) Do the Boards think that a single recognition pattern for all lease contracts within the scope of the 'receivable and residual' approach is appropriate (Approach A – depreciated cost approach)?

B) If more than one recognition pattern should be used in the 'receivable and residual' approach, which approach should be used (Approach B – fair value proxy or Approach C – cost based)?

C) If more than one recognition pattern should be used in the 'receivable and residual' approach, what criteria should be used to distinguish between one recognition pattern and another? (Reasonably assured criteria in Appendix B or another set of criteria)

***Scope exception to 'receivable and residual' approach***

50. At the July 2011 joint meeting, in Agenda paper 5G / FASB memo 193, the staff recommended to use current operating lease accounting with disclosure of lease receivables for those assets where it was impractical to determine the carrying amount of a leased portion of an asset (for example, a multi-tenant leased asset) when the entire asset is measured at cost. The rational for that recommendation is on cost/benefit grounds (that is, for

practical reasons) and feedback from lessors that have articulated that the 'receivable and residual' approach does not align with the underlying economics of certain transactions.

51. As outlined above, the staff continued to hear feedback that the 'receivable and residual' approach is not operational or economically consistent with certain underlying assets subject to multiple lease contracts.

52. The majority of staff members continue to recommend that a lessor uses current operating lease accounting when it enters into multiple lease contracts for physically distinct portions of an underlying asset. As a result, these lessors would continue to recognize and depreciate the leased asset (PP&E) and provide disclosure of the committed lease receivables among other disclosures.

53. The staff notes that this scope exception to the 'receivable and residual' approach could be applied in combination with any of the above approaches to the general lessor model.

| **Question 3 – Underlying assets subject to multiple leases of physically distinct portions** |
| --- |
| Do the Boards agree that lessors with underlying assets subject to multiple leases of physically distinct portions should apply current operating lease accounting rather than the 'receivable and residual' approach? |

## Appendix A: Illustrative examples of approaches

| Lease Terms | | |
|---|---|---|
| Lease Term | 3 | |
| Useful Life | 6 | |
| Annual Payment | 30 | |
| Residual (FV estimate at the end of lease term) | 55 | * |
| Residual (PV of estimated residual) | 43.2 | * |
| FV of Underlying | 120 | * |
| Cost Basis of Underlying | 100 | |
| Expected depreciation during the lease term | 50 | |
| Interest Rate (implicit) | 8.38% | * |

** Item may not be available under not reasonably assured scenario*

**July 2011 Tentative decisions**

**Lessor - July 2011 Tentative Decisions -Reasonably Assured**

| | | | | Income Statement | | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|
| | Cost | FV | Future CF | Mfg Profit | Interest / Accretion | Total Profit | Beginning | Ending |
| Receivable | 64.0 | 76.8 | 90.0 | 12.8 | 13.2 | 26.0 | 76.8 | - |
| Residual | 36.0 | 43.2 | 55.0 | - | 9.8 | 9.8 | 36.0 | 45.8 |
| *Total* | 100.0 | 120.0 | 145.0 | 12.8 | 23.0 | **35.8** | 112.8 | 45.8 |

**Lessor - Tentative Decisions - Not Reasonably Assured**

| | | | | Income Statement | | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|
| | Cost | FV | Future CF | Mfg Profit | Interest / Accretion | Total Profit | Beginning | Ending |
| Receivable | ? | 76.8 | 90.0 | - | 13.2 | 13.2 | 76.8 | - |
| Residual | ? | ? | ? | - | 26.8 | 26.8 | 23.2 | 50.0 |
| *Total* | 100.0 | ? | ? | - | 40.0 | **40.0** | 100.0 | 50.0 |

**Alternative approaches**

**Lessor - Approach A - depreciation to estimated residual value / Approach B - current capital/finance lease**

| | | | | Income Statement | | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|
| | Cost | FV | Future CF | Mfg Profit | Interest / Accretion | Total Profit | Beginning | Ending |
| Receivable | 64.0 | 76.8 | 90.0 | 12.8 | 13.2 | 26.0 | 76.8 | - |
| Residual | 36.0 | 43.2 | 55.0 | 7.2 | 11.8 | 19.0 | 43.2 | 55.0 |
| *Total* | 100.0 | 120.0 | 145.0 | 20.0 | 25.0 | **45.0** | 120.0 | 55.0 |

**Lessor - Approach A - straight-line depreciation to year 3**

| | | | | Income Statement | | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|
| | Cost | FV | Future CF | Mfg Profit | Interest / Accretion | Total Profit | Beginning | Ending |
| Receivable | ? | 76.8 | 90.0 | ? | 13.2 | ? | 76.8 | - |
| Residual | ? | ? | ? | ? | 10.7 | ? | 39.3 | 50.0 |
| *Total* | 120.0 | ? | ? | 16.1 | 23.9 | **40.0** | 116.1 | 50.0 |

**Lessor - allocated cost approach (Approach C)**

| | | | | Income Statement | | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|
| | Cost | FV | Future CF | Mfg Profit | Interest / Accretion | Total Profit | Beginning | Ending |
| Receivable | 64.0 | 76.8 | 90.0 | 12.8 | 13.2 | 26.0 | 76.8 | - |
| Residual | 36.0 | 43.2 | 55.0 | - | - | - | 36.0 | 36.0 |
| *Total* | 100.0 | 120.0 | 145.0 | 12.8 | 13.2 | **26.0** | 112.8 | 36.0 |

## Appendix B: preliminary draft guidance relating to reasonably assured

*The preliminary draft guidance in this appendix reflects the Boards tentative decision in July 2011. Refer to paragraphs 64-65 of FASB Memo 193 / IASB Agenda paper 5G. The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards reach decisions regarding the terminology of reasonably assured for lessor accounting in the leases standard. The Boards have not yet made final decisions about the views reflected in this appendix, and, therefore, the wording is subject to change.*

### Reasonably assured

B1. **A lessor shall recognize profit on the right-of-use asset transferred to the lessee at lease commencement when that profit is reasonably assured. Profit on the right-of-use asset is reasonably assured when all of the following criteria are met:**
   - (a) **The lessor can reliably determine the payments that relate to the lease component of the contract (see paragraph B2).**
   - (b) **The lessor can reliably measure the fair value of the underlying asset at lease commencement (see paragraph B3).**
   - (c) **The lessor can reliably estimate the residual value of the underlying asset at the end of the lease term (see paragraphs B4-B6).**

B2. Paragraph x requires a lessor to allocate payments to the lease component of a contract at an amount that depicts the amount to which the lessor expects to be entitled in exchange for transferring the right-of-use asset to the lessee. In order to reliably determine that amount, a lessor must have sufficiently reliable data on which to base its allocation of payments, particularly when using the estimation methods set out in paragraph x [include cross-reference to wording that will be similar to what is included in the revenue recognition ED regarding allocation of the transaction price to separate performance obligations].

B3. Reliably measuring the fair value of the underlying asset may be more difficult in some situations when sufficiently reliable data is unavailable for one or more fair value inputs. For example, if the fair value of an underlying asset is determined:
   - (a) by estimating the future residual value, reliably measuring that fair value may be more difficult when that underlying asset is not typically bought or sold in the market (e.g. the underlying asset is a portion of a larger asset such as a retail unit in a shopping mall or space on a telecommunications tower), or
   - (b) on the basis of future lease payments, reliably measuring that fair value is likely to be more difficult when a significant proportion of lease payments are variable in nature (e.g. the lease contract includes lease payments that are dependent on future sales of the lessee).

B4. A lessor can reliably estimate the residual value of the underlying asset at the end of the lease term when either:
   - (a) the lessor has a residual value guarantee relating to the underlying asset that guarantees that the lessor will receive at least an amount equal to that estimated residual value; or
   - (b) the lessor has experience with similar types of lease contracts (or has other evidence such as access to the experience of other lessors or valuations from reliable independent sources), and the lessor's experience (or other evidence) is predictive of the residual value of the underlying asset at the end of the lease term.

B5. Indicators that an entity's experience may not be predictive of the residual value of the underlying asset at the end of the lease term include, but are not limited to, the following:
   - (a) the second-hand sales or rental market for the underlying asset is highly volatile;
   - (b) the period before which the lessor can re-lease or sell the asset is long;
   - (c) the lessor's experience with similar types of lease contract is limited.

B6. An entity shall use judgment and consider all facts and circumstances when evaluating whether the entity's experience is predictive of the residual value of the underlying asset at the end of the lease term. The presence of any one of the indicators in paragraph B5 does not necessarily mean that the entity cannot reliably estimate the residual value of the underlying asset at the end of the lease term. In addition, the lessor shall consider the significance of the residual asset when making this evaluation. For example, when the residual asset is small, any volatility in the market for the residual asset is less likely to affect the lessor's assessment of whether the profit on the right-of-use asset is reasonably assured. In contrast, if the residual asset is large and either the market is volatile or the lease term is long; it may be more difficult to reliably estimate the residual value.