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Project **Leases**

Topic **Lessor accounting – summary of approaches**

Objective

1. This paper should be read with IASB agenda paper 2F / FASB memo 210 and summarizes the approaches outlined. This paper is organized as follows:
   (a) Part 1 – Side by side comparison of approaches
   (b) Part 2 – Summary of approaches
   (c) Part 3 – Illustrative example of approaches
2. The approaches outlined in this paper include the following:
   (a) July 2011 tentative decisions that include a distinction between when profit is or is not reasonably assured (RA)
   (b) Approach A – Depreciated cost
   (c) Approach B – Current finance/capital lease (fair value proxy)
   (d) Approach C – Allocated cost
   (e) Approach D – Deferred income
3. Approaches A, B & C are outlined in memo 210/ paper 2F and Approach D is a modified Approach C that was initially raised at the FASB Education Session last week and is further outlined herein.

Part 1 – Side by side comparison of approaches

		Initial measurement	Subsequent measurement	MEASUREMENT profit* at commencement		Accretion (unwinding of discount)		RECOGNITION profit* at commencement		Recognition of profit* over lease term
		Residual		Receivable	Residual	Receivable	Residual	Receivable	Residual	Residual
July 2011 tentative decision	RA	Proportionate share of historical cost basis	Initial value accreted using rate in the lease	Full profit	No profit	Yes	Yes	Full	None	No
	not RA	Historical cost basis less recorded receivable	Accreted using a constant rate to the expected depreciated cost at end of lease	No profit	No profit	Yes	Yes	None	None	It depends
Approach A Depreciation policy		Expected depreciated cost at end of lease discounted back to commencement using rate charged in the lease	Accreted to expected depreciated cost at end of lease	**It depends		Yes	Yes	**It depends		No
Approach B Current finance/ capital		Expected residual value at end of lease discounted back to commencement using rate charged in the lease	Accreted to expected residual value	Full profit	Full profit	Yes	Yes	Full	Full	No
Approach C Allocated cost		Proportionate share of historical cost basis	No change - historical cost basis	Full profit	No profit	Yes	No	Full	None	No
Approach D Deferred income		Proportionate share of historical cost basis and deferred income associated with such share identified; 2 separate items presented	Accreted to expected residual value; deferred income identified at commencement not recognized	Full profit	Profit measured but fully deferred	Yes	Yes	Full	None	No

* Profit exists when the fair value of the underlying asset subject to lease is greater than the lessor's carrying value at lease commencement.

** Measurement of the residual depends on the depreciation policy that may provide full, partial, or no profit on both the receivable and the

Part 2 – Summary of approaches

Approach A – Depreciation policy	The lessor, using its depreciation policy, expects the carrying amount of the underlying asset, if otherwise owned instead of leased, to be depreciated to CU50 at the end of three years. Therefore, the lessor uses CU50 as the value of the underlying asset at the end of the lease term and discounts that back to CU39.3 using the rate the lessor charges the lessee (8.38%). The lessor recognizes the lease receivable at the present value of payments, (CU76.8), recognizes the residual asset (CU39.3), and derecognizes the carrying amount (CU100) of the underlying asset. Thus, the lessor measures profit from the underlying asset (CU16.1) as a portion of total profit (CU20) at commencement. Subsequently, the lessor accretes (or unwinds) the discount on the receivable and the residual asset, using the rate that the lessor charges the lessee, for total interest/accretion of CU13.2 and CU10.7, respectively, over the lease term. At the end of year 3, the residual asset is measured at depreciated cost (CU50) and total income recognized from the lease is CU40 (profit CU16.1 + interest/accretion CU13.2 + CU10.7).
Approach B – Current	The lessor estimates that the fair value of the underlying asset at the end of the lease term will be CU55 and records the present value of that (i.e., today's value of the expected future fair value), discounted using the rate the lessor charges the lessee (8.38%), at CU43.2. The lessor recognizes the lease receivable at the present value of payments (CU76.8), recognizes the residual asset (CU43.2), and derecognizes the carrying amount (CU100) of the underlying asset. Thus, the lessor measures *all* of the profit from the underlying asset, CU20, at commencement. Subsequently, the lessor accretes the discount on the receivable and the residual asset, using the rate the lessor charges the lessee, for total interest/accretion of CU13.2 and CU11.8, respectively, over the lease term. At the end of year 3, the residual asset is measured at the expected value (CU55) and total income recognized from the lease is CU45 (profit CU20 + interest/accretion CU13.2 + CU11.8).
Approach C – Allocated cost	The lessor uses the historical carrying amount of the underlying asset and identifies the proportionate share of that carrying amount associated with the retained rights in the residual asset. As a result, the lessor maintains a carryover basis in the residual asset using the historical cost measurement. The lessor uses the following formula to calculate the residual asset (CU36): [Cost – (PV of payments/FV of underlying) x Cost] = [100 – (76.8/120) x 100] The lessor recognizes the lease receivable at the present value of payments (CU76.8), recognizes the residual asset on an allocated cost basis (CU36), and derecognizes the carrying amount (CU100) of the underlying asset. Thus, the lessor measures profit solely from the receivable recognized (CU12.8) rather than on both the receivable and residual. Subsequently, the lessor accretes the discount on the receivable, using the rate the lessor charges the lessee (8.38%), for total interest of CU13.2 over the lease term. The lessor does *not* accrete the residual asset recognized at commencement. At the end of year 3, the lessor has a residual asset of CU36 and total income recognized from the lease of CU26 (profit CU12.8 + interest CU13.2).

Approach D – Deferred income approach	The lessor estimates that the fair value of the underlying asset at the end of the lease term will be CU55 and records the present value of that (i.e., today's value of the expected future fair value), discounted using the rate the lessor charges the lessee (8.38%), at CU43.2, similar to Approach B. The lessor calculates total profit from the underlying asset (CU20 = CU120 FV – CU100 cost) and allocates the profit between the receivable and residual asset by using the following formula to calculate an amount of deferred profit (CU7.2) that pertains to the residual asset: [Total profit – (PV of payments/FV of underlying) x Total profit] = [20 – (76.8/120) x 20]. Thus, profit embedded in the residual asset, to be deferred until the end of the lease term when the lessor would sell or re-lease the underlying asset, is CU 7.2 and the net value of the residual asset is CU36 (CU43.2 – CU7.2). The lessor recognizes the lease receivable at the present value of payments (CU76.8) and derecognizes the carrying amount of the underlying (CU100) of the underlying asset. The lessor also recognizes the residual asset (CU43.2) and the deferred profit (CU7.2), either separately or as a net residual asset. Thus, the lessor measures total profit (CU20) separately as two components: (a) receivable (CU12.8) and (b) residual (CU7.2). Subsequently, the lessor accretes the discount on the receivable and the gross residual asset (CU43.2), using the rate the lessor charges the lessee, for total interest/accretion of CU13.20 and CU11.80, respectively, over the lease term, consistent with Approach B. The lessor holds the CU7.2 of deferred profit constant. At the end of year 3, the lessor has a residual asset of CU55, deferred profit to be recognized upon sale or re-lease of CU7.2, and total income recognized from the lease of CU37.8 (profit CU12.8 + interest/accretion CU13.2 + CU11.8).

Part 3 – Illustrative example of approaches

Lease Terms		* Item may not be available under not reasonably assured scenario
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%	*

Lessor - Reasonably Assured - (FAIR VALUE > COST)

				Income Statement			Balance Sheet	
	Cost	FV	Future CF	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 - Reasonably Assured - (FAIR VALUE = COST)

				Income Statement			Balance Sheet	
	Cost	FV	Future CF	Profit	Interest / Accretion	**Total Profit**	Beginning	Ending
Receivable	76.8	76.8	90.0	-	13.2	13.2	76.8	-
Residual	43.2	43.2	55.0	-	11.8	11.8	43.2	55.0
Total	120.0	120.0	145.0	-	25.0	**25.0**	120.0	55.0

Lessor - Not Reasonably Assured

				Income Statement			Balance Sheet	
	Cost	FV	Future CF	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

July 2011 Tentative decisions

Alternative approaches

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

	Cost	FV	Future CF	Income Statement: Profit	Income Statement: Interest / Accretion	Income Statement: Total Profit	Balance Sheet: Beginning	Balance Sheet: Ending
Receivable	n/a	76.8	90.0		13.2		76.8	-
Residual	n/a	n/a	n/a		10.7		39.3	50.0
Total	100.0	n/a	n/a	16.1	23.9	**40.0**	116.1	50.0

Lessor - Approach B - current capital/finance lease

	Cost	FV	Future CF	Income Statement: Profit	Income Statement: Interest / Accretion	Income Statement: Total Profit	Balance Sheet: Beginning	Balance Sheet: 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 C - allocated cost approach

	Cost	FV	Future CF	Income Statement: Profit	Income Statement: Interest / Accretion	Income Statement: Total Profit	Balance Sheet: Beginning	Balance Sheet: 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

Lessor - Approach D - deferred profit approach

	Cost	FV	Future CF	Income Statement: Profit	Income Statement: Interest / Accretion	Income Statement: Total Profit	Balance Sheet: Beginning	Balance Sheet: Ending
Receivable	64.0	76.8	90.0	12.8	13.2	26.0	76.8	0.0
Residual	36.0	43.2	55.0	-	11.8	11.8	43.2	55.0
Deferred Profit	-	-	-	-	-	-	(7.2)	(7.2)
Total	100.0	120.0	145.0	12.8	25.0	**37.8**	112.8	47.8