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Staff Paper

FASB Memorandum **200**

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Project **Leases**

Topic **Applicability of Financial Asset Guidance to the Right to Receive Lease Payments**

Introduction

1. This paper discusses the potential application of existing financial asset guidance regarding initial and subsequent measurement (in IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Classification and Measurement* and Topic 825 *Financial Instruments* in the *FASB Accounting Standards Codification®*) to a lessor's right to receive lease payments, herein referred to as a lease receivable.

2. This paper is written to address the boards' request in the July 2011 joint board meeting that the staff analyse the consequences of including the lease receivable in the scope of existing financial asset guidance.

3. This paper does not address the applicability of impairment or derecognition guidance in IAS 39, IFRS 9 or Topic 825 to the lease receivable. The *Leases* exposure draft ('the ED') proposed, consistent with current guidance, that the lease receivable be subject to existing financial asset impairment and derecognition guidance. The staff think that this proposal should be carried forward to the final leases standard. This paper explores whether the scope of applicable financial asset guidance should be expanded to include initial and subsequent measurement guidance.

4. This paper contains:

   (a) A background of existing financial asset guidance and the boards' previous discussions regarding this issue;

   (b) A discussion of the possible inclusion of the lease receivable in the scope of IFRS 9 and Topic 825 for measurement purposes; and

   (c) If the boards decide not to include the lease receivable in the scope of IFRS 9 and Topic 825 for measurement purposes, a discussion of the inclusion in the leases standard of a potential requirement or option that the lease receivable be measured at fair value.

Summary of staff recommendations

5. The staff recommend the boards confirm their previous tentative decisions that:

   (a) The lease receivable should be excluded from the scope of IFRS 9 and Topic 825 for purposes of initial and subsequent measurement; and

   (b) Fair value measurement of the lease receivable should be prohibited.

Background

6. At the May 2011 joint board meeting, the boards briefly discussed the possibility of including the lease receivable in the scope of existing financial asset guidance. The IASB Update/FASB SDR from that joint board meeting reported that:

   > The boards indicated a tentative preference for measuring a lessor's right to receive lease payments in accordance with the requirements for other similar financial assets. The boards nevertheless requested the staff to analyse whether this would create any unintended consequences, specifically if the boards were to specify two approaches for lessor accounting.

7. Currently, IAS 39 (and therefore IFRS 9) excludes lease receivables from the scope of guidance regarding initial and subsequent measurement. IAS 39 and IFRS 9 apply to lease receivables only in the context of impairment and derecognition.

8. IFRS 9 requires that financial assets either be subsequently measured at fair value or amortised cost. A financial asset is required to be measured at amortised cost if:

> (a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows, [and]
>
> (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. [paragraph 4.1.2]

Appendix A contains the application guidance in IFRS 9 regarding the second 'contractual cash flows' condition.

9. IFRS 9 also provides for a fair value option for financial assets to eliminate accounting mismatches:

> [A]n entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring asset or liabilities or recognising the gains and losses on them on different bases.

10. Lease receivables are also excluded from the scope of Topic 825. This guidance allows entities to elect a fair value option for any in-scope financial asset.

11. In its project, *Accounting for Financial Instruments*, the FASB has tentatively decided not to provide an unrestricted fair value option for financial instruments. Instead, a debt instrument would be measured at amortised cost if it meets a 'characteristics of instrument' test and three business strategy criteria. The proposed 'characteristics of instrument' criteria are as follows:

    (a) It is not a financial derivative instrument subject to the guidance in Topic 815, Derivatives and Hedging.

    (b) An amount is transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any discount or premium at acquisition.

    (c) The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice.

12. Additionally, the project has proposed the following business strategy criteria for measurement at amortised cost:

    (i) Financial instruments issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing (lending or borrowing) activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower or payment of contractual cash flows to the lender.

    (ii) Financial instruments for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit.

    (iii) Financial instruments that are not held for sale (assets) or transfer (liabilities) at acquisition or issuance.

Summary of feedback received

13. Under both the performance obligation and derecognition approaches, the ED proposed that the lease receivable be measured at amortised cost using the effective interest method. The majority of respondents supported the ED's proposal. However, a very small minority of respondents requested that lease receivables be measured consistently with financial instruments guidance; that is, that lease receivables be measured at fair value or that a fair value option be provided for the lease receivable. These respondents did not offer any other arguments in favor of fair value measurement. Additionally, a few constituents from the insurance industry requested that the lease receivable be permitted to be measured at fair value when those receivables back liabilities (eg insurance liabilities) measured at fair value (or an amount close to fair value) to avoid accounting mismatches.

Application of IFRS 9 and Topic 825 to the lease receivable

14. The staff think that a lease receivable would meet the definition of a financial asset under IFRS and US GAAP and would therefore fall into the scope of IFRS 9 and Topic 825, absent the current scope exceptions. The lease receivable is 'a contractual right to receive cash…from another entity' (the definition given in IAS 32 *Financial Instruments: Presentation*) and 'a contract that conveys to one entity a right to…receive cash…from a second entity' (the definition given in US GAAP).

15. The staff have identified the following consequences of removing the scope exceptions for lease receivables from IFRS 9 and Topic 825.

IFRS 9

16. If included within the scope of IFRS 9, the lease receivable would be initially measured at fair value.

17. Subsequent measurement of the receivable would depend on both the lessor's business model for managing the lease receivable (IFRS 9 4.1.2(a)) and the contractual cash flow characteristics of the receivable (IFRS 9 4.1.2(b)).

18. According to IFRS 9 4.1.2(a), in order to measure a lease receivable at amortised cost, a lessor would have to hold the receivable in a business model with the objective of holding that receivable to collect contractual cash flows. The staff think that lessors would usually meet this condition; however, in some situations (eg if a lessor was planning to securitise the lease receivables), the condition may not be met. The staff think that it would be appropriate to measure the lease receivable at fair value if the lessor did not meet the business model condition.

19. However, the staff have greater concerns with the contractual cash flows condition in IFRS 9.4.1.2 (b). Specifically the staff are concerned with the implications of features typically included in lease contracts such as option periods, variable lease payment and residual value guarantees which could be considered more than 'solely payments of principal and interest' and therefore

could lead to a requirement to subsequently measure the entire lease receivable at fair value irrespective of an entity's business model.

20. Therefore, the staff thinks that applying IFRS 9 to the right to receive lease payments could mean that 'plain vanilla' lease contracts without any options, variable lease payments or residual value guarantees would be measured at amortised cost. However, lease receivables arising from many other 'non vanilla' lease contracts may be required to be measured at fair value.

21. Additionally, under IFRS 9 a lessor would not need to make a separate assessment for embedded derivatives; bifurcation of embedded derivatives from financial asset hosts within the scope of IFRS 9 is prohibited under IFRS 9. The requirements of IFRS 9 would always be applied to the lease receivable as a whole.

22. Finally, IFRS 9 contains a fair value option permitting an entity to measure a financial asset at fair value if doing so would eliminate or significantly reduce an accounting mismatch. Therefore, if the lease receivable was in the scope of IFRS 9, this fair value option could be elected by a lessor if a lease receivable was backing a liability measured at fair value, or an amount close to fair value (as could happen in the insurance industry).

Topic 825/Accounting for Financial Instruments project

23. Currently, under Topic 825, if the lease scope exception was removed, a lessor would always have an option to measure the lease receivable at fair value.

24. Under the proposed new guidance in the AFI project (which is still being deliberated by the FASB), the unrestricted fair value option in Topic 825 would be eliminated. An entity would be required to classify a financial asset or financial liability at either amortised cost or fair value on the basis of the cash flow characteristics of the instrument and the entity's business strategy. In addition, as part of this proposal, the FASB has tentatively decided to retain the embedded derivatives guidance in Topic 815-15. Therefore, if an embedded derivative is not clearly and closely related to its host contract (and other bifurcation requirements are met), the embedded feature would require bifurcation and measurement at fair value.

25. The staff thinks that the lease receivable would likely meet the AFI project 'characteristics of instrument' criteria (criteria a-c in paragraph 11 of this paper), meaning that it could be potentially be measured at amortised cost, and then would be required to be classified on the basis of the lessor's business strategy. The lease receivable would not meet the definition of a derivative, the lessor's initial investment in the lease will be returned by the end of the lease term through the lease payments made by the lessee, and the lessor would normally have a contractual right to fully recover its initial investment in the lease contract. However, under the proposed model in the AFI project a lessor would always have to assess each lease receivable to determine whether it meets the 'characteristics of instrument' criteria.

26. Regarding the additional business strategy criteria (the criteria in paragraph 12 of this paper), the staff thinks the lessor may be required to measure the lease receivable at fair value if it does not plan to hold the receivable to collect all of the cash flows. Such fair value measurement would mainly be required in the case of securitisations as discussed in paragraph 18 of this paper.

27. Finally, the FASB is still considering as part of the AFI project whether to include a restricted fair value option for financial assets. The staff think it is too early to draw any conclusions as to how this option could apply to the lease receivable as the board has not made any tentative decisions on this topic.

Staff analysis and recommendations

Inclusion of the lease receivable in the scope of financial asset measurement guidance

28. The staff thinks the boards first need to consider whether the lease receivable should be included in the scope of existing or proposed financial asset guidance for measurement purposes.

Potential results

29. Under IFRSs, receivables for 'plain vanilla' lease contracts could generally be measured at amortised cost (subject to the lessor's business model). However, the inclusion of variable lease payments, options or residual value guarantees

in a lease contract would generally trigger fair value measurement and the entire lease receivable would be required to be measured at fair value.

30. If the lease receivable was included in the scope of Topic 825, a lessor would always have an option to measure the lease receivable at fair value. Under the proposed AFI guidance, a lessor would generally measure the lease receivable at amortised cost unless it planned to securitise that receivable. Under either set of guidance, embedded derivatives that were not clearly and closely related to the host lease receivable would have to be bifurcated and measured at fair value.

Advantages of scope inclusion

31. Including the lease receivable in the scope of existing financial asset measurement guidance for measurement purposes has a number of advantages:

    (a) Consistent treatment of lease receivables with other financial assets;

    (b) A requirement for fair value measurement of securitised lease receivables (under IFRS 9 and the proposed AFI guidance), which provides more decision useful information based on the analysis discussed in the FI projects;

    (c) An option for fair value measurement to remove accounting mismatches (under IFRS 9 and Topic 825, and possibly the proposed AFI guidance); and

    (d) Fair value measurement, if permitted under existing financial asset guidance, could result in more relevant information for lease contracts with variable lease payments, options and residual value guarantees because the value of those components of a lease contract can vary greatly over the contract life.

Disadvantages of scope inclusion

32. However, the staff has a number of concerns with including the lease receivable in the scope of existing and proposed financial asset measurement guidance. First of all, fair value measurement (whether required, as under IFRS 9 or permitted, as under Topic 825) would be inconsistent with the

boards' previous tentative decisions regarding measurement of the right to receive lease payments if the lease contract included variable lease payments or options. The boards previously decided that a lessee or a lessor would limit the inclusion of variable lease payments and options in the measurement of the lease receivable. Either through bifurcation or fair value measurement of the entire lease receivable, these features would be subject to fair value measurement. Fair value measurement would be costly and complex, requiring reassessment and estimations every reporting period.

33. Fair value measurement could also result in a Day 1 gain or loss if there was a difference between the initial measurement of a lease receivable under the proposed guidance (the present value of lease payments discounted using the rate implicit in the lease) and the fair value of that receivable.

34. Moreover, the financial asset measurement guidance in IFRSs and US GAAP is not converged and referring to such guidance will, in many cases, result in different subsequent measurement of the lease receivable under IFRSs and US GAAP. IFRSs and US GAAP have different criteria for fair value measurement and the restrictions around fair value options. IFRSs and US GAAP also have different guidance regarding bifurcation of embedded derivatives in hybrid financial assets.

35. Additionally, under US GAAP, the proposed accounting for classification and measurement in the AFI project is still being deliberated and is subject to change. The staff think it is too early to see how this guidance will be applied to the lease receivable with any certainty.

Staff recommendation

36. Given the boards' tentative decisions and the other reasons discussed in paragraphs 32-35, the staff does not recommend that the right to receive lease payments be included in the scope of existing financial asset guidance regarding initial and subsequent measurement.

Question 1
Do the boards agree with the staff recommendation that the right to receive lease payments not be included in the scope of existing financial asset guidance regarding initial and subsequent measurement?

Inclusion of a fair value measurement requirement or option for the lease receivable in the leases standard

37. If the boards decide to exclude the right to receive lease payments from the scope of existing financial asset guidance for measurement purposes, there is a question about including guidance in the leases standard itself to require or permit fair value measurement of the lease receivable in some circumstances. The staff considered two different ways that the boards could require or permit fair value measurement of the lease receivable:

    (a) including a business model condition for fair value measurement, and

    (b) including a fair value option for lease receivables.

Inclusion of a business model condition for fair value measurement

38. As discussed previously, at the April 2011 joint board meeting in Agenda Paper 1L/FASB Memo 166, some staff recommended that lease receivables be subsequently measured at fair value depending on a lessor's business model or business strategy. The staff think the boards could consider the inclusion of such a 'business model' condition for fair value measurement even if they choose not to require the lease receivable to be in the scope of existing financial asset guidance. Such a condition would require fair value measurement of lease receivables if a lessor's business model was not to hold the receivable for collection of contractual cash flows.

39. The addition of a 'business model' condition to the leases guidance could result in greater consistency with both IFRS 9 and the proposed AFI guidance. Both sets of guidance essentially require that, when an investor's business model is such that it does not intend to hold a financial asset to collect contractual cash flows, that financial asset must be measured at fair value. Such a 'business model' condition, if included in the final standard, could

require lessors intending to securitise their receivables or to otherwise sell them to measure them at fair value. The staff think there are advantages to including such a condition in the final leases standard. Fair value measurement of these lease receivables may more faithfully reflect the economics of the lease transaction in the case of subsequent derecognition through securitisation. The condition would result in more consistent accounting for all financial assets not held to collect contractual cash flows and produce more relevant information.

40. Moreover, the staff think that the 'business model' condition could be drafted in such a way that it would require fair value only in very limited circumstances in practice, reducing the burden of fair value measurement to only those cases when the information is most relevant. Additionally, the staff do not think that requiring such receivables to be measured at fair value would result in significant additional cost for lessors as lessors who monetise their receivables are likely to have knowledge of the fair value of those receivables already.

41. However, there are disadvantages to including such a condition:

    (a) Requiring fair value measurement when the business model condition is met would result in incomparability with other lessors' lease receivables.

    (b) In most cases, lessors securitise their receivables very quickly after originating them. There would, therefore, be very little timing differences in recognising the fair value measurement gain at lease commencement versus when the receivable was securitised/derecognised.

    (c) Lessors may incur additional costs by having to prove that their business model does not meet the condition for fair value measurement.

    (d) Having a second measurement basis for the lease receivable would introduce complexity into the final standard.

(e) As discussed in paragraph 32, fair value measurement may be inconsistent with the boards' earlier decisions regarding variable lease payments, options and residual value guarantees.

(f) Including just part of the guidance from IFRS 9/proposed AFI guidance would result in the guidance in the leases standard only being partially consistent with the IFRS 9/proposed AFI guidance.

(g) Introducing a condition requiring fair value measurement only in limited circumstances may encourage structuring to achieve or avoid fair value measurement.

(h) Such a condition would not be consistent with Topic 825, the current US GAAP financial asset guidance that allows an unrestricted fair value option for financial assets and does not contain business model guidance.

(i) The AFI guidance is still being deliberated and is therefore subject to change. There is a risk that a business model condition would not be consistent with the FASB's final measurement guidance for financial instruments.

Staff recommendation

42. While the majority of the staff see the advantages of applying fair value measurement to lease receivables in some cases, they think the disadvantages of including a requirement for fair value measurement of lease receivables outweigh the advantages. Therefore, the staff does not recommend including a business model condition requiring fair value measurement of the lease receivable in the final standard.

43. Additionally, these staff members note that there was not significant feedback from respondents requesting a requirement for the lease receivable to be accounted for as a financial instrument.

44. A minority of the staff recommend that a business model condition be included in the final standard. These staff members think that lessors who intend to securitise their lease receivables should measure them consistently with other financial assets. They also think that the practicality and cost considerations in

developing the leases standard are less relevant for lessors whose business model is to securitise lease receivables because they are sophisticated preparers.

Question 2
Should fair value measurement be required for lease receivables if a lessor's business strategy is not to hold the receivable for collection of contractual cash flows?

Inclusion of an option for fair value measurement

45. The staff also considered including an option in the leases standard permitting fair value measurement of the lease receivable. A fair value option for financial assets exists in both IFRS 9 and Topic 825. IFRS 9 gives entities an option to measure financial assets at fair value if by doing so the entity would avoid an accounting mismatch. Topic 825 provides an unrestricted fair value option for financial assets. The FASB has tentatively decided not to include an unrestricted fair value option for financial assets in the AFI project but is still considering whether a restricted fair value option (eg for hybrid financial assets or for financial assets and financial liabilities that are managed on the basis of a reporting entity's net exposure to market risks) should be contained in the proposed guidance.

46. The staff think that there are advantages to including a fair value option for the lease receivable in the final leases standard. The option would provide flexibility and cost-benefit concerns would be mitigated as the option could be elected by lessors as they thought appropriate. An 'accounting mismatch' fair value option as exists in IFRS 9 could provide a solution for the issue of the insurance accounting mismatch (and any other accounting mismatches arising when lease assets are measured at amortised cost). However, the deliberations on the insurance project are not yet complete and the staff have not come across examples of other mismatches so the benefits of such an option for reducing accounting mismatches could be limited.

47. There are also disadvantages to including a fair value option. If both boards elected the same fair value option, such an option would result in inconsistency with either existing IFRSs or US GAAP guidance. The inconsistency would be further aggravated if the AFI project completely removed the fair value

option for financial assets, or introduced a restricted fair value option for financial assets that would not be the same as the fair value option in IFRS 9. There is also the risk of a non-converged answer if, for example, just the IASB elected a fair value option to be consistent with IFRS 9 or each of the boards elected a fair value option that would be consistent with their respective financial asset guidance.

48. Introducing a fair value option would also contain some of the disadvantages discussed in paragraph 41. Introducing such an option would result in inconsistency in accounting for different lease receivables, which is not helpful to users of financial statements, and would introduce additional complexity in the leases standard. Moreover, there was limited support from constituents for the addition of a fair value option.

49. The staff think the disadvantages of a fair value option outweigh the advantages and would not recommend introducing a fair value option for the lease receivable in the leases standard.

Question 3
Do the boards agree to not include a fair value option in the leases standard?

Appendix A

IFRS 9 provides guidance regarding the contractual cash flows condition as follows:

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

B4.1.7 Paragraph 4.1.1 requires an entity (unless paragraph 4.1.5 applies) to classify a financial asset as subsequently measured at amortised cost or fair value on the basis of the contractual cash flow characteristics of the financial asset that is in a group of financial assets managed for the collection of the contractual cash flows.

B4.1.8 An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated (see also paragraph B5.7.2).

B4.1.9 Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include leverage. Thus such contracts do not meet the condition in paragraph 4.1.2(b) and cannot be subsequently measured at amortised cost.

B4.1.10 Contractual provisions that permit the issuer (ie the debtor) to prepay a debt instrument (eg a loan or a bond) or permit the holder (ie the creditor) to put a debt instrument back to the issuer before maturity result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:

(a) the provision is not contingent on future events, other than to protect:

(i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or

(ii) the holder or issuer against changes in relevant taxation or law; and

(b) the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

B4.1.11 Contractual provisions that permit the issuer or holder to extend the contractual term of a debt instrument (ie an extension option) result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:

(a) the provision is not contingent on future events, other than to protect:

(i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations) or a change in control of the issuer; or

(ii) the holder or issuer against changes in relevant taxation or law; and

(b) the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.

B4.1.12 A contractual term that changes the timing or amount of payments of principal or interest does not result in contractual cash flows that are solely principal and interest on the principal amount outstanding unless it:

(a) is a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding; and

(b) if the contractual term is a prepayment option, meets the conditions in paragraph B4.1.10; or

(c) if the contractual term is an extension option, meets the conditions in paragraph B4.1.11.

…

B4.1.15 In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b) and 4.1.3 of this IFRS.

B4.1.16 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, the contractual cash flows may include payment for factors other than consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. As a result, the instrument would not satisfy the condition in paragraph 4.1.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

B4.1.17 However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraph 4.1.2(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraph 4.1.2(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

B4.1.18 If a contractual cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

B4.1.19 In almost every lending transaction the creditor's instrument is ranked relative to the asset of the debtor's other creditors. An instrument that is subordinated to other asset may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.