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Project	**Leases**		
Paper topic	Lessor accounting: measurement of the underlying asset when a lease terminates prematurely		
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Introduction

1. At the May 2012 joint board meeting during the *Financial Instruments – Impairment* project discussion, the Boards discussed the application of the proposed expected credit loss model to lease receivables.
2. At that time, the staff indicated that the leases team would consider the broader issue of the interaction between the accounting for the lease receivable, the impairment of the lease receivable and the asset underlying the lease, if that asset were to be returned to the lessor before the end of the lease term.
3. Consequently, this issue relates to how the lessor would initially measure the underlying asset when:

   (a) it applies the receivable and residual approach; and

   (b) the lease terminates before the end of the expected lease term, resulting in the lessor reclaiming the underlying asset and re-recognising the underlying asset earlier than expected.

4. The boards have previously made tentative decisions regarding remeasurement of the lease receivable and residual asset when the lease period changes as a result of reassessment of purchase options and options to extend or terminate the lease. We do not think that this paper addresses the same issue as remeasurement of the

lease receivable or residual asset during the lease term, because this issue relates to the initial measurement of the **underlying asset** when it is re-recognised by the lessor before the end of the lease term.

Analysis of the options for measuring the underlying asset on re-recognition

The possible alternatives for measurement at re-recognition

5. The staff have identified three options for the boards' consideration:

   (a) **Option X:** Fair value

   (b) **Option Y:** Carrying Amount of Lease-Related Assets

   (c) **Option Z:** Revised value

6. The staff has also included a fact pattern in Appendix A to this paper to illustrate how we think the measurement of the underlying asset would be calculated under the options presented.

7. For each of the options presented, in addition to any impairment testing of the lease receivable during the lease term, immediately before the lessor reclaims the underlying asset, the lessor would measure the impairment allowance for the lease receivable in accordance with the proposed financial instrument impairment guidance. Consequently, because the lessor will no longer receive all of the lease receivable (ie the financial asset) at the time that the lease terminates prematurely, the lessor would record any impairment loss by comparing:

   (a) the carrying amount of the lease receivable; and

   (b) the fair value of the portion of the underlying asset related to the lease receivable (ie the collateral) plus any cash expected on termination.

Option X: Fair Value

The mechanics of how this option works

8. At the point in time when the lease terminates prematurely, the lessor would derecognise the 'lease-related assets' (ie, the lease receivable and the net residual asset) and re-recognise the underlying asset at its fair value. The difference between the carrying amount of the lease-related assets derecognised and the fair value of the underlying asset re-recognised is the gain or loss to be recognised when the underlying asset is returned to the lessor.
9. Refer to Appendix A for an illustrative example of how the mechanics would apply under this option.

Rationale

10. The receivable and residual approach requires that a lessor must derecognise the underlying asset and recognise a lease receivable (a financial asset), and a residual asset (a nonfinancial asset) at lease commencement.
11. When the lease terminates prematurely, Option X views the transaction as the initial recognition of a new asset, ie the underlying asset, in exchange for the lease receivable and the residual asset.
12. When initially recognising an item of property, plant and equipment, IAS 16 *Property, Plant and Equipment* paragraph 24 states:

> One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired item is measured in

> this way even if an entity cannot immediately derecognise the asset given up. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

13. Consequently, Option X's rationale is based on the principle that:

    (a) the recognition of the underlying asset is the initial recognition of a new item of property, plant and equipment; and

    (b) items of property, plant and equipment that are acquired in exchange for monetary and non-monetary assets are initially measured at fair value.

Advantages and disadvantages of Option X

14. The advantages of applying Option X are that:

    (a) It is a simple method that provides an underlying asset value that is relevant and understandable to users of financial statements.

    (b) The rationale is similar to that applied in finance leases today under IFRSs. In other words, if a lessor reclaimed the underlying asset on termination of a finance lease, it would recognise the underlying asset at fair value.

15. The disadvantages of applying Option X are that:

    (a) it will result in any deferred profit on the residual asset being recognised when the underlying asset is re-recognised. The boards' previous tentative decision on the deferral of any profit on the residual asset was based on the rationale that this profit is not realised until the underlying asset is sold or re-leased. Applying Option X would mean that any deferred profit on the residual asset would be recognised before the profit from the residual asset is recoverable from a third party.

    (b) it can potentially allow for a net gain from the repossession of the underlying asset and some may question why an entity would record a gain (ie 'good news') as a result of a lessee terminating the lease contract (ie 'bad news'). However, on the basis of limited discussions that we have held, we understand that the termination of a lease prematurely typically results in a loss for the lessor, rather than a gain.

Option Y: Carrying Amount of Lease-Related Assets

The mechanics of how this option works

16. As explained in paragraph 7 above, immediately before the lessor re-recognises the underlying asset, the lessor would measure the impairment allowance for the lease receivable in accordance with the proposed financial instrument impairment guidance.
17. When the lease terminates prematurely, after performing the impairment test for the lease receivable, the lessor reclassifies the lease receivable and the net residual asset as the underlying asset. In other words, the lessor measures the underlying asset at the carrying amount of the lease-related assets. Consequently, this option would never result in a gain being recognised on the residual asset as a result of the lease terminating prematurely.
18. The early termination of the lease is likely to be an indicator of impairment of the underlying asset. Consequently, when the underlying asset is re-recognised, it would be tested for impairment under IAS 36 *Impairment of Assets*/Topic 360 *Property, Plant, and Equipment* in the *FASB Accounting Standards Codification*®. The requirement to test the underlying asset for impairment when it is re-recognised would ensure that there is no unrecognised impairment under this option.
19. Refer to Appendix A for an illustrative example of how the mechanics would work under this option.

Rationale

20. The receivable and residual approach requires that a lessor must derecognise the underlying asset, and recognise a lease receivable (a financial asset) and a residual asset (a nonfinancial asset) at lease commencement. Because the portion of the underlying asset represented by the financial instrument (ie the lease receivable)

has different characteristics to the non-financial portion (ie the residual), the two components of the underlying asset are measured differently and presented separately in the balance sheet or the notes. However, the two assets continue to represent the underlying asset—the current tentative decisions align with this rationale because the current tentative presentation proposals would require the lease receivable and residual asset to be presented together as 'lease assets', with a breakdown of the lease assets that relate to the receivable and residual either on the face of the balance sheet or in the notes.

21. Consequently, this option views re-recognising the underlying asset as nothing more than a reclassification of the two assets (ie the collateral on the lease receivable and the residual asset) that represent the underlying asset. The fact that the two components of the reclassification were previously measured on different bases is consistent with the way in which the receivable and residual model is initially applied.

Advantages and disadvantages of Option Y

22. The advantages of applying Option Y are that:

    (a) It is simple to understand and to apply.

    (b) It is consistent with boards' tentative decision not to recognise profit on the residual asset, ie the deferred profit on the residual asset is not recognised under this option.

    (c) It has a basis that is partially consistent with a lessor's accounting for lease modifications under US GAAP.

    > **840-30-40-7** A termination of a lease shall be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and charging the net adjustment to income of the period.

23. The disadvantages of applying Option Y are that:

    (a) If the fair value of the portion of the underlying asset related to the lease receivable (ie the collateral on the lease receivable) is greater than the carrying amount of the lease receivable, the lessor would not recognise any gain when the underlying asset is re-recognised. This is not consistent with the way that collateral on a financial asset would be measured on initial recognition. However, on the basis of limited discussions that we have held, we understand that the termination of a lease prematurely typically results in a loss for the lessor, rather than a gain. When a loss is recognised, the portion of the underlying asset related to the lease receivable would be measured at fair value, which is consistent with the way that collateral on a financial asset would be measured on initial recognition.

(b) The boards' previous tentative decision on the deferral of any profit on the residual asset was based on the rationale that this profit is not realised until the underlying asset is sold or re-leased. Applying Option Y would mean that any of the profit that was recognised on the initial recognition of the lease receivable is, in effect, no longer realised at the date that the lease is terminated prematurely. Nonetheless, this 'unrealised' profit is not reversed (this would generally only be the case for manufacturer lessors, because 'finance-only' lessors, typically, do not recognise profit at lease commencement).

Option Z: Revised value

The mechanics of how this option works

24. When the lease terminates prematurely, the lessor calculates a revised rate implicit in the lease (the rate actually earned on the abbreviated lease) based on the fair value of the underlying asset at that time. The lessor uses the revised inputs to compute what the deferred profit on the residual asset **would have been** at lease commencement as if the lessor had known that the lease would terminate prematurely at that time.

25. The lessor calculates the revised net residual asset by subtracting the revised deferred profit from the fair value of the underlying asset at the time of repossession.
26. The difference between the carrying amount of the lease-related assets (after recording any impairment under the proposed financial instrument impairment guidance) and the revised net residual value is recognised as a gain or loss from early termination of the lease. The revised net residual value is the amount at which the lessor will re-recognise the underlying asset. The gain or loss recognised represents:
    (a) the reversal of any impairment that was recognised as a result of the proposed financial instrument impairment guidance;
    (b) the reversal of the portion of the profit that, with hindsight, should not have been recognised at lease commencement; and
    (c) the original carrying amount of the lease receivable and the gross residual asset at the date that the lease terminates, compared to what the underlying asset's fair value actually is at the date that the lease terminates.
27. Refer to Appendix A for an illustrative example of how the mechanics would work under this option.

Rationale

28. The boards' previous tentative decision on the deferral of any profit on the residual asset was based on the rationale that this profit is not realised until the underlying asset is sold or re-leased. This approach is consistent with that tentative decision, because it eliminates any profit that was previously recognised and which is no longer realised at the date that the lease is prematurely terminated.
29. Under the receivable and residual approach, the lease is viewed as a sale of a portion of the underlying asset. Option Z views the premature termination of the lease as analogous to the lessee returning a portion of the underlying asset that the

lessor had initially accounted for as sold. Consequently, the rationale for Option Z is similar to the accounting that some staff think would be acceptable when accounting for a return of inventory, ie this option attempts to re-recognise the underlying asset on a cost basis.

Advantages and disadvantages of Option Z

30. The advantages of applying Option Z are that:

(a) It restricts the profit on the portion of the underlying asset that is ‘sold’ to the amount that is actually realised. Restricting the profit to reflect the relative proportion of the asset ‘sold’ is consistent with the initial measurement of the net residual asset under the receivable and residual approach.

(b) It restricts the value of the residual asset to an amount based on cost, which would be the carrying value of the residual asset at the end of the shortened lease term if the lessor had had perfect information at lease commencement.

31. The disadvantages of applying Option Z are that:

(a) The accounting mechanics are complex because Option Z requires the use of hindsight to reflect the transaction as if the lessor had known at lease commencement that the lease would be terminated prematurely.

(b) The impairment testing for the lease receivable under the proposed financial instrument impairment guidance would not be consistent with the way in which the underlying asset is initially measured on re-recognition. In other words, any accounting effect as a result of performing the financial instrument impairment testing on the lease receivable (as explained in paragraph 7 above) would be reversed out under this option. Some think that it would be inconsistent to apply the financial instrument impairment approach for a partial impairment of the lease receivable, but then to ignore the financial instrument impairment approach when the underlying asset is re-recognised as a result of a total impairment of the lease receivable.

(c) It can potentially allow for a net gain from the repossession of the underlying asset where the fair value of the underlying has increased significantly and some may question why an entity would record a gain (ie 'good news') as a result of a lessee terminating the lease contract (ie 'bad news'). However, on the basis of the types of leases subject to the receivable and residual approach, we think that the possibility of this occurring in practice would be rare.

Staff recommendation

32. The staff recommends Option Y for the reasons stated above.

Question for the Boards
Do the Boards agree with the staff recommendation that, when a lessor re-recognises the underlying asset when the lease terminates before the end of the expected lease term, the underlying asset is measured as the sum of the carrying amount of the lease receivable (after any impairment) and the net residual asset?

Appendix A – Examples of the application of the three options in this paper

Initial lease schedule before expected lease term terminates prematurely

Fact pattern - Lease Terms	
Lease Term	3
Useful Life	6
Annual Fixed Payment (at end of each year)	30
Expected Residual Value	55
FV of Underlying	120
Cost Basis of Underlying	100
Gross Residual (PV of estimated residual)	43
Interest Rate (implicit)	8.38%

This is the Expected Residual Value at the end of the lease term plus the last year's payment as follows:

Cash in last year:	30
FV of underlying asset at the end of the lease	55
Total expected inflow at end of the lease	85

Year	Investment	Cash	Lease Receivable	Interest Income	Gross Residual Asset	Deferred Profit	Net Residual Asset	Residual Accretion	Net Income
0	-120		77		43	-7	36		13
1	30	30	53	6	47	-7	40	4	10
2	30	30	28	4	51	-7	44	4	8
3	85	30	0	2	55	-7	48	4	7
TOTAL		**90**		**13**				**12**	**38**

Cost	100
Net Residual	36
COGS	**64**

Revenue	77
COGS	64
Gain	**13**

Deferred profit calcualtion	
FV of underlying asset	120
PV of lease receivable	77
Percentage of FV realised	64%
Cost of underlying asset	100
Portion to derecognise	64
Net residual asset	36
Compared to gross residual asset	43
Deferred profit	(7)

Day One Journal Entry

Lease Receivable	77	
Gross Residual Asset	43	
COGS	64	
Underlying Asset		100
Revenue		77
Deferred Profit on residual		7

The net of these two numbers is the net residual of 36

Updated fact pattern at the end of year 1 when the lease terminates prematurely

Fair value of underlying asset at year 1 (assumed)	80
Portion of that fair value that relates to the receivable (assumed):	32

One way of calculating the portion of the underlying asset's fair value that relates to the receivable could be by calculating the discounted cash flows that the lessor could obtain at the end of year 1 for the remaining lease term, ie what is the present value of the next 2 years' worth of lease payments when the lease terminates prematurely.

Journal Entry for Impairment under proposed Financial instrument impairment guidance immediately before lease terminates

impairment Loss	21		
Lease receivable		21	**[53 - 32]**

So the lease receivable immediately before the underlying asset is re-recognised is 32

Option X - Fair Value

Underlying Asset	80	
Deferred Profit	7	
Lease Receivable		32
Gross Residual Asset		47
Gain on Repossession		8

So the 'Gain on repossession' is the balancing figure and represents the difference between:
a) the carrying amount of the lease receivable and the net residual asset at the date of repossession **[32 + 40]**; and
b) the fair value of the underlying asset at the date of repossession **[80]**

Option Y - Carrying Amount of Lease-Related Assets

Underlying Asset (net residual)	40	
Deferred Profit	7	
Gross Residual Asset		47
Underlying Asset (lease receivable)	32	
Lease receivable		32

So the "Underlying asset" is the aggregate of:
a) the carrying amount of the lease receivable at the date of repossession (after any impairment based on the financial instrument impairment guidance) **[32]**; plus
b) the carrying amount of the net residual asset at the date of repossession **[40]**.

Option Z - Revised values

We need to set up a revised lessor schedule to be able to see what the accounting would have been if the lessor had perfect information:

Year	Investment	Cash	Lease Receivable	Interest Income	Gross Residual Asset	Revised Deferred Profit	Net Residual Asset	Residual Accretion	Net Income
0	-120		33		87	-14.5	73		0
1	110	30	0	-3	80	-14.5	66	-7	-10
2									
3									
TOTAL		**30**		**-3**				**-7**	**-10**

Revised values at lease commencement assuming the lessor knew of the repossession at that time:

Revised implicit rate	-8.33%	
Revised lease receivable	33	
Revised gross residual	87	
Underlying asset	66	
Loss on repossession	6	
Deferred profit	7	
Gross residual		47
Lease receivable		32

So the 'Loss on repossession' is the balancing figure and represents the difference between:

a) the carrying amount of the lease receivable and net residual asset at the date of repossession **[32 + 40]**; less

b) the revised underlying asset assuming that the lessor had known about the revised lease terms at the date of lease commencement **[66]**.

<u>The loss on repossession is made up of two pieces:</u>

(1) The reversal of a portion of the profit that was recognised initially:

Day 1 gain originally recognised -	13
What should have been recognised -	6
Loss	**7**

(2) The change in the fair value of the underlying asset from:

What was expected initially at the date of repossession -	100
What it actually is at the date of repossession -	80
Loss	**20**
Loss before considering impairment of lease receivable	**27**
Less: reversal of impairment loss already recognised	**(21)**
Net loss on repossession	**6**

This is the Fair value of the underlying asset at the end of the revised lease term plus the last year's payment as follows:

Cash in last year:	30
FV of underlying asset at time of repossession:	80
Value obtained at date of repossession	110

<u>Deferred profit calcualtion</u>

FV of underlying asset	120
PV of lease receivable	33
Percentage of FV realised	27%
Cost of underlying asset	100
Portion to derecognise	- 27
Net residual asset	73
Compared to gross residual asset	87
Deferred profit	(14.5)