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STAFF PAPER

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Project	**Financial Instruments: Impairment**		
Paper topic	Impairment of lease receivables		
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Introduction

1. The boards have tentatively decided to require an entity to assess the impairment of lease receivables consistent with *existing* financial instruments standards. The question this paper attempts to address is whether an entity should apply the boards' *proposed* impairment requirements (ie the 3 Bucket model) to lease receivables and, if so, how. Thus, this paper discusses the application of the boards' proposed 3 Bucket impairment model to:
   (a) lease receivables recognised by a lessor as per the boards' tentative decisions in the leases project.
   (b) lease receivables recognised by a lessor under IAS 17 *Leases* and FASB Accounting Standards Codification® Topic 840 in US GAAP.
2. The staff recommends that an entity should assess and measure the impairment allowance in accordance with the proposed 3 Bucket model for lease receivables:
   (a) recognised under the proposed leases model (paragraph 21).
   (b) recognised by a lessor under IAS 17 *Leases* and Subtopic 840-30 (paragraph 24).

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Background

3. Finance leases (IFRSs) and capital and leveraged leases (US GAAP) today result in the recognition of a lease receivable by the lessor. Impairment is covered by IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39 paragraph 2(b)(1)) in IFRS and Topic 310 (paragraph 310-10-15-2).

4. The boards have tentatively decided in the leases project that:

   (a) a lessor would not be required to recognise lease receivables for leases with a term of one year or less (short-term leases).

   (b) a lessor would not be permitted to recognise lease receivables for leases of investment property.

   (c) a lessor should initially measure the right to receive lease payments at the present value of the lease payments, discounted using the rate that the lessor charges the lessee, and subsequently measure it at amortised cost applying an effective interest method (see paragraph **Error! Reference source not found.**). Additionally there should not be an option for fair value measurement of the right to receive lease payments.

   (d) a lessor should refer to existing financial instruments standards (IAS 39 and Topic 310) to assess the impairment of that right to receive lease payments.

   (e) a lessor should recognise immediately in profit or loss changes in the right to receive lease payments due to reassessments of variable lease payments that depend on an index or a rate.

5. The staff have included a summary of tentative decisions related to the 3 Bucket model in IASB Agenda Paper 5/FASB Memorandum 154.

6. The staff note that because lease receivables with a term of one year or less are not required to be recognised, this paper focuses on lease receivables with a term in excess of one year.

Applying 3 Bucket model to proposed leases model

7. The staff have identified the following alternatives:

   (a) Measure the impairment allowance in accordance with the full 3 Bucket model (paragraphs 9-17);

   (b) Allow entities to measure the impairment allowance at initial recognition and subsequently on the basis of lifetime expected losses (ie similar to the tentative decision for trade receivables with a significant financing component[1]) (paragraphs 18-20).

8. This paper only includes analysis of these alternatives, which focus on achieving some level of comparability in impairment measurement between lease receivables and other financial assets at amortised cost. The alternative would be for the leases project to develop the impairment measurement for lease receivables. That analysis could include carrying forward the incurred loss model used today.

Measuring impairment under 3 Bucket model

9. Applying the 3 Bucket impairment model to lease receivables would require entities to classify lease receivables between the three buckets and to measure expected credit losses for Bucket 1 at 12 months expected losses and for Buckets 2 and 3 at lifetime expected losses.

   Can it be done? If so, how?

10. The staff note that the tentative decisions made in the leases project result in a leases receivable that is measured similarly to, but not the same as, financial assets at amortised cost including differences in the application of the effective interest method. The cash flows included in lease contracts could include features such as contingent payments that would not be present in financial instruments subject to impairment accounting under IFRS 9 *Financial Instruments* or the

[1] As defined in the ED 2011/6 *Revenue from Contracts with Customers* (the Revenue ED).

tentative joint decisions of the boards in the classification and measurement project to date.

11. Under IFRS 9 and the tentative joint decisions of the boards in the classification and measurement project, only financial instruments with cash flows that represent the payment of principal and interest (representing the time value of money and credit risk) would be subject to accounting for credit impairment. An entity would be required to measure other financial instruments at fair value. In the leases project the boards concluded that an entity should not measure lease receivables at fair value and therefore decided to exclude lease receivables from the scope of IFRS 9. However, the existence of contingent and variable lease payments results in:

    (a) specific requirements for identifying the cash-flows included in the measurement of the lease receivable (such as criteria for including contingent lease payments, treatment of renewal options and the bifurcation of any embedded derivatives); and

    (b) a consequent effect on determining the discount rate (ie given (a), the discount rate cannot always be determined the same way as the effective interest rate for a financial asset at amortised cost).

12. Although the measurement for some lease receivables will be different from other financial assets measured at amortised cost as discussed above, the staff do not think that is a reason to apply a different model. In the same way, the boards' proposed impairment model will apply to financial assets measured at amortised cost under US GAAP and IFRS, even though those measures are slightly different. In the staff's view, the 3 Bucket model could be applied to lease receivables as long as:

    (a) the cash flows assessed for impairment are consistent with those included in the measurement of the lease receivable; and

    (b) the rate used to discount the expected cash shortfalls is consistent with the rate proposed under the 3 Bucket model.

13. The above could be accomplished by identifying the cash flows and the discount rate in the leases standard, and then applying the 3 Bucket impairment approach by deeming these as the contractual cash flows and effective interest rate to be used for the impairment assessment. That is, cash flows such as contingent payments not included in the lease receivables should not be included in the impairment assessment.

14. Under the proposed receivable and residual approach, a lessor would recognise a lease receivable and a residual asset representing components of the leased asset. By the nature of the lease, the lease receivable is "collateralized" by the leased asset because the lessor owns the lease asset and will reclaim that asset in the event of default. As a result, the value of the "collateral" related to the "right of use" asset underlying the lease receivable should be considered when measuring the impairment allowance.[2]

Should it be done?

15. The boards' tentative decisions in the leases project will change the population of lease receivables. In general, depending on how leases would be structured, it is expected that the population would increase due to the inclusion of some lease receivables for leases currently classified as operating leases[3].

16. The advantage of applying the 3 Bucket model to lease receivables would be a consistent model for impairment of lease receivables and financial assets measured at amortised cost. The staff have not identified any distinguishing characteristic between lease receivables and financial assets at amortised cost that would indicate measuring impairment under the 3 Bucket model would be appropriate for one but not the other. Lease receivables are typically secured over the leased assets, while the security and collateral characteristics vary between other financial assets. The staff do not consider this to imply that a different impairment approach should be required, because any collateral is taken into

[2] The leases team will consider the broader issue of the interaction between the receivable, the impairment of the receivable, and the asset underlying the lease that would be ultimately be returned before the end of the lease term.

[3] Subject to the scope decisions noted in paragraphs 4(a) and (b) above.

account in the measurement of the expected loss. Also, many other financial instruments subject to impairment accounting are secured over collateral.

17. The disadvantage will be the additional cost of moving from an incurred loss model to an expected loss model, including the tracking of credit deterioration required to apply the 3 Bucket model. From the limited outreach performed, the staff think that the additional cost to move to the 3 Bucket model would be similar to the cost that would be incurred by entities with other financial assets at amortised cost. It appears that it may be easier for lessors that are regulated in a manner similar to banks to apply the proposals than for lessors that are not. However, this difference can also be found among entities holding other financial assets including those that have trade receivables.

Allow lifetime expected losses as practical expedient

18. The boards have previously decided to allow an entity to elect to apply either the full 3 Bucket model or to measure lifetime expected losses from initial recognition for trade receivables with a significant financing component. The boards noted that allowing this option for trade receivables would reduce comparability. However, it would alleviate some of the practical concerns of tracking credit deterioration for trade receivables. Generally, in the staff's view, lifetime expected credit losses should not be recognised *at initial recognition* for instruments that are priced at market.

19. The staff note, that the population of lessors is smaller than the population of entities with trade receivables and the financing activities of lessors more closely resemble the activities of banks. There is also some overlap between the populations of lessors and banks which might make it easier for a small set of entities to apply a consistent impairment model for both lease receivables and other financial assets because of their internal systems. Thus the staff think that the balance between comparability and the cost of implementing the 3 Bucket model is different from the balance sought for trade receivables.

20. Given the above, the staff think that the benefits of achieving comparability between the accounting for lease receivables and the accounting for financial assets at amortised cost outweigh the costs to implement the proposals. Thus the staff do not recommend allowing a choice of applying the full 3 Bucket model or always measuring lifetime expected losses for impairment of lease receivables.

Staff recommendation

21. Based on the above, the staff recommends that an entity should assess and measure the impairment allowance for lease receivables in accordance with the proposed 3 Bucket model. As discussed in paragraph 13, this could be accomplished by identifying the cash flows and the discount rate in the leases standard, and then applying the 3 Bucket impairment approach by deeming these as the contractual cash flows and effective interest rate to be used for the impairment assessment.

Question 1
Do the boards agree with the staff recommendation that an entity should assess and measure the impairment allowance in accordance with the proposed 3 Bucket model for lease receivables recognised under the proposed receivable and residual leases model?

Applying 3 Bucket model to lease receivables under IAS 17 *Leases* and Topic 840

22. In the staff's view the analysis above would apply similarly to lease receivables under IAS 17 and Topic 840; however the population of lease receivables will be limited to those currently classified as finance leases under IAS 17 and Subtopic 840-30. Short-term finance lease receivables are required to be recognised under IAS 17 and Subtopic 840-30, and not under the proposed leases requirements, but in the staff's view this would not result in a significant difference, as short-term *finance leases* are rare in practice. Thus in the staff's view the cost to implement

would be expected to be lower for lease receivables under existing standards than for lease receivables under the lease proposals because the population would probably be smaller.

23. Lease receivables can also arise from operating leases if amounts recognised as income during the year are due and payable at the reporting date. For this subset the staff think the issues are similar to trade receivables without a significant finance component, and thus the staff recommend the board should require the same simplified approach, ie that impairment should be measured on the basis of lifetime expected losses.

24. Thus the staff recommends that an entity should assess and measure the impairment allowance in accordance with the proposed 3 Bucket model for lease receivables recognised under IAS 17 and Topic 840.

Question 2

Do the boards agree with the staff recommendation that an entity should:

(a) assess and measure the impairment allowance in accordance with the proposed 3 Bucket model for finance lease receivables recognised under IAS 17 and capital lease receivables recognised under Topic 840; and

(b) measure the impairment allowance at lifetime expected losses for operating lease receivables recognised under IAS 17 and Topic 840?