STAFF PAPER

17 October 2013

Prepared for Capital Markets Advisory Committee meeting

Project	**Leases**		
Paper topic	Lessor accounting proposals		
CONTACT(S)	Patrina Buchanan	pbuchanan@ifrs.org	+44 (0)20 7246 6468

This paper has been prepared by staff of the IFRS Foundation. The views expressed in this paper reflect the individual views of the author[s] and not those of the IASB or the IFRS Foundation. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Introduction

1. In May 2013, the IASB and the FASB (the boards) published a revised Exposure Draft *Leases* (the 2013 ED) for public comment. The comment period ended on 13 September 2013. To date, the boards have received just over 600 comment letters.

2. The 2013 ED proposed changes to both lessee accounting and lessor accounting. We have obtained valuable input from the Capital Markets Advisory Committee over the past few years about the changes proposed to lessee accounting. We have not, however, discussed the changes proposed to lessor accounting in the 2013 ED with the Committee since publishing that ED. We wish to do so at this meeting.

Background

3. The *Leases* discussion paper published by the boards in 2009 did not address lessor accounting in any detail. At that stage, the boards had decided to defer consideration of lessor accounting and concentrate on developing an improved lessee accounting model for a number of reasons, including the following:

   (a) most of the problems associated with the existing lease accounting model relate to the treatment of operating leases in the financial statement of lessees, and

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The-organisation/Advisory-bodies/CMAC/Pages/CMAC.aspx

(b) consideration of lessor accounting at the same time as lessee accounting could delay publication of a new accounting standard for lessees.

4. However, many respondents to the 2009 discussion paper recommended that the boards develop accounting models for both lessees and lessors on the basis of a consistent rationale. Those respondents also noted that developing lessor accounting proposals might provide additional insights into lessee accounting and a better understanding of the economics of leases. In addition, the boards saw merit in developing lessor accounting proposals at the same time as developing proposals on the recognition of revenue.

5. Consequently, the 2010 *Leases* Exposure Draft and the 2013 ED both proposed changes to lessor accounting.

The lessor accounting proposals

What does the 2013 ED propose to change?

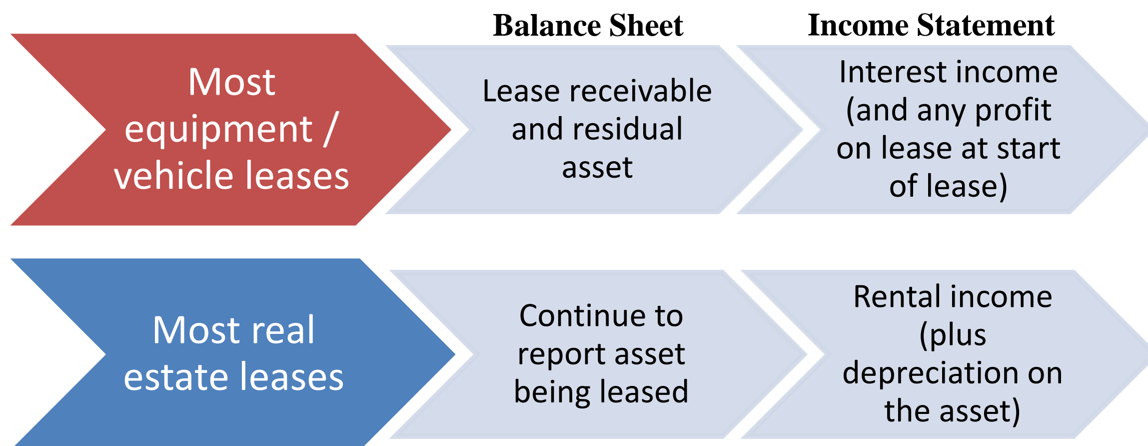
6. For all practical purposes, there are few changes proposed to the accounting applied by lessors of finance leases. For operating leases, the extent of change would depend on whether the underlying asset is real estate (ie land and/or a building) or equipment. A lessor would distinguish between most real estate leases and most equipment leases in the same way that a lessee would under the proposals (ie based on whether the lessee is expected to consume any significant portion of the underlying asset). For operating leases of real estate, the accounting applied by the lessor is essentially unchanged. For operating leases of equipment or vehicles, however, the changes proposed are significant.

7. A lessor of most equipment or vehicle leases would:

    (a) recognise a lease receivable and retained interest in the underlying asset (the residual asset), and derecognise the underlying asset; and

    (b) recognise interest income on both the lease receivable and the residual asset over the lease term.

8. A manufacturer or dealer lessor might also recognise profit on the lease when the underlying asset is made available for use by the lessee.



Why propose those changes?

9. The proposed changes to lessor accounting are intended to more closely reflect how a lessor prices its leases—ie that most real estate lessors price their leases differently from many equipment/vehicle lessors (which are often financial institutions, subsidiaries of manufacturers that operate like financial institutions or independent asset financing companies). The changes were also made to be responsive to some concerns raised by investors and analysts about a lack of transparency about the residual values of equipment and vehicles that are subject to operating leases. The proposals would provide better information about a lessor's exposure to credit risk (arising from the lease receivable) and asset risk (arising from its retained interest in the underlying asset) for leases of equipment and vehicles.

10. The boards did not propose any change to the accounting for real estate leases. This is because most real estate that is the subject of a lease meets the definition of investment property in IAS 40 *Investment Property*. Consequently, a real estate lessor either measures the real estate at fair value or discloses information about the fair value in its financial statements. Investors and analysts had previously informed the IASB that information about rental income and the real estate's fair value provides them with more useful information about the lessor's business than other approaches. Other approaches are also likely to be more complicated to apply.

An illustration of the change proposed to an individual lease

11. The following example illustrates the changes proposed to the accounting for a 3-year equipment lease, which would be classified as an operating lease under existing lease accounting requirements. In this example, the lessor would be expected to be a manufacturer or dealer lessor because the carrying amount of the underlying asset is less than its fair value at the start of the lease:

Assumptions in this example:

- Fair value of equipment at start of lease – CU1,000
- Carrying amount of equipment at start of lease – CU950
- Interest rate implicit in lease – 7.7%
- Estimated residual value at end of year 3 – CU500
- Cash receipts – CU231 in each year

	Current requirements			
Balance sheet (year)	*0*	*1*	*2*	*3*
Asset being leased (eg airplane/truck)	950	800	650	500
Income statement (year)		*1*	*2*	*3*
Rental income		231	231	231
Depreciation of asset		(150)	(150)	(150)
Total lease income		**81**	**81**	**81**

	2013 ED proposal			
Balance sheet (year)	***0***	***1***	***2***	***3***
Lease receivable	600	414	215	-
Gross residual asset	400	431	464	500
Unearned profit	*(20)*	*(20)*	*(20)*	*(20)*
Net residual asset	380	411	444	480
Income statement (year)	*0*	*1*	*2*	*3*
Profit on lease	30			
Interest on receivable		45	32	16
Interest on residual asset		31	33	36
Total lease income	**30**	**76**	**65**	**52**

Feedback received to date on the lessor accounting proposals

12. At outreach meetings held by the boards from June to September 2013[1], the feedback received on the lessor accounting proposals from both lessors and investors and analysts has been mixed.

13. Meetings held with investors and analysts indicate that:

    (a) almost all agree that better information about a lessor's exposure to credit risk and asset risk would be beneficial. However, those consulted are either indifferent as to whether they receive that information in note disclosures or on the balance sheet, or prefer it within the note disclosures.

    (b) those who follow lessors of long-lived assets (eg aircraft; drilling rigs; rail cars) do not support the proposed changes to the income statement—they prefer to receive revenue information that is relatively predictable and will often reflect actual cash inflow streams – this is what they receive today for operating leases. They are concerned about the potential volatility in amounts recognised in a lessor's income statement under the proposals, particularly when the second hand market for leased assets is volatile.

    (c) some who follow captive lessors of trucks indicated support for the proposed change that would align lease accounting more closely with sale accounting.

14. The views of lessors are also mixed:

    (a) Lessors of long-lived assets (eg aircraft; telecommunication towers; drilling rigs; rail cars; ship owners) do not support the proposals. They do not think that the proposals appropriately reflect their business model—ie they consider that they are in the business of managing assets over longer-term periods than any one lease. They are concerned

[1] As noted in paragraph 1 of this paper, the boards have, to date, received over 600 comment letters relating to the 2013 ED. We have not yet analysed the feedback received in all of those comment letters. Consequently, the views noted in this section of the paper reflect feedback received at outreach meetings held between June and September 2013—the views noted do not reflect comments received in comment letters.

about the effects on the income statement and, again, particularly when the second hand market for leased assets is volatile. Those lessors noted the subjectivity involved in estimating the value of the leased asset both at lease commencement and at the end of a lease. They are also concerned about the costs of applying the proposals and think the costs would outweigh any benefits.

(b) Other lessors agree that the proposals better reflect how they price leases (eg bank lessors, many captive lessors of car manufacturers, other asset financing companies who, for example, securitise their leases). However, some of those lessors are also opposed to the proposals because of concerns about the cost of enhancing their accounting systems to apply the proposals.

15. Many do not think that it is paramount that lessee accounting is aligned with lessor accounting. They would suggest that changes could be made to lessee accounting without any significant change being made to lessor accounting. They recommend retaining lessor accounting requirements that are similar to the requirements in existing standards, noting that the existing requirements are not fundamentally flawed. Others, however, have the opposite view and suggest that, if changes are to be made to lessee accounting, then changes should also be made to lessor accounting.

16. Some would suggest that, if existing lessor accounting is to be changed, any distinction in the accounting should be based on the lessor's business model. So, for example, if a lessor is a bank lessor that views its leasing activities as a way of providing secured funding to customers, then it would account for a lease as a financing transaction, and recognise a receivable for all of its leases. In contrast, for example, if a lessor is a real estate or drilling rig lessor that views its activities as managing the real estate or drilling rigs over a period typically longer than any one lease, then it would account for all of its leases similarly to existing operating leases, and recognise rental income over the lease term on a typically straight-line basis.

17. Others would suggest linking the lessor accounting model to the significance of the residual asset risk retained by the lessor. Under this approach, for example, if

the lessor retained any significant residual asset risk, then the lessor would recognise rental income over the lease term on a typically straight-line basis, and not recognise any revenue at the start of the lease.

Questions for the Committee

Questions: Lessor accounting proposals
What are your views regarding lessor accounting? (a) Do you agree with the proposals regarding real estate leases (ie the accounting for real estate leases should remain largely unchanged for the reasons described in paragraph 10 of this paper)? If not, what would you suggest and why? (b) Do you think that any change is needed to the existing requirements for leases of assets other than real estate? If not, why? If 'yes', why and on what basis? Should the accounting be linked to the type of lessor (ie the lessor's business model)? Should the accounting be linked to the type of asset being leased? Do you have another suggestion?