STAFF PAPER

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Project	**Leases**		
Paper topic	Lessor Accounting Model		
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Introduction

1. The purpose of this paper is to set out possible approaches to the lessor accounting model, taking into account feedback received on the lessor accounting proposals in the revised exposure draft on leases issued in May 2013 ("2013 ED"). The Boards and the staff obtained feedback on the lessor accounting proposals in the 2013 ED from investors and analysts ("users"), preparers, accounting practitioners, as well as others, in comment letters, at public roundtable discussions, and at private outreach meetings, including fieldwork meetings.

2. The staff are proposing three possible approaches for the Boards to consider with respect to lessor accounting:

   (a) *Approach 1* – An approach that would determine lessor lease classification (Type A vs. Type B) based on whether the lease is effectively a financing or a sale, rather than an operating lease (that is, the concept underlying existing U.S. GAAP and IFRS lessor accounting). That determination would be made based on whether the lease transfers substantially all the risks and rewards of ownership of the underlying asset.

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(b) *Approach 2* – This approach would also determine lessor lease classification (Type A vs. Type B) based on whether the lease is effectively a financing or a sale, rather than an operating lease. However, this approach would require that for any lease that gives rise to selling profit (or loss) – generally those of manufacturer and dealer lessors, the lessor would classify the lease as a Type A lease only if the lease transfers control of the underlying asset to the lessee (that is, in line with the notion of a sale in the forthcoming revenue recognition standard). Leases that do not give rise to selling profit (or loss) – generally those of financial lessors, would be classified in the same manner as all leases under Approach 1.

(c) *Approach 3* – An approach that would determine lessor lease classification (Type A vs. Type B) based on the lessor's business model.

3. This paper is structured as follows:

(a) Background to lessor accounting.

(b) Summary of feedback received on the lessor accounting proposals in the 2013 ED.

(c) Description of the possible lessor accounting approaches.

(d) Other options considered but rejected.

(e) Staff analysis of the proposed approaches.

(f) Staff views.

(g) Appendix A: Existing lessor lease classification guidance and guidance proposed in the 2013 ED.

4. This paper should be read in conjunction with the following two papers:

(a) ASAF Agenda Paper 4C (IASB Agenda Paper 3B/FASB Memo 263): Lessor Type A Accounting, which describes how a lessor would account for Type A leases under each of the approaches in this paper.

(b) ASAF Agenda Paper 4F (IASB Agenda Paper 3E/FASB Memo 266): Examples—Lessee and Lessor Accounting Models, which illustrates how a

lessor would apply each of the approaches in this paper to a number of lease scenarios.

Background to lessor accounting

5. In March 2009, the Boards issued a Discussion Paper entitled *Leases: Preliminary Views* ("2009 DP"). The Boards deferred any consideration of changes to lessor accounting because most of the problems associated with existing lease accounting relate to the accounting for operating leases in the financial statements of *lessees*.

6. Additionally, the Boards deferred consideration of lessor accounting in the 2009 DP because of the following:

   (a) Such consideration might delay needed improvements to lessee accounting. For example, many thought that any lessor accounting project would need to address how to account for investment property. Because the existing U.S. GAAP and IFRS models for such property are substantially different, it may be difficult and time-consuming to reconcile those differences.

   (b) Consideration of lessor accounting might raise issues related to other projects that were ongoing at that time, particularly derecognition and revenue recognition.

7. In August 2010, the Boards published a joint exposure draft, Leases ("2010 ED"). In the Basis for Conclusions, the Boards again acknowledge that many of the problems associated with existing lease accounting relate to the accounting for operating leases in the financial statements of lessees. Nonetheless, the Boards proposed a new model for lessor accounting in the 2010 ED because:

   (a) The new accounting model proposed for lessees would be inconsistent with existing lessor accounting. Many respondents to the 2009 DP recommended that the Boards develop a consistent model for lessees and lessors.

   (b) Existing lessor accounting would be inconsistent with the proposals in the Boards' joint revenue recognition project.

8. In the 2010 ED, the Boards proposed that a lessor would recognize a lease receivable for all leases, which would be consistent with a lessee recognizing a lease liability for all leases. Nonetheless, the proposed model was a dual model, resulting in different lessor accounting depending on whether the lessor retained exposure to significant risks or benefits associated with the underlying asset. If the lessor retained exposure to significant risks or benefits associated with the underlying asset, the lessor would continue to recognize the underlying asset as its asset, as well as recognize a lease receivable. The lessor also would recognize a liability. This approach was described as the performance obligation approach.

9. If the lessor did not retain exposure to significant risks or benefits associated with the underlying asset, the Boards proposed that a lessor would derecognize the portion of the underlying asset relating to the right-of-use asset transferred to the lessee and recognize a lease receivable. The rights retained in the underlying asset would be reclassified as a residual asset. That approach was described as the derecognition approach.

10. There was very little support for the performance obligation approach in response to the 2010 ED. Many viewed the approach as inappropriately inflating a lessor's assets and liabilities. Many questioned how one set of cash flows—the cash flows to be received from the lessee—could relate to both the lease receivable and the underlying asset. Many also questioned how the obligation to permit the lessee to use the asset would meet the definition of a liability.

11. Some supported applying the derecognition approach to all leases. Others thought that the existing lessor accounting requirements were not fundamentally flawed and questioned whether the benefit of changing lessor accounting would outweigh any costs associated with that change. Others were concerned about the lack of consistency between the 2010 ED lessee accounting proposals (which proposed a single lessee accounting model) and the 2010 ED lessor accounting proposals (which proposed a dual lessor accounting model). Many suggested that the Boards make the lessor proposals consistent with the revenue recognition proposals, the lessee accounting proposals or, ideally, both.

12. On the basis of the feedback received, the Boards revised the lessor accounting proposals in the 2013 ED. The Boards concluded that, under the right-of-use model,

the lessor's performance at lease commencement (that is, making the underlying asset available for the lessee's use) creates an unconditional right to receive lease payments (that is, a lease receivable). The lessor has performed by making the underlying asset available to the lessee (and has no further performance obligations relating to that right-of-use). The lessor, therefore, has a receivable from the lessee at lease commencement.

13. Nonetheless, the Boards decided not to propose the recognition of a lease receivable for all leases, thereby rejecting a single lessor model. Although a number of constituents had suggested applying the derecognition approach to all leases, the Boards rejected that approach, mainly for most property leases, for a number of reasons:

    (a) When a lessee is not expected to consume a very significant portion of the underlying asset (for example, in many property leases), an approach that requires a lessor to continue to recognize the underlying asset would generally provide more useful information to users. Users of financial statements of lessors of investment property had confirmed that they prefer the income statement effects that result from measuring the investment property at fair value (for IFRS lessors) and recognizing the rental income separately. Therefore, existing operating lease accounting would provide more useful information for leases of investment property.

    (b) A single model based on the recognition of a lease receivable and derecognition of the underlying asset would not appropriately reflect the business model of many lessors, principally those that lease longer lived assets (such as property).

    (c) It would be extremely complicated to apply the approach to leases of portions of a larger asset (that is, when a lessor leases portions of a single asset to multiple parties concurrently).

14. The Boards further concluded that lessors should apply an approach consistent with existing operating lease accounting to those leases for which the lessor would not recognize a lease receivable. Any other approach (such as netting the lease receivable

and the performance obligation liability) could not be justified from a cost-benefit perspective.

15. The Boards concluded that it could not simply retain existing lessor accounting without changes. First, it would be nearly impossible to make no changes to lessor accounting given the changes being made to lessee accounting (for example, with respect to scope, the definition of a lease and particular definitions). Second, the Boards concluded that the proposed dual model in the 2013 ED was an improvement to financial reporting for lessors of assets other than property. This point is further explained in the Basis for Conclusion (BC78) of the 2013 ED.

16. Therefore, to summarize the approach in the 2013 ED, the Boards proposed that a lessor would apply:

    (a) An approach similar to existing operating lease accounting (Type B accounting) to:

        (i) Leases of property (that is, land or a building, or part of a building, or both) unless the lease term is for a major part of the remaining economic life of the underlying asset *or* the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

        (ii) Leases of assets other than property when the lease term is for an insignificant portion of the total economic life of the underlying asset *or* the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.

    (b) The receivable and residual approach (Type A accounting) to all other leases (except short-term leases).

17. Under the receivable and residual approach for Type A leases proposed in the 2013 ED, at lease commencement a lessor would recognize a lease receivable (measured at the present value of the lease payments) separately from a net residual asset. The net residual asset would comprise both of the following:

(a) The gross residual asset (measured at the present value of the amount the lessor expects to derive from the underlying asset following the lease term).

(b) Any unearned profit (that is, the portion of any difference between the fair value and the carrying amount of the underlying asset that is attributable to the residual asset at lease commencement).

18. A lessor would accrete both the lease receivable and the gross residual asset over the lease term using the effective interest method, recognizing the accretion as interest income. The unearned profit on the residual asset would remain unchanged throughout the lease term (and, thus, unrecognized) until the lessor would sell or release the underlying asset, absent reassessment of the lease term.

Summary of feedback received on lessor accounting proposals in the 2013 ED

19. The Boards received significant feedback on the lessor accounting proposals in the 2013 ED.

Whether to change existing lessor accounting

20. Some constituents support changing the existing lessor accounting model in Topic 840, Leases and IAS 17 *Leases* because:

(a) Some users want better information about a lessor's exposure to asset risk and credit risk in equipment leases.

(b) Some lessors do not think the existing lessor accounting model appropriately reflects their leasing activities.

(c) Some constituents support consistency between lessee and lessor accounting. Consequently, these constituents think that the lessor accounting model needs to change if the lessee accounting model changes.

> "Complementary lessee and lessor model(s) – The lessee and lessor model(s) should be complementary. In particular, the financial reporting characterization of a lease should be the same for the lessee and the lessor, assuming no third-party involvement. We strongly

> believe that if a lease is a financing transaction, it is a financing transaction for both the lessee and the lessor." – CL #199

(d) Some constituents note that the Boards have recently developed a new revenue recognition model and support changing lessor accounting to the extent necessary to be consistent with that model.

> "This model should be, as far as possible, conceptually and operationally consistent with the accounting for contracts with customers in accordance with the forthcoming revenue recognition standard. The model would classify leases as either a sale of the underlying asset or an executory arrangement." – CL #117

21. The majority of constituents, however, do not support changing the existing lessor accounting model because:

(a) The existing lessor accounting model in Topic 840 and IAS 17 is well understood and accurately reflects the different economics of different lease transactions.

> "We believe that the changes proposed in the ED for lessors will meaningfully reduce transparency in our financial statements; result in reported financial results that are not representative of the economics of our transactions; introduce significantly more subjectivity in deriving our financial results, which will diminish comparability between lessors and present greater opportunities for earnings manipulation; and significantly increase complexity and cost for preparers and users of financial statements… The current lessor model provides an adequate and appropriate recognition and measurement model." – CL #288 (An aircraft lessor)

(b) Most users do not currently adjust lessors' financial statements.

(c) Although there is a clear need to change lessee accounting, lessor accounting is not fundamentally flawed and should not be changed solely

because lessee accounting is changing. These constituents do not think that consistency between the lessee and the lessor accounting models is necessary.

> "We also believe that the accounting by lessors should be based on the evaluation of the lease transaction from the lessor perspective not from that of the lessee…We understand that the construct in the ED would provide symmetry between accounting by lessees and lessors. However, we do not believe symmetry in this area is either necessary or appropriate" – CL #551

(d) Changes to lessee accounting should not be delayed because of difficulties in determining the appropriate lessor accounting model.

(e) Although there would be some benefits from the proposed changes to lessor accounting, the costs involved in the proposals would outweigh the benefits.

More specific comments on the 2013 ED lessor accounting model

22. All users and preparers of financial statements for lessors of property that provided feedback on the 2013 ED support the proposals, which would result in accounting that is similar to existing U.S. GAAP and IFRS. These constituents generally think that existing lessor accounting appropriately reflects the lessor's business model, is relatively simple to apply, and also provides the most useful information to users.

23. Users and preparers of financial statements for lessors of assets other than property were more mixed in their views on the lessor accounting proposals.

(a) Most users agree that information about a lessor's exposure to credit risk and asset risk would be beneficial for most leases of assets other than property. In particular, those who already estimate the lessor's exposure to those risks in their analysis support changes that would provide this information. However, many of these users were indifferent as to whether

they receive that information in the balance sheet or in the notes, while others would prefer to receive that information within the notes.

(b) Most users and preparers of financial statements for lessors of long-lived equipment assets, including equipment currently considered "integral equipment" under U.S. GAAP, disagree with the lessor accounting proposals (for example, lessors of railcars, shipping containers, aircraft, drilling rigs, telecommunication towers). In general, both the users and the lessors view the proposals as being inconsistent with the lessor's business model, which is generally similar to that of property lessors. The lessors generally do not think they are selling a portion of the underlying asset each time they enter into a lease. Instead, they view their leases as a means of earning income from managing the assets over their entire economic lives. The users of such lessors' financial statements prefer to receive revenue information that is relatively predictable and would often reflect actual cash inflows. They are concerned about the potential volatility in amounts recognized in a lessor's income statement under the proposals, particularly when the second-hand market for leased assets is volatile.

(c) Users and preparers of financial statements for lessors of other equipment were mixed in their feedback. Some users support the changes proposed to leases of assets other than property because, in their view, the accounting proposed more closely aligns the accounting with the underlying economics of most of those leases. In particular, some who follow captive lessors support the proposed change that would align lease accounting more closely with sale accounting. Some lessors, however, oppose the proposals principally on cost-benefit concerns. Although they acknowledge, for example, the financing nature of their leases (for example, some captive finance subsidiaries), they do not think that the benefits of the proposed changes would justify the systems and process costs that would be required to effect the changes.

Description of the possible lessor accounting approaches

24. In proposing the following three lessor accounting approaches, the staff first considered the feedback throughout the project with respect to lessor accounting and its effect on lessee accounting.

25. The 2009 DP did not propose revisions to the lessor accounting model because the main perceived deficiency in existing lease accounting is associated with *lessee* accounting for operating leases. Nonetheless, in responding to the 2009 ED as well as the 2010 ED and 2013 ED, many constituents expressed the view that a lessor's accounting for a lease should correlate with a lessee's accounting for that same lease (that is, the lessee and lessor accounting models should be broadly symmetrical). For most of these constituents, the view that leases create a financial liability for the lessee should result in those same leases creating a financial asset (that is, a lease receivable) for the lessor.

26. Because of this feedback, the 2010 ED proposed changes to existing lessor accounting as well as lessee accounting. The 2010 ED proposed that a lessor would recognize a lease receivable broadly equivalent to the lessee's lease liability for all leases other than short-term leases. In this respect, the proposed lessee and lessor accounting models were somewhat symmetrical in that both parties would recognize a financial asset or liability (that is, a lease receivable or a lease liability) upon which interest income or expense would be recognized. However, the lessor model proposed was a dual model:

    (a) For leases in which the lessor retains significant risks and benefits of ownership of the underlying asset, the lessor would not derecognize the asset. Instead, the lessor would recognize a corresponding liability reflective of the lessor's obligation to provide the lessee with access to the underlying asset during the lease term.

    (b) For all other leases, the lessor would derecognize a portion of the underlying asset.

27. Because the lessor model was a dual approach and the lessee model a single approach, the proposed lessee and lessor accounting models were not, in fact, symmetrical.

28. In response to concerns raised about the 2010 ED lessor accounting proposals, the 2013 ED included significant changes to those lessor accounting proposals. The 2013 ED proposed a symmetrical lease classification test for lessors and lessees, but did not prescribe symmetrical accounting. This is because, for Type B leases, the lessee would recognize a financial liability as a result of the lessor's performance at lease commencement (that of transferring the right to use the underlying asset to the lessee by making the underlying asset available for the lessee's use), but the lessor would not recognize a lease receivable. In the Basis for Conclusions to the 2013 ED, the Boards state that, for all leases, a lessor has a lease receivable that meets the definition of an asset at lease commencement. Nonetheless, the Boards explain that they did not propose that a lessor would recognize a lease receivable for all leases, largely because of the following:

    (a) The negative feedback on the performance obligation approach proposed in the 2010 ED that suggested significant resistance to recognizing a lease receivable that would "gross-up" the lessor's balance sheet (together with a performance obligation liability). If the lessor has performed at lease commencement with respect to the right-of-use, it would be difficult to understand why a lessor would recognize a performance obligation liability relating to that right-of-use.

    (b) The feedback received that indicated that:

        (i) The receivable and residual approach would be prohibitively complex to apply for leases of multi-tenanted property; and

        (ii) For most leases of property, existing lessor accounting works well in practice and provides users with the information that they need, without adjustments.

29. As outlined earlier in the paper, constituents also have concerns about the lessor accounting proposals in the 2013 ED. In particular, many are concerned about the changes proposed to recognize lease receivables for almost all leases of assets other than property. Those constituents would prefer to retain the existing lessor accounting requirements.

30. The feedback received indicates that a majority of constituents, including most users consulted, view leases differently from a lessee's perspective than from a lessor's

perspective. For a lessee, the issue that arises regarding the accounting for leases is whether a lessee has appropriately recognized the assets and the liabilities that arise from leases. For a lessor, the accounting for leases is mainly about the timing of recognition of income or revenue, and the accounting for the underlying assets. Users tend to have a different focus when analyzing the financial statements of a lessee compared to analyzing the financial statements of a lessor. Consequently, many have expressed the view that existing lessor accounting works well in practice whereas change is needed to existing lessee accounting.

> "We do not agree with the [lessor accounting] proposal and are in fact, broadly in favour of retaining the bulk of the current model for lessor accounting. We recognize this takes an asymmetrical view toward leasing relative to our stance on lessee accounting; however, we believe it is more important to arrive at an analytically relevant approach than to unnecessarily adhere to symmetry between parties to a transaction." – CL #442 (credit rating agency)

31. From a conceptual perspective, the staff think that there are strong arguments to support requiring the recognition of a lease receivable for all leases (other than short-term leases), assuming that the Boards propose the recognition of a lease liability by lessees for all leases (other than short-term leases). This is because the staff agree with the Boards' conclusions in the Basis for Conclusions to the 2013 ED that, under a right-of-use model, a lessor has a lease receivable that meets the definition of an asset at lease commencement. Nonetheless, having considered all of the feedback received throughout the project, the staff have concluded that achieving symmetry between the lessee and lessor accounting models should not be paramount for any final leases standard. This view is almost entirely influenced by cost-benefit considerations.

32. As a consequence, none of the three lessor accounting approaches proposed in this paper would achieve symmetry between the lessor and lessee accounting models (assuming the Boards elect one of the three proposed lessee accounting approaches in ASAF Agenda Paper 4E/ IASB Agenda Paper 3D/FASB Memo 265). Nonetheless, the staff think that each of the approaches would address the main cost-benefit

concerns raised about the lessor accounting proposals in the 2013 ED and achieve a converged lessor accounting solution.

Approach 1 – Determine whether the lease is effectively a sale or a financing based on the transfer of risks and rewards incidental to ownership

Overview of Approach 1

33. A lessor would apply Type A accounting when the lease is effectively a sale or a financing of the underlying asset, rather than an operating lease (note: the staff are proposing in ASAF Agenda Paper 4C/ IASB Agenda Paper 3B/FASB Memo 263 that Type A lessor accounting should be consistent with existing IFRS finance lease accounting, rather than the receivable and residual approach proposed in the 2013 ED). All other leases would be classified as Type B leases. Evaluating whether the lease is effectively a sale or a financing transaction, rather than an operating lease, is the underlying principle for existing lessor accounting, as expressed in the Basis for Conclusions to U.S. GAAP Statement No. 13.

> **FAS 13, paragraph 60 (Basis for Conclusions).** "The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases."

34. A lessor would account for a lease as a sale or a financing when the lease:

    (a) Transfers ownership of the underlying asset to the lessee by the end of the lease term;

    (b) Grants the lessee a purchase option that it has a significant economic incentive to exercise (note: If the Boards decide to revise the notion of significant economic incentive, the staff would propose to revise this criterion accordingly); or

    (c) Otherwise transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Situations that individually or in

combination would normally lead to a conclusion that the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset include:

(i) The lease term is for a major part of the remaining economic life of the underlying asset.

(ii) The present value of the sum of the lease payments and any residual value guarantees obtained from any unrelated third-party amounts to substantially all of the fair value of the underlying asset at lease commencement.

(iii) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

35. The indicator in (iii) above is consistent in principle with the indicator in paragraph 10(e) of IAS 17. However, because this indicator would be new to U.S. GAAP preparers, the staff think it is preferable to align the wording to the alternative use concept in the forthcoming revenue recognition standard. The concept of "alternative use" includes when the lessor would have to incur significant economic losses to direct the asset to another use (for example, incurring significant costs to rework the asset or only being able to sell the asset at a significant loss).

36. In addition:

(a) Consistent with existing IFRS, lessors would assess whether the situations ((i)-(iii)) in the paragraph above are conclusive in determining whether the lease transfers substantially all the risks and rewards incidental to asset ownership. If it is otherwise clear that the lease does *not* transfer substantially all the risks *and* rewards, the lease would be classified as a Type B lease.

(b) Consistent with existing IFRS (and similar to existing U.S. GAAP), land and other elements would be assessed separately for purposes of lease classification when necessary, unless the land element is clearly immaterial.

37. Approach 1 would retain the principle in existing IFRS and U.S. GAAP that a manufacturer or dealer lessor would present gross revenue and costs of goods sold at lease commencement relating to a Type A lease.

38. The staff considered whether to embed within Approach 1 an additional requirement that would preclude a manufacturer or dealer lessor from recognizing gross revenue (and costs of goods sold) unless the lessee obtains control of the underlying asset as a result of the lease, consistent with the definition of a sale in the forthcoming revenue recognition standard. If the lessor transferred substantially all the risks and rewards incidental to ownership but the lessee did not obtain control of the underlying asset, the lessor would not recognize revenue and cost of goods sold separately. Instead, the lessor would recognize any gain or loss on a net basis. As outlined in the discussion of Approach 2, consideration of the transfer of control of the underlying asset from the lessee's perspective generally would not take into consideration third-party involvement in the lease.

39. The staff decided against including such a requirement at this point because, as noted under Approach 2, the staff understand that there are very few leases for which adding this requirement would result in a different outcome from Approach 1 as proposed. Nonetheless, the Boards could decide to adopt Approach 1 but include such a requirement that might prevent the recognition of gross revenue (and cost of goods sold) in some instances for manufacturer or dealer lessors of Type A leases.

Rationale for Approach 1

40. Approach 1 would retain existing lessor accounting for U.S. GAAP and IFRS preparers in all material respects. When compared to eliminating lessor accounting from the project entirely, this approach achieves a converged lessor accounting model that does not introduce new concepts or result in inconsistencies (such as in lease definition, scope, etc.) with the proposed lessee accounting model. The rationale for this approach is based on the following feedback received with respect to the 2013 ED lessor accounting proposals and throughout the project:

    (a) The main perceived deficiency in existing lease accounting is *lessee* accounting for existing operating leases. There has not been a significant perceived deficiency in existing lessor accounting, as evidenced by the fact

that most users do not adjust a lessor's financial statements. Therefore, this approach aims to achieve a converged solution while minimizing the accounting changes, and thereby minimizing costs to preparers and users (in terms of their analyses).

(b) The majority of constituents support a dual lessor accounting model. Most of them support retaining the *existing* dual lessor model. They suggest that classification should be based on the transfer of risks and rewards, transfer of control, or sale of the underlying asset, in a manner similar or identical to the existing lessor lease classification guidance. This approach fundamentally retains existing lessor accounting by using the existing IFRS risks and rewards concept to determine whether the lease is effectively a sale or a financing.

(c) Many constituents commented that the changes proposed in the 2013 ED to lessor accounting would result in accounting that does not align to the economics of all leases or to a lessor's business model. This has been expressed in particular by users and preparers of financial statements for lessors of long-lived assets other than property (for example, lessors of drilling rigs, aircraft, railcars, ships, and telecommunications towers). Some of those users commented that the changes proposed in the 2013 ED to lessor accounting would *complicate* their analyses, and potentially require them to make adjustments to the reported income statement amounts for which they had not made adjustments previously. For example, some users of financial statements of drilling rig and aircraft lessors indicated that they wish to receive revenue information for lessors that largely reflects the cash lease rentals received and would adjust to get back to that information. Consequently, some lessors may resort to non-GAAP reporting to satisfy users' needs. Accordingly, applying Type A accounting to these transactions would not appear to provide any associated benefits. This approach would address the concerns of these constituents.

(d) Almost all users and preparers of financial statements for lessors of property generally support the lessor accounting proposed in the 2013 ED (Type B for most leases of property), which is generally consistent with

existing U.S. GAAP and IFRS lessor accounting for such leases. Each of the approaches proposed in this paper would achieve similar lessor accounting for property lessors as was proposed in the 2013 ED.

Approach 2 – Determine lease classification based on the transfer of risks and rewards for financial lessors and based on the transfer of control for other lessors

Overview of Approach 2

41. Under Approach 2 (as in Approach 1), a lessor would account for a lease that is effectively a sale of the underlying asset *or* a financing transaction as a Type A lease. A lessor would account for all other leases as Type B leases.

42. For purposes of classifying leases as Type A or Type B, Approach 2would distinguish between:

    (a) Those leases that do *not* give rise to selling profit or loss (typically leases entered into by financial lessors); and

    (b) Those leases that give rise to selling profit or loss (typically leases entered into by all other lessors - including manufacturers and dealers, as well as most other lessors that manage their leased assets as their "stock-in trade").

43. A lessor would classify a lease that does *not* give rise to selling profit or loss in the same manner as Approach 1—that is, based on the transfer of risks and rewards.

44. A lessor would classify a lease that gives rise to selling profit or loss by assessing whether the lessee obtains control of the underlying asset as a result of the lease (consistent with the notion of a sale in the forthcoming revenue recognition standard). Consequently, a lessor would account for a lease as an instalment sale on the same basis as any other revenue contract. If control of the underlying asset does not transfer to the lessee, the lessor would account for the lease as a Type B lease.

45. A lessee would effectively obtain control of the underlying asset when any one of the following three criteria is met at lease commencement (*criteria (a) and (b) are identical to those in Approach 1*):

    (a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

(b) The lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

(c) The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease. Situations that individually or in combination would normally result in the conclusion that the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include (*indicators (i) and (iii) are identical to those used in assessing whether the lease transfers substantially all the risks and rewards incidental to ownership in Approach 1)*:

  (i) The lease term is for a major part of the remaining economic life of the underlying asset.

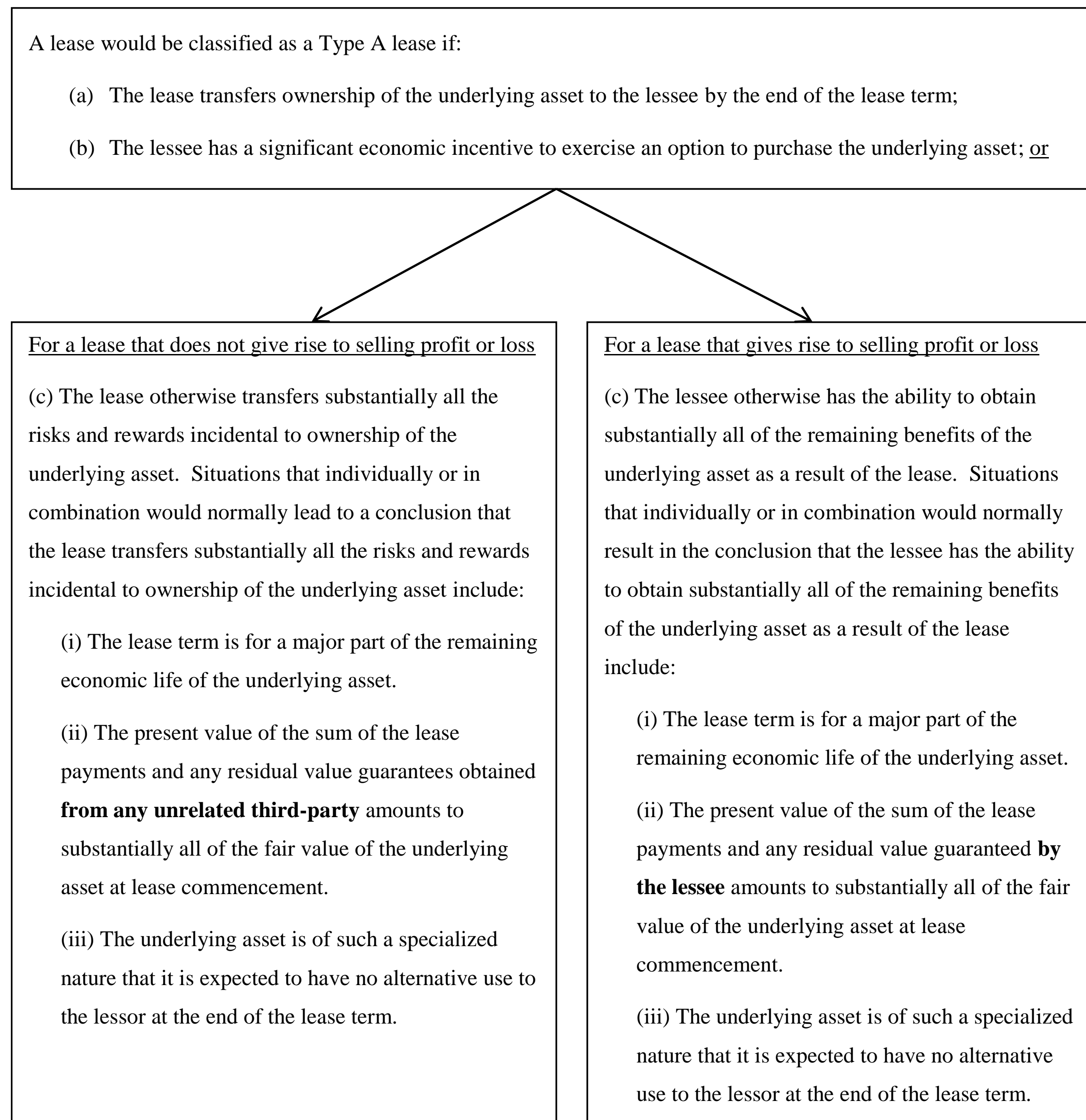
  (ii) The sum of the present value of the lease payments and any residual value guaranteed **by the lessee** amounts to substantially all of the fair value of the leased asset.

  (iii) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

The situations in (i) - (iii) are not always conclusive. If it is otherwise clear that the lessee would not have the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease (for example, the estimated fair value of the underlying asset is expected to appreciate over the lease term such that the remaining economic benefits at the end of the lease term are effectively unchanged or enhanced since lease commencement), this criteria would not be met.

46. Consistent with existing IFRS and Approach 1 (and similar to existing U.S. GAAP), land and other elements would be assessed separately for purposes of lease classification when necessary, unless the land element is clearly immaterial.

47. The following table summarizes the proposed approach:



Rationale for Approach 2

48. Existing U.S. GAAP (Topic 840) and IFRS (IAS 17) differentiate between those leases that give rise to selling profit (or loss) and those that do not. Under Topic 840, the presence (or absence) of selling profit (or loss) directly affects the lease classification (sales-type or direct-financing). For example, a lessor would classify a lease of real estate that gives rise to selling profit (or loss) as a sales-type lease only if it transfers title to the lessee by the end of the lease term. If it does not, the lease is an

operating lease. A lessor, however, would classify the same real estate lease as a direct-financing lease, without a transfer of title, if there is no selling profit (or loss).

49. Under IAS 17, this distinction does not affect lease classification. Nonetheless, if a finance lease gives rise to selling profit (or loss), a manufacturer or dealer lessor would recognize gross revenue and cost of goods sold (and any resulting selling profit or loss) at lease commencement in accordance with its policy for outright sales. For a finance lease of a financial lessor, if there is any difference between the fair value and cost/carrying amount of the underlying asset, a financial lessor would simply recognize a gain or loss on disposal of a nonfinancial asset at lease commencement (and not revenue and cost of goods sold).

50. In addition, under existing U.S. GAAP and IFRS, a lessor recognizes sales/product revenue and selling profit from a lease, based on the same principle as for revenue recognition. The following table illustrates the requirements for sales-type lease accounting under Topic 840 and IAS 17 as compared to the applicable *existing* revenue recognition guidance:

Type of Lease	**Requirement in Leases Guidance**	**Requirement in Revenue Guidance**
Non-real estate leases under U.S. GAAP; all leases under IFRS	Transfer substantially all risks and rewards incidental to ownership	Transfer substantially all the risks and rewards of ownership (SEC SAB Topic 13.A; IAS 18 *Revenue*)
Real estate leases under U.S. GAAP	Account for under ASC 360-20 (FAS 66)	Account for under ASC 360-20 (FAS 66)

51. Approach 2 would retain the link that exists under current U.S. GAAP and IFRS between "sales-type" lease accounting (that is, those leases of manufacturers and dealers that generally give rise to selling profit or loss and typically result in "top-line" sales or product revenue) and revenue recognition (based on the forthcoming revenue recognition standard). This approach would stipulate that lessors should recognize sales or product revenue arising from a lease, as well as profit or loss on the underlying asset, only if the lease is effectively a sale based on the concept in the

forthcoming revenue recognition standard (that is, whether the lessee obtains control of the underlying asset as a result of the lease because it has the ability to direct the use and obtain substantially all of the remaining benefits of the underlying asset).

52. Leases that do not give rise to selling profit or loss are typically those leases of financial lessors, as well as any other lease for which the period of time between the lessor's purchase of the underlying asset and lease commencement is not significant. For such leases, for which the lessor also typically does not recognize sales or product revenue and related cost of goods sold, the existing risks and rewards lessor classification model provides an appropriate, and understood, framework for evaluating whether the lease is effectively a financial transaction. When a lessor does not take on or retain the significant risks or rewards incidental to ownership of the underlying asset, the lessor is effectively a financial agent (or facilitator). It facilitates asset sales by manufacturers or dealers, while simultaneously facilitating the lessee's ability to obtain access to those same assets at acceptable financial terms, in order to generate interest income. Therefore, the most faithful representation of the lessor's involvement in the lease is through recognition of its financial investment in the lease and recognition of financial income on that investment accordingly.

53. However, for leases that give rise to selling profit or loss (such as those of manufacturers or dealers that use leasing as a means to market their products), the assessment as to whether the lease is effectively an installment sale should be based on the sale requirements in the forthcoming revenue recognition standard. A lessor should recognize sales or product revenue (as for outright sales) and selling profit (or loss) only where the lessee obtains control of the underlying asset as a result of the lease.

54. This proposed difference in the lease classification analysis performed by those lessors that use leasing as a means to market their products would be consistent with the requirement in the forthcoming revenue recognition standard to determine whether a sale has occurred from the *customer's* perspective. The Basis for Conclusions (draft) to the forthcoming revenue recognition standard states:

> "The Boards observed that the assessment of when control has transferred could be applied from the perspective of either the entity selling the good or service or the customer

> purchasing the good or service. Consequently, revenue could be recognized when the seller surrenders control of a good or service. Although in many cases both perspectives lead to the same result, the Boards decided that control should be assessed primarily from the perspective of the customer."

55. The primary difference between an analysis based on whether the lessee obtains control of the underlying asset as a result of the lease (Approach 2) as compared to one based on whether the lessor transfers substantially all the risks and rewards incidental to ownership (Approach 1) is the consideration of third-party involvement in the lease. Third-party involvement in the lease can take the form of third-party residual value guarantees, insurance, or other residual value support, such as that provided in buyback or remarketing agreements. This is because an unrelated third party's guarantee of the residual value of an underlying asset would be expected to have no bearing on whether the lessee has, as a result of the lease, the right to direct the use of the underlying asset and obtain substantially all of its remaining benefits. That assessment would focus solely on the rights and benefits that the *lessee* obtains as a result of the lease. As a consequence, any third party involvement in a lease could affect the assessment of the transfer of the asset from the lessor's perspective but would not from the lessee's perspective.

56. The staff think that when the lessee has guaranteed all or a portion of the residual value, the lessee controls that portion of the underlying asset that it has guaranteed. Under the terms of such a contract, the lessee could either return the asset to the lessor with the required residual value or it could use and consume the asset, making a financial payment to the lessor to satisfy the residual value guarantee. Because the lessee controls that decision, it controls the corresponding portion of the remaining benefits of the underlying asset. A lessor would therefore consider that portion to be controlled by the lessee in determining whether the lessee has the ability to obtain substantially all the remaining benefits of the underlying asset as a result of the lease.

Approach 3 - Lessor business model approach

Overview of Approach 3

57. The staff think that there are broadly two different lessor business models. Those lessors in the first category would apply a Type A lessor accounting approach (“Type A lessors”), while those in the second category would apply a Type B lessor accounting approach (“Type B lessors”):

    (a) Type A lessors—Those lessors who price leases based on estimates of the value of the asset at the beginning and end of the lease to obtain a desired return. The following are possible indicators of such a business model:

        (i) The lessor typically leases the underlying asset only once (or perhaps twice) before disposing of the asset.

        (ii) The pricing of any services associated with the lease is clearly separated.

        (iii) The lessor purchases the underlying asset only as a consequence of the lease (for example, only once a lessee has been identified).

    (b) Type B lessors—Those lessors who price leases to obtain a desired return on their total investment in the underlying asset over the entire period that the lessor intends to hold the asset, which is typically much longer than the period of any individual lease. The following are possible indicators of such a business model:

        (i) The lessor leases the underlying asset multiple times over its economic life.

        (ii) The underlying asset is a long-lived asset, and may be a portion of a larger physical asset.

        (iii) The pricing of the lease is more akin to the pricing of a commodity rather than determined by the desire to obtain a particular return on the underlying asset from the lease.

        (iv) The lessor provides services associated with the underlying asset to the lessee, with the pricing often not clearly separated.

58. Lessors would apply the lessor business model approach by class of underlying asset, based on their business model in leasing those assets.

59. The staff would anticipate that, according to a lessor business model approach, bank lessors, captives of car and truck manufacturers, and many asset financing companies would apply Type A accounting to their leases. In contrast, most real estate lessors, railcar lessors, drilling rig lessors, non-captive aircraft lessors, ship owners, and owners of telecommunications tower and/or fiber-optic cable would apply Type B accounting to their leases.

60. In addition, under this approach, a Type B lessor should account for a lease as a Type A lease if the terms of that lease are significantly outside of the lessor's business norm. For example, if the lessor entered into a lease that: (a) transfers title to the lessee, (b) grants the lessee a purchase option for which it has a significant economic incentive to exercise, or (c) is for a term that is for the major part of the underlying asset's total economic life, this would likely suggest that the lessor's typical business model (that is, to manage the underlying asset over its economic life and to lease the asset multiple times) does not apply to that lease.

Rationale for Approach 3

61. This approach is based on the rationale that lessor accounting should be reflective of the underlying economics of the lease, which is often best reflected by aligning lessor accounting to the lessor's business model. Most constituents support a dual lessor model because they think that there are economic differences between different types of leases, and that different lessors have different business models.

62. As outlined in the feedback section of this agenda paper, users and preparers of the financial statements of property lessors generally support the proposals in the 2013 ED, largely because they think the accounting reflects those lessors' business model. In contrast, many of the concerns expressed with respect to lessor accounting for leases of long-lived assets other than property are based on the view that the receivable and residual approach would not appropriately reflect those lessors' business model, which is typically better reflected by Type B lessor accounting.

63. Some constituents have explicitly suggested a business model approach to lessor accounting.

> "If the Boards proceed with the model proposed in the ED, we believe lessors should have the ability to base their financial accounting presentation on their business model, as that is what users desire. Equipment operating lessors share many of the attributes of lessors of property and therefore should be able to use the operating lease method. Conversely, the direct finance lease method is the preferred approach for financial lessors, whose position is generally closer to that of a creditor. The result would be balance sheet and P&L presentations that satisfy users' needs as they reflect the substance of the respective lessors' businesses." – CL #112

64. The lessor business model approach would directly address the feedback from constituents that support having a dual lessor model in order to more appropriately reflect lessors' business models. This approach would also retain the accounting that users and preparers of financial statements for property lessors have stated is most useful and representationally faithful. It would also be responsive to the concerns of those that expressed the view that the proposals in the 2013 ED resulted in lessor accounting that did not reflect the economics of certain types of lease transactions.

65. The lessor business model approach would be applied by class of underlying asset. This is mainly to acknowledge that some lessors lease multiple classes of assets with different attributes, and for which the lessor's business model varies accordingly. The staff think that it would be inappropriate to require a lessor to account for leases of different assets for which it has different business models in the same manner.

66. The lessor business model approach is based on the premise that lessors of property and lessors of other long-lived assets (for example, railcars or ships) have a different business from, for example, a bank lessor of equipment. The bank lessor would typically price its leases based on estimates of the value of the equipment at the beginning and end of the lease to obtain a desired return. That lessor would typically have no on-going involvement with the leased equipment while it is under lease. In contrast, a lessor of property or other long-lived assets would typically price its leases to obtain a desired return on the underlying asset over the entire period that it intends to hold the asset (rather than focusing only on the period of the lease). It would often

continue to manage the asset, providing other services to lessees while the underlying asset is under lease.

67. Because a lessor of property or other long-lived assets often continues to actively manage the underlying asset and the value of the asset may not decrease substantially over the lease term, it would appear to provide useful information in those situations for the lessor to continue to recognize the entire underlying asset during the lease, instead of accounting for the lease as if the lessor had sold a "piece" of the asset. Users have indicated that, for these leases, they prefer to see the return or "yield" generated on the entire asset, which would be provided by recognizing rental income over the lease term (under Type B accounting). That information would not be available under a Type A accounting model.

68. In addition, lessor accounting is not just about determining how to account for the lease, but is also about accounting for the underlying asset (and ultimately determining when to recognize revenue/income from disposing of that underlying asset). From a lessor's perspective, and when thinking about what is useful for users of a lessor's financial statements, supporters of the lessor business model approach think that it is important to consider differing lessor business models when assessing when it is appropriate to recognize revenue generated from a lease.

69. The IASB address the use of the business model concept in financial reporting in its Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013. The IASB's preliminary view in that Discussion Paper is that financial statements can be made more relevant if the IASB considers, when it develops or revises particular Standards, how an entity conducts its business activities.

70. Furthermore, a lessor business model approach may address one of the main arguments against Approach 1 or Approach 2 in this paper. That argument is mainly that, because the existing lease classification test does not result in outcomes that sufficiently reflect a lessor's business model, it can provide anomalous results that are not useful to users. This would be the case when particular leases "fall out of" the lessor's typical lease accounting approach because that lease ends up on the opposite side of the existing lease dividing line. For example, assume a lessor predominantly utilizes leasing as a means of finance to sell its equipment, and therefore typically enters into finance leases. That lessor may apply operating lease accounting to a

proportion of its leases for which various factors lead the lessor to accept minimum lease payments that do not equal at least 90% of the fair value of the equipment. This may be the outcome, even though the lessor's principal purpose for entering into the lease has not changed (that is, to finance the sale of its equipment). The staff understand that some lessors often go to great lengths (and cost) to achieve the accounting that they believe best reflects their business model (for example, by purchasing a specified amount of third-party residual value insurance to meet the existing lease classification thresholds).

Other options considered but rejected

71. The staff considered, but rejected, the following additional lessor lease classification options (viewing the three approaches proposed in this paper as better than these other options):

    (a) *Single lessor model (all Type A*) – Some constituents have expressed the view that a single Type A lessor model would be most appropriate (and, for some of those constituents, it is essential), if the Boards continue to propose a right-of-use model for lessees. The Boards rejected this approach at earlier stages of the project for the reasons set out in paragraph BC73 of the Basis for Conclusions to the 2013 ED. The background section of this agenda paper notes those reasons. The staff think that the reasons for rejecting this approach remain valid. Even with possible targeted exceptions, such as for investment property or multi-tenanted assets, the staff think the costs of applying this approach would not justify the benefits for the same reasons as outlined in the staff's rejection of the 2013 ED dual lessor model below.

        In addition, although some constituents think that it is important to have symmetrical lessor and lessee accounting models, the staff think symmetry is not a paramount objective for the final leases standard as discussed earlier in this paper.

    (b) *The 2013 ED dual lessor model* – The staff rejected carrying forward the lessor accounting model from the 2013 ED because of the following:

(i) Although users of financial statements of property lessors and some others generally supported the model proposed in the 2013 ED, users of financial statements of long-lived and integral equipment lessors (for example, aircraft and drilling rig lessors) generally rejected the 2013 ED approach. These users indicated that they typically do not make adjustments to a lessor's financial statements for leases, calling into question the need for substantive change. Some expressed the view that the 2013 ED proposals would require them to obtain non-GAAP information from lessors or begin to make adjustments in their analyses. This would indicate that the proposed changes would be detrimental to their analysis in some cases. Many users were in favor of more transparent information about residual assets. However, most of those users were generally indifferent as to whether that information would be provided in the balance sheet or the notes.

(ii) Many lessors, principally long-lived and integral equipment lessors, stated that the receivable and residual approach proposed in the 2013 ED would not reflect their business model appropriately. They think that existing operating lease accounting reflects their business model of managing assets over their entire economic lives. Many lessors indicated that it would be costly for them to track the various components (that is, the lease receivable, the residual asset and the unearned profit) and make the estimations necessary to apply the receivable and residual approach.

Consequently, the staff think that, in general, the benefits of the 2013 ED approach do not justify the increased costs to apply it.

(c) *Retaining existing lessor guidance in Topic 840 and IAS 17* – This option would have simply suggested that U.S. GAAP preparers continue to apply the provisions of Topic 840 to lessor transactions, while IFRS preparers would continue to apply IAS 17. The staff rejected this approach because:

(i) Retention of each respective framework's individual lessor accounting guidance would defeat one of the principal goals of the

leases project, which is a *converged* leases solution. Although relatively minor in most scenarios, differences exist between existing U.S. GAAP and IFRS lessor accounting.

(ii) Issuing a new lessee accounting standard and retaining the existing lessor accounting guidance without revision or amendment could result in other significant inconsistencies such as in scope, the definition of a lease and other definitions. These inconsistencies would likely be exacerbated in sublease scenarios. There is also the potential for further unintended inconsistencies or consequences.

(iii) Existing U.S. GAAP lessor lease classification guidance is complex. The staff think that either Approach 1 or Approach 2 as proposed in this paper would achieve the same outcomes for almost all leases as under existing guidance, but can be drafted so as to simplify and streamline lessor lease classification as compared to existing U.S. GAAP. Appendix A includes a decision tree that sets out the existing U.S. GAAP lease classification guidance applicable to lessors.

Staff analysis of the proposed approaches

Approaches 1 and 2 based on whether the lease is effectively a sale or a financing as compared to Approach 3 based on the lessor's business model

72. Despite the fact that the staff think there is a coherent rationale for Approach 3, the staff also see three main areas of concern with adopting that approach: (a) cost-benefit, (b) subjectivity, and (c) concerns about understandability.

73. Adopting a lessor business model approach would result in significant changes for some lessors and for leases of some classes of assets. Given the significant amount of user and preparer feedback supporting existing lessor accounting, this approach may not provide sufficient benefit to justify the costs that would be incurred by those lessors that would need to significantly change their lessor accounting systems and processes.

74. As noted above, each lessor would be responsible for determining its business model based on indicators. Consequently, there would be an inherent level of subjectivity to this approach that might negatively affect comparability between similar lessors and the consistency of accounting for similar leases. For example, an independent aircraft lessor may conclude that it is a Type B lessor, while the captive finance company of an aircraft manufacturer may conclude that it is a Type A lessor, resulting in different accounting for a similar lease. Nonetheless, the staff think that most similar lessors and lessors of the same class of underlying asset would be likely to apply similar accounting.

75. The staff think that the introduction of a lessor business model approach might not be easily understood given that the approach would depend upon a new series of indicators. Constituents have not had the opportunity to comment on those indicators. In saying that, the staff note that many constituents suggested considering a lessor's business model when determining the appropriate lessor accounting model. In addition, one of the main reasons that the Boards decided to propose changes to existing lessor accounting for leases of assets other than property was to better reflect the business model of some financial lessors, as noted in paragraphs BC73 and BC78 of the Basis for Conclusions to the 2013 ED. Accordingly, the consideration of a lessor's business model has influenced the development of the lessor accounting proposals in the 2013 ED.

76. An approach based on the existing principle of determining whether a lease is effectively a sale or a financing (either Approach 1 or Approach 2) would be less costly than Approach 3. This is because any change in accounting carries some measure of incremental cost. Approach 1 and Approach 2 would be both less subjective in application and more understandable to preparers and others than Approach 3 because of its linkage to the existing principle underlying lessor accounting.

Approach 1 based on the transfer of risks and rewards as compared to Approach 2 based on the transfer of control (for leases that give rise to selling profit or loss)

77. The staff think that there should be only minimal differences in lease classification from applying Approach 1 versus Approach 2. This is because, as outlined above in the discussion of Approach 2, the principal difference in applying a transfer of control analysis as compared to a transfer of risks and rewards analysis relates to how third-party involvement in the lease is considered for leases that give rise to selling profit or loss. Based on information obtained about existing practice in this respect, the staff understand that the types of third-party involvement that are more common in leases of financial lessors are generally infrequent in leases that give rise to selling profit or loss (that is, leases entered into by manufacturers, dealers, and those lessors that generally maintain their underlying assets as their "stock-in trade"). Consequently, the staff would expect relatively few instances when a lessor would conclude that it has transferred substantially all the risks and rewards incidental to ownership of the underlying and *not* transferred control of the underlying asset.

Reasons to support Approach 1

78. Because it is not expected that the adoption of either approach would achieve materially different lessor accounting results, the advantage of Approach 1 would be that it would be the simplest path towards a goal of retaining, in most material respects, existing lessor accounting while also achieving a converged solution. This is because U.S. GAAP and IFRS lessors are generally familiar with the criteria and indicators that would be used in this approach for classifying leases. There would only be the potential for some minor changes in lease classification from existing guidance for some preparers because of the minor differences between existing U.S. GAAP and IFRS (which would occur under Approach 2 as well). By way of example, a land only lease can only be accounted for as a sales-type or direct-financing lease under U.S. GAAP if the lease transfers title to the land to the lessee by the end of the lease term or the lease contains a bargain purchase option. Under IFRS, for very long-term land leases (for example, 99 years), lessors very often apply finance lease accounting even when title is not transferred or a bargain purchase option does not exist.

79. In addition, when determining how to account for leases in the financial statements of a lessor, some staff think that it might be more appropriate to determine when a lessor has sold an underlying asset from the perspective of the *lessor* (as proposed in Approach 1), instead of the perspective of the *lessee* (as proposed in Approach 2 for those leases that give rise to selling profit or loss, and as established in the forthcoming revenue recognition standard). Although the staff have come to understand that third-party involvement is not common in those leases entered into by nonfinancial lessors, some of the staff think there could be instances when the accounting that might result from assessing the sale from the perspective of the lessee might result in accounting that does not reflect the economics of the transaction from the lessor's perspective. For example, assume a dealer lessor transferred virtually all of the risks and rewards incidental to ownership of an underlying asset by entering into a lease with a lessee and also obtaining a buyback agreement with a third party. The buyback agreement is a noncancellable agreement, entered into in conjunction with the lease, for which the third party agrees to buy the underlying asset for a fixed price at the end of the lease with the lessee. In this instance, those staff think it would be appropriate for that dealer lessor to recognize revenue and cost of goods sold (and related selling profit or loss) because it has given up its rights to any material economic benefits to be derived from the asset. If assessed from the perspective of the lessee and the third-party, the dealer lessor may be prevented from recognizing the overall transaction as the sale of the underlying asset. Other staff members think that in the context of the forthcoming revenue recognition standard, this transaction should not be a considered a sale at the beginning of the lease. This is because the benefits of the underlying asset that will accrue to the third-party at the end of the lease term have not been transferred to the customer at lease commencement.

Reasons to support Approach 2

80. The main reason to support Approach 2 is that it conceptually aligns to the forthcoming revenue recognition standard in determining whether a lease is an installment sale. This is because the transfer of control analysis would be based on the requirements for a sale (that is, based on the transfer of control) in the forthcoming revenue recognition standard. Approach 1 and Approach 2 would achieve nearly identical results if adopted currently. However, given the ever-changing business

landscape, new leasing models may emerge that would not necessarily mean that would always be the case. Adoption of Approach 2 would ensure that lessors would recognize sales or product (“top-line”) revenue and selling profit (or loss) from a lease only on the same basis as recognition of those same items resulting from outright sales. At the same time, Approach 2 would still maintain an appropriate framework for determining when financial lessors are effectively entering into a financial transaction, rather than a lease.

81. In addition, use of a transfer of control concept to determine whether a lease is effectively an installment sale would also increase consistency within the proposed leases guidance. In particular:

    (a) The 2013 ED stipulates that a lease exists when a lessee controls the right to use an underlying asset that is transferred by the lessor at lease commencement. The right-of-use is deemed transferred only when the lessee has the ability to direct the use of the underlying asset and the right to obtain substantially all the potential economic benefits from use of the underlying asset throughout the lease term. Therefore, determining whether a right-of-use has been transferred is consistent with determining whether a good has been transferred in the forthcoming revenue recognition standard. However, if the Boards were to adopt Approach 1, a lessor would assess whether a lease is effectively a sale of the underlying asset based on a different transfer principle (that is, risks and rewards) from that used to determine whether a right-of-use is transferred to the lessee.

    (b) If the Boards retain the decision with respect to sale and leaseback transactions (that is, that the seller-lessee should determine whether a sale has occurred based on the transfer of control), the leases guidance would be consistent in concept as to how it determines whether a sale as occurred in a sale and leaseback and how it determines whether a lease is effectively an installment sale.

82. Regarding cost and complexity, the staff think that there would be little incremental complexity (and cost) in applying the transfer of control classification analysis as compared to the transfer of risks and rewards analysis. This is because the analyses for lease classification would be similar in most respects (except for the consideration

of third-party involvement) under both approaches. Further, the staff think that for the vast majority of leases (all but those that give rise to selling profit or loss *and* include third-party involvement in the lease – which the staff understand to be relatively few):

(a) The resulting lease classification would be the same under either the transfer of control or transfer of risks and rewards evaluation (for example, most common existing operating leases would get the same lease classification under either analysis); and

(b) Determining which analysis to apply would not be complex. The staff think, as indicated in existing U.S. GAAP, that selling profit (or loss) would generally be presumed to exist for manufacturer or dealer lessors, as well as for any other lease for which there is a significant lapse in time between the lessor's purchase of the underlying asset and lease commencement.

83. Lastly, the staff have considered that all entities with revenue transactions (which should include all manufacturer and dealer lessors) would be familiar with the transfer of control principle because they will have to apply it under the forthcoming revenue recognition standard.

Staff views

84. The staff think that an approach based on the existing principle of determining whether a lease is effectively a sale or a financing (that is, either Approach 1 or Approach 2) is preferable to Approach 3 mainly because of the increased judgment and complexity that would result from determining a lessor's business model under Approach 3. The staff think that Approach 3 would result in lessor accounting outcomes that are most closely aligned with how a lessor operates its leasing activities. For this reason and if applied consistently, the staff think that Approach 3 has the potential to provide the most useful information to users. Nonetheless, there is a cost associated with Approach 3 for some lessors. It is also unclear whether lessors would be able to determine their respective business models consistently on the basis of the proposed guidance for Approach 3. Consequently, the staff do not think that introducing the lessor business model approach would be appropriate at this time.

85. The staff see merits in adopting either Approach 1 or Approach 2. Approach 1 may be more appropriate, principally because, in the absence of any substantive difference in accounting outcomes, retention of the existing lessor guidance would reduce interpretive and other complexities that could result from the adoption of Approach 2. The incremental complexity of having two lease classification principles (both risks and rewards for financial lessors and the transfer of control for manufacturers, dealers, and other lessors) might not be justified when the accounting outcomes are expected to be identical for the vast majority of leases. Some staff also think that it may be more appropriate to assess when a lessor has sold an underlying asset from the lessor's perspective, rather than from the lessee's perspective.

86. In contrast, the staff also see merits for the longer term in establishing conceptual alignment between the requirements for a sale in the forthcoming revenue recognition standard and the evaluation of whether a lease is effectively an installment sale in any final leases standard. Those staff that would support Approach 2 as their first choice think that Approach 2 accomplishes this goal at minimal incremental cost to preparers as compared to Approach 1. This is because the lease classification analysis for those leases that generally give rise to selling profit or loss (that is, those of manufacturers, dealers, and other nonfinancial lessors) is not significantly different from the analysis that would be applied to leases not giving rise to selling profit (or loss). These staff members think that the relatively minor additional complexity of Approach 2, as compared to Approach 1, would be justified. This is because the outcome of adopting Approach 2 would be the issuance of revised revenue guidance and leases guidance, both of which would include the same principle on which to determine what constitutes the sale of a nonfinancial asset.

Questions: Lessor Accounting Model
Question #1 – Do the Boards have any questions on the proposed approaches?
Question # 2 – Are there any other approaches that the Boards think the staff should explore?

APPENDIX A: Existing lessor lease classification guidance and guidance proposed in the 2013 ED

Classification of leases (2013 ED)

A1. At the commencement date, an entity shall classify a lease as either a Type A lease or a Type B lease. An entity shall not reassess the classification after the commencement date.

A2. If the underlying asset is not property, an entity shall classify a lease as a Type A lease unless one of the following two criteria is met:

(a) The lease term is for an insignificant part of the total economic life of the underlying asset.

(b) The present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease.

A3. If the underlying asset is property, an entity shall classify a lease as a Type B lease unless one of the following two criteria is met:

(a) The lease term is for the major part of the remaining economic life of the underlying asset.

(b) The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type A lease.

A4. Notwithstanding the requirements in paragraphs A2-A3, a lease is classified as a Type A lease if a lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

A5. If a lease component contains the right to use more than one asset, an entity shall determine the nature of the underlying asset on the basis of the nature of the primary asset within the lease component. An entity shall regard the economic life of the primary asset to be the economic life of the underlying asset when applying the classification criteria in paragraphs A2-A3.

A6. Notwithstanding the requirements in paragraph A5, if a lease component contains both land and a building, an entity shall regard the economic life of the building to be the economic life of the underlying asset when applying the classification criteria in paragraph A3.

Classification of leases (IAS 17)

A7. The following is an excerpt from the lease classification guidance in IAS 17:

> 7. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.
>
> **8. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.**
>
> 9. Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.
>
> 10. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
>
> (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

12. The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

13. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7-12 if the changed terms had been in effect at the

inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

14-15 [Deleted]

15A When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7-13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.

16. Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

17. For a lease of land and buildings in which the amount that would initially be recognised for the land element, in accordance with paragraph 20, is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with paragraphs 7-13. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.

18. Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted. Detailed calculations are required for

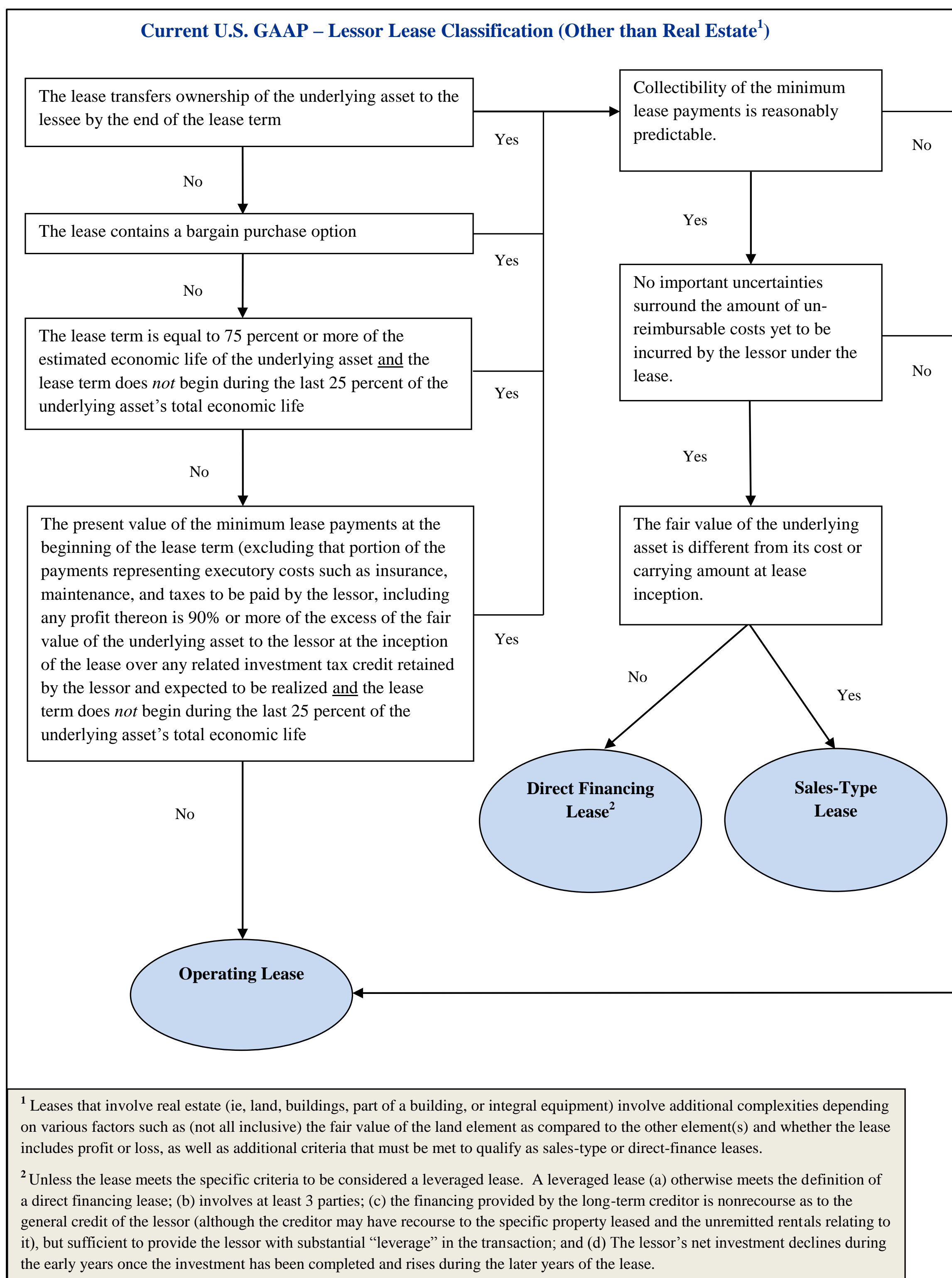
this assessment only if the classification of one or both elements is otherwise uncertain.

19. In accordance with IAS 40, it is possible for a lessee to classify a property interest held under an operating lease as an investment property. If it does, the property interest is accounted for as if it was a finance lease and, in addition, the fair value model is used for the asset recognised. The lessee shall continue to account for the lease as a finance lease, even if a subsequent event changes the nature of the lessee's property interest so that it is no longer classified as investment property. This will be the case if, for example, the lessee:

(a) occupies the property, which is then transferred to owner-occupied property at a deemed cost equal to its fair value at the date of change in use; or

(b) grants a sublease that transfers substantially all of the risks and rewards incidental to ownership of the interest to an unrelated third party. Such a sublease is accounted for by the lessee as a finance lease to the third party, although it may be accounted for as an operating lease by the third party.

Classification of leases (existing U.S. GAAP) - Flowchart



[1] Leases that involve real estate (ie, land, buildings, part of a building, or integral equipment) involve additional complexities depending on various factors such as (not all inclusive) the fair value of the land element as compared to the other element(s) and whether the lease includes profit or loss, as well as additional criteria that must be met to qualify as sales-type or direct-finance leases.

[2] Unless the lease meets the specific criteria to be considered a leveraged lease. A leveraged lease (a) otherwise meets the definition of a direct financing lease; (b) involves at least 3 parties; (c) the financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it), but sufficient to provide the lessor with substantial "leverage" in the transaction; and (d) The lessor's net investment declines during the early years once the investment has been completed and rises during the later years of the lease.