STAFF PAPER

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Project	**Leases**		
Paper topic	Lessor Type A Accounting		
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Introduction

1. This paper asks the Boards to consider two possible approaches for accounting for "Type A" leases by lessors. This paper should be read in conjunction with ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262): Lessor accounting model, which discusses when a lessor would classify a lease as a Type A lease.

2. The two possible Type A approaches discussed in this paper are:

   (a) Approach A – To retain the receivable and residual approach proposed in the 2013 ED for all Type A leases.

   (b) Approach B – To eliminate the receivable and residual approach proposed in the 2013 ED and instead apply existing IFRS finance lease accounting (which is also existing U.S. GAAP sales-type lease accounting) to all Type A leases, subject to potential minor drafting improvements.

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3. The following table illustrates the composition of the approaches:

Approach	Receivable	Residual Asset	Unearned Profit
A	Reported Separately	Reported Separately	Yes – Reported as part of Net Residual Asset
B	Included in the Net Investment in the Lease	Included in the Net Investment in the Lease	No unearned Profit

4. This paper is structured as follows:

(a) Background to Type A lessor accounting.

(b) Summary of feedback received on the Type A lessor accounting approach proposed in the 2013 ED.

(c) Lessor Type A accounting approaches.

(d) Staff views.

(e) Appendix A, which includes an example of application of the receivable and residual approach (as proposed in the 2013 ED) and an example of application of existing sales-type (U.S. GAAP)/ finance (IFRS) lease accounting under Topic 840, *Leases*/IAS 17 *Leases*.

Background to Type A lessor accounting

5. In the Boards' initial exposure draft on leases issued in August 2010 ("2010 ED"), a lessor would apply the derecognition approach to leases for which the lessor did not retain exposure to the significant risks or benefits associated with the underlying asset. Under the derecognition approach, the lessor would initially:

(a) Recognize a lease receivable, measured at the present value of the lease payments, discounted at the rate the lessor charges the lessee, plus any initial direct costs.

(b) Derecognize the portion of the carrying amount of the underlying asset that represents the lessee's right to use the underlying asset during the lease term.

(c) Reclassify as a residual asset the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains.

6. A lessor would recognize the following in the income statement:

(a) *At initial measurement*: Lease income representing the present value of the lease payments and lease expense representing the cost of the portion of the underlying asset that is derecognized at lease commencement.

(b) *Subsequent to initial measurement:* Interest income on the lease receivable.

7. A lessor would not remeasure or adjust the carrying amount of the residual asset during the lease term, except in the case of impairment or reassessment of the lease term.

8. With respect to applying the derecognition approach, many respondents expressed concerns relating to the proposal to "freeze", rather than accrete, the carrying amount of the residual asset. The Boards addressed this concern by revising the derecognition approach in the 2013 ED (the revised derecognition approach in the 2013 ED is referred to as the "receivable and residual" approach in this paper).

9. 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 the net 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); less

(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).

If the lessor reflected an expectation of variable lease payments in the discount rate applied to the lease receivable and the residual asset, the net residual asset would also include an amount representing those expected variable lease payments.

10. 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 sells or re-leases the underlying asset, absent reassessment of the lease term. A lessor would assess the lease receivable for impairment separately from the residual asset.

11. Refer to Appendix A to this paper for an example of application of the receivable and residual approach for Type A leases proposed in the 2013 ED.

Summary of feedback received on the Type A lessor accounting approach proposed in the 2013 ED

12. Some constituents support specific aspects of the receivable and residual approach proposed in the 2013 ED, such as the accretion of the residual asset and the recognition of profit on the lease at lease commencement. Many of these constituents commended the Boards for making improvements to the derecognition model proposed in the 2010 ED.

13. Many constituents however expressed various concerns or have questions about the measurement of the residual asset, including the following:

    (a) Many constituents are concerned about the judgment required in determining the expected value of the underlying asset at the end of each lease, especially for assets for which the second-hand market is volatile (for example, aircraft or ships).

    (b) Constituents note that the determination of the expected value of the underlying asset at the end of each lease would have a significant effect on the amount and timing of income recognition. Some constituents are concerned that the proposals provide opportunities for lessors to manage the timing of income recognition.

(c) Some constituents are concerned that the carrying amount of the residual asset provides less useful information because:

  (i) It comprises disparate parts including variable lease payments and any unearned profit on the residual asset.

  (ii) It is subsequently measured (or accreted) in a way that is inconsistent with the treatment of other nonfinancial assets.

14. Some constituents have specific concerns about the proposal to include variable lease payments in the measurement of the residual asset if the lessor reflects an expectation of variable lease payments in the rate the lessor charges the lessee. These constituents said that the proposal:

  (a) Is too complex.

  (b) Would lead to inconsistent accounting between different lessors because it relies on subjective estimates.

  (c) Inappropriately includes cash flows to be received as part of the lease in the measurement of the residual asset.

15. Some constituents disagree with the proposed recognition of profit on a lease at lease commencement because they think that it would be inappropriate for a lessor to recognize any profit before the lessor has sold the whole underlying asset. Some of these constituents also note the possibility for profit reversal if the lease is terminated early.

16. However, others think that a lessor should recognize the entire difference between the fair value of the underlying asset and its carrying amount as profit at lease commencement. These constituents think that it is complex and counterintuitive to split the profit into a realized portion and an unrealized portion and include the unrealized portion as part of the residual asset.

17. Some constituents also disagree with the proposals with respect to impairment. They are concerned that splitting the cash flows assessed for impairment purposes into those related to the receivable and those related to the residual asset would be complex and arbitrary.

18. Many constituents suggest that the Boards should not change existing U.S. GAAP and IFRS lessor accounting for leases that would receive Type A accounting (that is, a lessor should apply existing sales-type (U.S. GAAP) or finance lease (IFRS) accounting to leases that are effectively sales or financings rather than the receivable and residual approach).

19. Other constituents suggest changing particular aspects of the proposed receivable and residual approach. Those suggestions include:

    (a) Not recognizing the residual asset separately from the lease receivable.

    (b) Providing more guidance on determining the estimated value of the residual asset.

    (c) Measuring the residual asset at fair value, or the present value of the expected residual value at the end of the lease.

    (d) Not recognizing any profit on the lease at lease commencement, or recognizing the full difference between the underlying asset's fair value and its carrying amount.

    (e) "Freezing" the carrying amount of the residual asset without any accretion (as was proposed in the 2010 ED), or allowing reassessment of the carrying amount of the residual asset.

    (f) Removing the requirement to include variable lease payments as part of the residual asset, or introducing a requirement to include variable lease payments as part of the lease receivable.

    (g) Treating the lease receivable and the residual asset as one asset for purposes of impairment.

Lessor Type A accounting approaches

20. On the basis of the feedback received, the staff think that there are two possible ways that a lessor could account for Type A leases, discussed in the following paragraphs.

Approach A – 2013 ED receivable and residual approach

21. Under Approach A, a lessor would apply the receivable and residual approach in the 2013 ED to Type A leases. If the Boards were to adopt this approach, the staff would further consider possible simplifications or improvements to the approach by, for example:
    - (a) Simplifying or removing the complex accounting that could result when a portion of the lease payments are variable; and therefore, are included in determining the interest rate implicit in the lease (for example, by allowing the lessor to otherwise estimate a reasonable discount rate).
    - (b) Allowing the lessor to evaluate the lease receivable and residual asset as a single asset for purposes of impairment.

22. The decision to propose the receivable and residual model in the 2013 ED stemmed from the Boards' proposals on the lessor accounting model. Those proposals would result in a lessor applying the receivable and residual approach to a much larger population of leases than the population to which finance (or sales-type/direct financing) lease accounting applies under existing guidance. According to the 2013 ED, a lessor would apply the receivable and residual approach to most leases of assets other than property, including leases for relatively short portions of the life of the underlying assets (for which the residual asset would be significant). Because of this, the Boards concluded that accounting for the residual asset separately from the lease receivable would provide useful information to financial statement users. In particular, the receivable and residual approach would provide more transparent information about a lessor's exposure to credit risk (associated with the lease receivable) and asset risk (associated with the residual asset). It would also restrict the recognition of profit at lease commencement to only the profit relating to the lease (rather than the profit relating to the entire underlying asset, which is recognized at lease commencement under existing finance (IFRS) and sales-type (U.S. GAAP) lease accounting).

23. The rationale to support the receivable and residual approach changes somewhat depending on the Boards' decision regarding the lessor accounting model (that is,

depending on which of the approaches in ASAF Agenda Paper 4B/ IASB Agenda Paper 3A/FASB Memo 262 the Boards support).

24. If the Boards adopt Approach 1 or Approach 2 (an approach generally consistent with existing lessor accounting lease classification) in ASAF Agenda Paper 4B (Agenda Paper 3A/FASB Memo 262), the staff think that the costs of applying the receivable and residual approach will likely outweigh the benefits. This is because:

    (a) The benefits of separately recognizing a lease receivable and a residual asset are reduced when compared to the rationale for doing so in the 2013 ED because (1) the population of leases to which a lessor would apply the receivable and residual approach under Approach 1 or Approach 2 would be expected to be smaller than under the proposals in the 2013 ED and (2) the amount of those residual assets, as compared to the lease receivables, would be expected to be smaller. Under both Approach 1 and Approach 2, the population of Type A leases would align closely to the population of existing finance (sales-type/direct financing) leases. For many of those leases, there may be no residual asset because the lease is a full-payout lease. Even when a residual asset exists, the amount of the residual asset compared to the lease receivable would be expected to be small (and any profit associated with the residual asset relatively insignificant). Consequently, there is minimal incremental benefit in applying the receivable and residual approach compared to retaining existing finance lease accounting.

    (b) There is a cost associated with applying the receivable and residual approach. Lessors have confirmed that they would need new or enhanced accounting systems to calculate and track the unearned profit, as well as to accrete and track the residual asset separately from the lease receivable. Even for those lessors that already have data available about the expected value of the underlying asset at the end of the lease term, there is a cost associated with implementing the new accounting systems.

25. If the Boards adopt Approach 3 (that is, the lessor business model approach) in ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262), the staff think that the cost-benefit conclusion with respect to the receivable and residual approach is not as

apparent. Under a lessor business model approach, some lessors will likely have a material amount of Type A leases for which the residual asset is a significant portion of the underlying asset, and for which the unearned profit is a significant proportion of the total profit relating to the underlying asset. For example, a car subject to a three-year lease generally has a significant residual value at the end of the lease. This may mean that the receivable and residual approach would provide substantive additional benefit for users when compared to existing finance lease accounting, particularly for those that have expressed support for the improved residual asset information proposed in the 2013 ED. Nonetheless, it is worth noting that many users were indifferent as to whether they receive the improved information about residual assets in the balance sheet or in the notes, while others would prefer to receive that information in the notes.

Approach B – Existing finance lease accounting approach

26. Under Approach B, a lessor would account for all Type A leases in accordance with existing IFRS finance lease accounting, subject to possible minor drafting improvements. Approach B would also retain the FASB's decision in the 2010 ED and the 2013 ED to eliminate direct financing and leveraged lease accounting in U.S. GAAP (existing IFRS finance lease accounting is substantially equivalent to existing U.S. GAAP lessor accounting for sales-type leases).

27. If a lease is classified as a finance lease under existing IFRS, the lessor recognizes a receivable for an amount equal to the net investment in the lease (and does not recognize the underlying asset in its balance sheet). The lessor measures the net investment in the lease at the present value of the minimum lease payments plus any unguaranteed residual value. A lessor recognizes interest income on the net investment in the lease over the lease term using the effective interest method, and any profit on the underlying asset at lease commencement. Manufacturer or dealer lessors recognize revenue and cost of goods sold on finance leases in the same way as for outright sales.

28. Similarly to Approach A, the rationale to support Approach B also changes somewhat depending on the Boards' decision regarding the lessor accounting model.

29. If the Boards adopt Approach 1 or Approach 2 in ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262), the staff think that, from a cost benefit perspective, it is preferable to adopt Approach B (that is, to apply existing finance lease accounting to Type A leases). This is because:

    (a) As noted earlier in this paper, the staff expect little incremental benefit in applying the receivable and residual approach (Approach A in this paper) compared to retaining existing finance lease accounting.

    (b) Retaining existing finance lease accounting would result in substantively lower costs for lessors than adopting the receivable and residual approach.

30. If the Boards adopt Approach 3 (the lessor business model approach) in ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262), there will likely be more benefit from applying the receivable and residual approach rather than existing finance lease accounting. Accordingly, there would be a greater incentive to support Approach A in this paper if the Boards support the lessor business model approach. In addition, some may object to applying existing finance lease accounting to all Type A leases under the lessor business model approach because of the profit recognition consequences. If existing finance lease accounting were to be applied to leases written by lessors with a Type A business model, those lessors would recognize any profit relating to the entire underlying asset at lease commencement, even though the residual asset may be a significant portion of the value of the underlying asset. Nonetheless, it is important to note that there would not be any profit to be recognized by many lessors (namely, financial lessors) who typically purchase underlying assets close to or at lease commencement.

31. Alternatively, the Boards could direct the staff to adopt Approach B in this paper, but stipulate that a lessor should present the lease receivable separately from the residual asset in the balance sheet. This modified version of Approach B would provide additional residual asset information that users have said would be beneficial. At the same time, this modified version of Approach B would alleviate many of the difficulties associated with the receivable and residual approach, which largely stem from accounting for the unearned profit component. The staff think that the incremental costs and complexity to adopt this modified version of Approach B would not be significant when compared to existing finance lease accounting.

Staff views

32. The staff recommend Approach B (that is, retain existing finance lease accounting) with respect to lessor accounting for Type A leases, regardless of the lessor accounting model selected in ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262).

33. If the Boards prefer Approach 1 or Approach 2 in ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262), the staff do not think Approach A (the receivable and residual approach proposed in the 2013 ED) provides sufficient additional benefit to financial statement users to justify the costs lessors would incur to adjust their accounting systems and processes.

34. The staff recommend Approach B even if the Boards prefer Approach 3 in ASAF Agenda Paper 4B (IASB Agenda Paper 3A/FASB Memo 262). Even though Approach 3 would result in more Type A leases for some classes of leases than under existing U.S. GAAP and IFRS (principally some leases written by *some* bank and captive lessors), the staff do not think Approach A would provide sufficient incremental benefit compared to existing finance lease accounting to justify its costs in terms of system and process changes. Some staff members think that if the Boards pursue this course of action, they should consider the modified Approach B discussed earlier in this paper. This modified approach would separately present the lease receivable and the residual asset (measured at the present value of the estimated residual value without any unearned profit component), which has the potential to provide valuable information to users in a more cost-effective manner than retaining the entire receivable and residual approach.

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

APPENDIX A

Example of application of "receivable and residual approach"

Assumptions:

Assumption	Value
Lease term in years	5
Interest rate	6.0%
FV of underlying asset	1,000
Cost of underlying asset (for lessor)	950
Estimated residual value	100
Guaranteed residual value	-
Unguaranteed residual value	100
PV of estimated residual value	75
Portion of asset consumed (90%)	900
Lease payments	220

Workings:

Total Profit = 1,000 - 950 = 50

Profit on ROU = 925/1,000 x 50 = 46

Unearned Income = 50-46 = 4

Periods	0	1	2	3	4	5	
Lessor accounting (receivable and residual)							
Balance Sheet							
Lease receivable	**927**	**763**	**589**	**404**	**208**	**-**	
Gross residual asset	75	80	85	90	95	100	
Unearned income	(4)	(4)	(4)	(4)	(4)	(4)	
Residual asset	**71**	**76**	**81**	**86**	**91**	**96**	
Income Statement							
Interest on receivable		56	46	35	24	12	
Interest on residual asset		5	5	5	5	6	
Interest Income		**61**	**51**	**40**	**29**	**18**	
Profit/Gain at lease commencement	**46**						
Total Lease Income	**46**	**61**	**51**	**40**	**29**	**18**	**245**

Example of application of existing finance/sales-type lease accounting

Assumptions:

Lease term in years	5
Interest rate	6.0%
FV of underlying asset	1,000
Cost of underlying asset (for lessor)	950
Estimated residual value	100
Guaranteed residual value	-
Unguaranteed residual value	100
PV of estimated residual value	75
Portion of asset consumed (90%)	900
Lease payments	220

Workings:

Total Profit = 1,000 - 950 = 50

Periods	-	1	2	3	4	5	
Lessor accounting							
Balance Sheet							
Lease payments receivable	*925*	*763*	*589*	*404*	*208*	*-*	
Unguaranteed residual value	*75*	*80*	*85*	*90*	*95*	*100*	
Net investment in the lease	**1,000**	**843**	**674**	**494**	**303**	**100**	
Income Statement							
Interest on receivable		56	46	35	24	12	
Interest on unguaranteed residual value		5	5	5	5	6	
Interest Income		61	51	40	29	18	
Profit at lease commencement	50						
Total Lease Income	50	61	51	40	29	18	249