IASB Agenda ref	**3C**
FASB Agenda ref	**270**

March 2014

STAFF PAPER

REG FASB│IASB Meeting

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‖), as well as from the discussion of the Boards at the January 2014 joint meeting.

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). A lessor would make that determination by assessing whether the lessor transfers substantially all the risks and rewards incidental to ownership of the underlying asset.

   (b) *Approach 2* – This approach would determine lease classification as Type A or Type B in the same manner as Approach 1. However, this approach would preclude recognition of selling profit and revenue at lease

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commencement for any Type A lease that does not transfer control of the underlying asset to the lessee, consistent with the requirements for a sale in the forthcoming revenue recognition standard.

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

3. Approach 1 and Approach 3 in this paper are largely unchanged from the description of those approaches in Agenda Paper 3A/FASB Memo 262 discussed at the January 2014 joint board meeting. Approach 2 in this paper has been modified and simplified since the January 2014 meeting, while retaining as its core premise that the in order to account for a lease as an effective sale of the underlying asset, it should meet the sale requirements in the forthcoming revenue recognition standard.

4. This paper is structured as follows:

(a) Summary of staff recommendations

(b) Background to lessor accounting

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

(d) Description of the possible lessor accounting approaches

(e) Staff analysis of the proposed approaches

(f) Staff recommendations

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

(h) Appendix B: Application of Approach 2

(i) Appendix C: Alternative development of Approach 2 (Approach 2A)

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

(a) Agenda Paper 3D/FASB Memo 271: Lessor Type A Accounting, which describes how a lessor would account for Type A leases under each of the approaches in this paper.

(b) Agenda Paper 3E/FASB Memo 272: 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.

6. Agenda paper 3A/FASB Memo 262 discussed at the January 2014 joint board meeting included a discussion of lessor accounting models considered but rejected by the staff. This paper does not repeat that discussion—please refer to paragraph 71 of that January 2014 board paper for further information in this respect.

Summary of staff recommendations

7. The staff recommend that the Boards adopt Approach 2. This is because we see substantial benefit in aligning the lessor accounting guidance to the forthcoming revenue recognition standard at only a modest incremental cost in terms of additional complexity. Approach 2 would retain, in the final leases guidance, the present link with respect to sale accounting between existing U.S. GAAP and IFRS leases and revenue guidance, which the staff view as beneficial.

Background to lessor accounting

8. January 2014 Agenda Paper 3A/FASB Memo 262: Lessor Accounting Model provided background on the Boards' proposals with respect to lessor accounting in the initial Discussion Paper entitled *Leases: Preliminary Views* issued in March 2009 (–2009 DP‖) and the Boards' initial joint exposure draft, *Leases*, issued in August 2010 (–2010 ED‖). We have not repeated all of that background information in this paper, but have incorporated it herein by reference to the January 2014 board paper.

9. In the 2013 ED the Boards concluded that, under the right-of-use model, the lessor's performance at lease commencement creates an unconditional right to receive lease payments. 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). Consequently, the lessor has a lease receivable from the lessee at lease

commencement that meets the definition of an asset in the Boards' respective frameworks.

10. Nonetheless, the Boards decided not to propose the recognition of a lease receivable for all leases. They, thereby, rejected a single lessor model and symmetry between the lessee and lessor accounting proposals. Although a number of constituents had suggested that a lessor should recognize a lease receivable and a residual asset for all leases, the Boards rejected that approach for the reasons set out in paragraph BC73 of the Basis for Conclusions to the 2013 ED.

11. 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).

12. Under the receivable and residual approach, at lease commencement a lessor would recognize a lease receivable (measured at the present value of the lease payments) and 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).

13. 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 the lessor accounting proposals in the 2013 ED

14. The Boards received significant feedback on the lessor accounting proposals in the 2013 ED. January 2014 Agenda Papers 3A & 3B/FASB Memos 262 & 263 provided substantive summaries of this feedback the staff considered with respect to lessor accounting and its impact on lessee accounting. That paper also set out the staff's view on symmetry between the lessor and lessee accounting models. This paper does not repeat all of that feedback and discussion but it is incorporated herein by reference.

Description of the possible lessor accounting approaches

15. In summary, from a conceptual perspective, 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 for those same leases by the lessee. 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*.

16. 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 lessee accounting approaches proposed in Agenda Paper 3A/FASB Memo 268). Nonetheless, the staff think that each of the approaches in this paper would address the main cost-benefit concerns raised about the lessor accounting proposals in the 2013 ED and achieve a converged lessor accounting solution, while not detracting from efforts to make needed changes to lessee accounting.

Approach 1 – Legacy Topic 840/IAS 17 approach

Overview of Approach 1

17. 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 Agenda Paper 3D/FASB Memo 271 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."

18. A lessor would determine whether a lease is effectively a financing or a sale, rather than an operating lease, by assessing whether the lessor transfers substantially all the risks and rewards incidental to ownership of the underlying asset (similar to the principle in IAS 17 *Leases*).

19. 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 guaranteed by any third-party unrelated to the lessor (including the lessee) 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.

20. 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 being able to sell the asset only at a significant loss).

21. In addition:

(a) Consistent with existing IFRS, a lessor 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), a lessor would assess land and other elements separately for purposes of lease classification when necessary, unless the land element is clearly immaterial.

Rationale for Approach 1

22. Approach 1 would retain existing lessor accounting for U.S. GAAP and IFRS preparers in all material respects. This approach would achieve a converged lessor accounting model that would not introduce new concepts or result in inconsistencies (such as in the definition of a lease or lease term) with the proposed lessee accounting model. The rationale for this approach is based on the following feedback on 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. It thereby minimizes 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 of the underlying asset.

(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. It would 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 that largely reflects the cash lease rentals received. They would adjust the reported income statement amounts under Type A accounting to get back to that information. Consequently, some lessors may have resorted to non-GAAP reporting to satisfy users' needs. This approach would address the concerns of these constituents.

(d) Users and preparers of financial statements for property lessors generally support the lessor accounting proposed in the 2013 ED (Type B for most leases of property). This is generally consistent with existing U.S. GAAP and IFRS 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 – Updated Topic 840/IAS 17 approach

Overview of Approach 2

23. Approach 2 would classify leases as Type A or Type B based on the same principle and classification test proposed for Approach 1.

24. Notwithstanding that, a lessor would recognize selling profit on a Type A lease and/or ―gross‖ revenue (that is, ―top-line‖ sales or product revenue and cost of goods sold) consistently with the requirements for a sale in the forthcoming revenue recognition standard. Accordingly, a lessor would recognize selling profit and/or revenue on a Type A lease only when the lessee obtains control of the underlying asset as a result of the lease (that is, only when the lessee has the ability to direct the use and obtain substantially all the remaining benefits of the underlying asset).

25. A lessee would obtain control of the underlying asset when any of the three criteria in the Approach 1 classification test are met. The three criteria are set out in paragraph 19 of this paper. However, the evaluation of the three criteria would *not* take into consideration any portion of the risks or benefits of the underlying asset that are transferred to a party other than the lessee as a result of, or in conjunction with, the lease (for example, residual value guarantees or asset buyback commitments of a third-party unrelated to the lessee).

26. A Type A lease would give rise to selling profit if the fair value of the underlying asset is higher than its carrying amount at lease commencement. This is often the case for a manufacturer or dealer lessor. If a Type A lease gives rise to selling profit but the lessee does not obtain control of the underlying asset as a result of the lease, the lessor defers that profit at lease commencement, reducing the lessor's net investment in the lease at that date. The lessor would then recognize the deferred profit over the lease term in such a manner so as to produce, when combined with the interest income on the lease receivable and the residual asset, a constant periodic rate of return on the lease. A lessor would recognize the deferred profit together with the interest income on the lease receivable and the residual asset. From a practical perspective, a lessor could apply this requirement at lease commencement simply by determining the net investment in the lease as the *carrying amount* of the underlying asset, rather than its

fair value (less the deferred profit). Appendix B to this agenda paper provides an example of the accounting resulting from this proposal.

27. A lessor would not defer any selling *loss* on the underlying asset under Approach 2 if the lessee does not obtain control of the underlying asset as a result of the lease. A lessor would consider other applicable U.S. GAAP or IFRS (such as the impairment guidance with respect to inventory in Topic 330 or property, plant and equipment in Topic 360 and IAS 36 *Impairment of Assets*). The staff think that such considerations would generally result in the recognition of any loss on the underlying asset on or before lease commencement. This is because, for example, the pricing in the lease would likely serve as evidence that the cash flows to be derived from the underlying asset will be less than its carrying amount, resulting in the recognition of impairment.

Rationale for Approach 2

28. Approach 2 retains the existing U.S. GAAP and IFRS lessor accounting models in all significant respects, while *updating* that guidance in order to:

    (a) Converge U.S. GAAP and IFRS – as does Approach 1; and

    (b) Align the guidance for determining whether the lease is effectively a sale of the underlying asset with the Boards' forthcoming revenue recognition standard – which Approach 1 does not.

29. Approach 2, like Approach 1, accepts that the existing concept of the transfer of risks and rewards provides an appropriate, and understood, framework for evaluating whether the lease is effectively a financial transaction; that is, a transaction that converts risk arising from the underlying asset (asset risk) into credit risk for the lessor. Consequently, the most faithful representation of a lessor's involvement in a lease that transfers substantially all the risks and rewards incidental to asset ownership is to recognize the lessor's financial investment in the lease, and recognize financial income on that investment.

30. Approach 2 would, however, differ from Approach 1 by proposing to *retain* the link in existing U.S. GAAP and IFRS between:

(a) –Sales-type‖ lessor accounting (that is, those leases that give rise to selling profit or loss and generally result in ―top-line‖ sales or product revenue – typically those of manufacturers or dealers); and

(b) The revenue recognition guidance.

31. Under existing U.S. GAAP and IFRS, a lessor recognizes selling profit and sales/product revenue from a sales-type/finance lease based on the same principle as for revenue recognition; therefore, that retained linkage in Approach 2 represents –status quo‖ lessor accounting in that respect. The following table illustrates the requirements for –sales-type‖ lease accounting in 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 (formerly FAS 66)	Account for under ASC 360-20 (formerly FAS 66)

32. Approach 2 would stipulate that a lessor would recognize sales or product revenue arising from a lease, as well as profit on the underlying asset, only if the lease meets the requirements for a sale in the forthcoming revenue recognition standard. Approach 2 would state that a sale has occurred only when 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 the remaining benefits of the underlying asset. Approach 2 asserts that recognition of selling profit and –gross‖ revenue from a Type A lease on a basis other than that in the forthcoming revenue recognition standard would be inappropriate and would represent a change from existing lessor guidance.

33. The proposed requirements for recognizing selling profit and/or sales/product revenue in Approach 2 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."

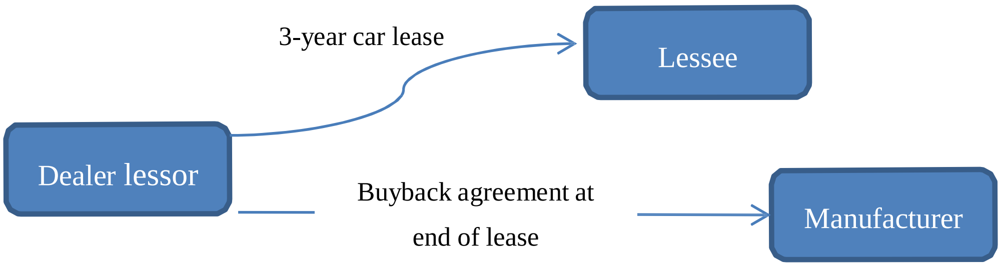
Differences between Approach 2 and Approach 1

34. 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.

35. The staff understand that, in practice, it is relatively rare that those lessors with leases that typically give rise to selling profit would obtain third-party residual value support. Nonetheless, to illustrate the possible difference between Approach 1 and Approach 2, consider the following examples.

36. **Example 1**: Assume that a dealer lessor transfers substantially all of the risks and rewards incidental to ownership of a car by entering into a 3-year lease with a lessee and, at the same time, entering into a buyback agreement with the car manufacturer. The lease includes a clause that requires the lessee to return the car in a specified condition. The price of the car in the buyback agreement is a predetermined, fixed price, representing the expected residual value of the car at the end of the 3-year lease.

That expected residual value is 45% of the fair value of the car at lease commencement.



37. In this example, under Approach 1, the dealer lessor would classify the lease as a Type A lease and recognize selling profit and revenue on the transaction at lease commencement (assuming the dealer lessor is also in the business of selling cars). This is because the lessor would conclude that it has transferred substantially all the risks and rewards incidental to ownership of the car to the lessee *and* the manufacturer.

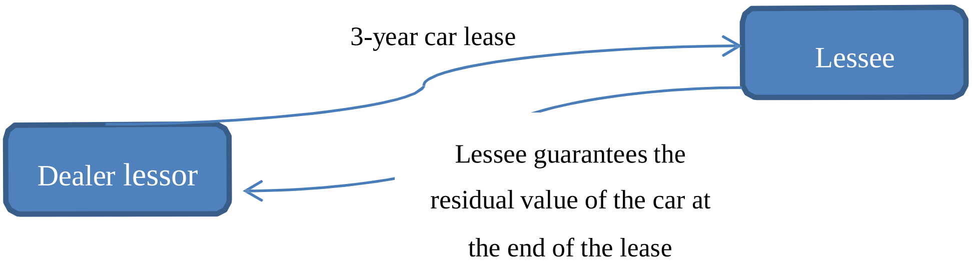
38. Under Approach 2, the dealer lessor would classify the lease as a Type A lease but would *not* recognize selling profit and sales revenue on the transaction at lease commencement. Instead, it would recognize any selling profit on the car over the 3-year lease term, together with interest income on its net investment in the lease. This is because a sale has not occurred. Neither the lessee, nor the manufacturer, has obtained control of the car at lease commencement.

(a) The lessee does not obtain control of the car because it does not have the ability to obtain substantially all the remaining benefits of the car as a result of the lease. The residual value support provided by the manufacturer, in the form of the buyback agreement, would be expected to have no bearing on whether the lessee has the right to direct the use and obtain substantially all the remaining benefits of the car.

(b) The manufacturer does not obtain control of the car until after the 3-year lease term (that is, it cannot direct the use, nor obtain substantially all the remaining benefits, of the car until after the lease term).

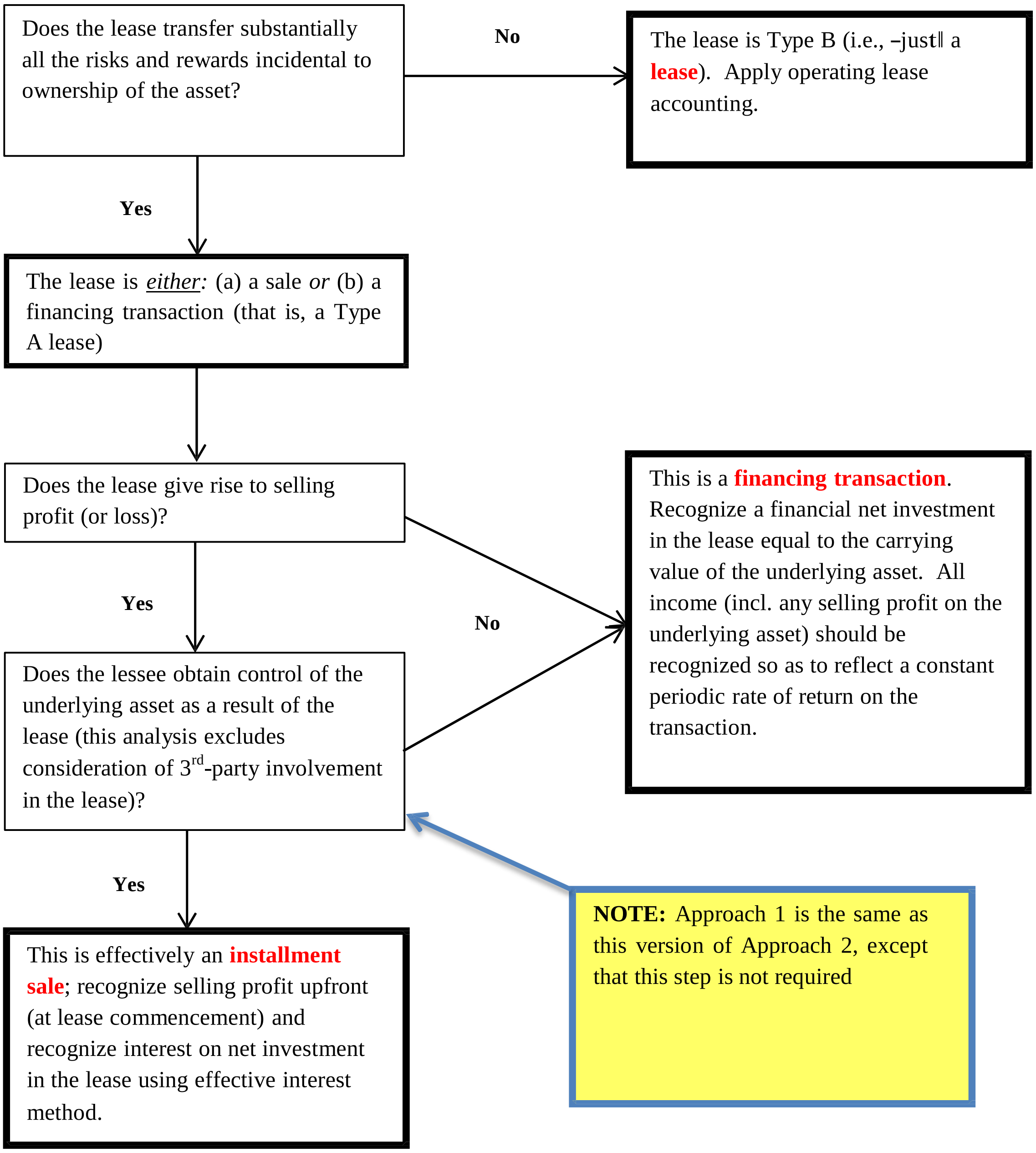
39. Under this example, there is no difference in lease classification for the dealer lessor—the lessor recognizes a net investment in the lease under both Approach 1 and Approach 2. The difference in outcomes relates to the timing of the recognition of selling profit and the recognition of revenue and cost of goods sold. Appendix B to this paper illustrates this difference using an example.

40. **Example 2**: Assume that this example is changed so that the lessee provides residual value support to the lessor:


3-year car lease
Lessee
Dealer lessor
Lessee guarantees the residual value of the car at the end of the lease

41. The staff would expect the conclusion under Approach 2 to change from that in Example 1. The staff think that when *the lessee* has guaranteed all or a portion of the lessor's estimated residual value, the lessee controls that portion of the underlying asset that it has guaranteed. Under the terms of this contract, the lessee could either return the car to the lessor with the required residual value or it could use and consume the economic benefits in the car, making a financial payment to the lessor to satisfy the residual value guarantee. Because the lessee controls that decision, it controls the remaining benefits of the car. In this example, the lessor would therefore conclude that the lessee has obtained control of the car by considering the residual asset to be controlled by the lessee. Consequently, the lessor in this example would recognize selling profit and sales revenue under both Approach 1 and Approach 2.

The following flowchart depicts how a lessor would apply Approach 2, and compares it to Approach 1:



Does the lease transfer substantially all the risks and rewards incidental to ownership of the asset?

The lease is Type B (i.e., ―just‖ a **lease**). Apply operating lease accounting.

The lease is *either*: (a) a sale *or* (b) a financing transaction (that is, a Type A lease)

Does the lease give rise to selling profit (or loss)?

This is a **financing transaction**. Recognize a financial net investment in the lease equal to the carrying value of the underlying asset. All income (incl. any selling profit on the underlying asset) should be recognized so as to reflect a constant periodic rate of return on the transaction.

Does the lessee obtain control of the underlying asset as a result of the lease (this analysis excludes consideration of 3rd-party involvement in the lease)?

NOTE: Approach 1 is the same as this version of Approach 2, except that this step is not required

This is effectively an **installment sale**; recognize selling profit upfront (at lease commencement) and recognize interest on net investment in the lease using effective interest method.

Alternative development of Approach 2

42. The staff think that Approach 2 could be developed in an alternative way to achieve the same accounting result as that described above (hereafter, referred to as Approach 2A). Appendix C outlines Approach 2A, including a flowchart depicting how Approach 2A would work.

Approach 3 - Lessor business model approach

Overview of Approach 3

43. 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 to different lessees.

(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.

44. Lessors would apply the lessor business model approach by class of underlying asset.

45. Under Approach 3, the staff would anticipate that bank lessors, captives of car and truck manufacturers, and many asset financing companies would apply Type A accounting to their leases. In contrast, lessors of most property, railcars, drilling rigs, aircraft (non-captive lessors), ships, telecommunications towers and fiber-optic cables would apply Type B accounting to their leases.

46. In addition, under this approach, a Type B lessor would 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 a Type B lessor enters 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 does not apply to that lease.

Rationale for Approach 3

47. 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.

48. 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.

49. 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 An Equipment Leasing Association

50. The lessor business model approach would directly address the feedback from constituents that support having lessor accounting requirements that more closely reflect lessors' business models. This approach would 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 would result in lessor accounting that would not reflect the economics of particular types of leases.

51. 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.

52. The lessor business model approach is based on the premise that lessors of property and 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.

53. For such leases of property or other long-lived assets, it would appear to provide useful information for the lessor to continue to recognize the entire underlying asset during the lease. This is because of the lessor's active management of the underlying asset and because the value of the asset may not decrease substantially over the lease term. For these leases, users have indicated that 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.

54. In addition, lessor accounting is not just about determining how to account for the lease. It 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.

55. The IASB addresses 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.

56. 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 substantially all 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, some lessors purchase a specified amount of third-party residual value insurance to meet the existing lease classification thresholds.

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

57. Approaches 1 and 2 essentially retain existing lessor accounting for most leases, whereas Approach 3 would propose changes for some lessors. When assessing the merits of adopting a new model (that is, Approach 3) compared to retain existing lessor accounting (Approaches 1 or 2), the staff considered three areas: (a) cost-benefit, (b) subjectivity, and (c) concerns about understandability.

58. Adopting a lessor business model approach (Approach 3) 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 change their lessor accounting systems and processes.

59. 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. This 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.

60. 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.

61. 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 more understandable and less subjective in application than Approach 3 because of the link to the existing principle underlying lessor accounting.

Approach 1 as compared to Approach 2

62. The staff think that if the Boards adopt Approach 2, they should develop the guidance as described for Approach 2 (rather than Approach 2A outlined in Appendix C). Although Approach 2 and Approach 2A would result in the same accounting outcomes, the staff think that Approach 2 would be more easily applied by lessors and understood by users. Therefore, the remainder of this analysis compares Approach 1 to Approach 2, not Approach 2A.

63. Both Approach 1 and Approach 2 use the same lease classification test to determine if a lease should be classified as Type A or Type B. Consequently, there would be no

difference in lease classification as Type A or Type B between Approach 1 and Approach 2.

64. Approach 1 and Approach 2 differ only with respect to the requirements to recognize selling profit and –gross‖ sales or product revenue on Type A leases. The staff think that there are only limited scenarios for which a lessor would be precluded from recognizing selling profit and/or –gross‖ revenue on a Type A lease under Approach 2 at lease commencement, but would recognize these amounts under Approach 1. These scenarios are relatively rare in practice. This is because the principal difference in applying Approach 1 (that is, a risks and rewards analysis from the lessor's perspective) as compared to Approach 2 (that is, a transfer of control analysis from the lessee's perspective) relates to how third-party involvement in the lease is considered in the analysis. Based on information obtained about existing practice, the staff understand that third-party involvement is generally infrequent in leases that give rise to selling profit (that is, leases entered into by manufacturers or dealers). In contrast, third-party involvement is common in leases entered into by financial lessors, whose leases typically do not give rise to selling profit or –top-line‖ revenue. 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 asset but that the lessee has not obtained control of that underlying asset.

Reasons to support Approach 1

65. Approach 1 would likely 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 Approach 1 does not have the additional transfer of control overlay for leases that give rise to selling profit under Approach 2. A lessor would recognize any selling profit at lease commencement on a lease classified as Type A, without any further consideration. A manufacturer or dealer lessor would present sales or product revenue (and related cost of goods sold) on such leases if such presentation best reflects their business model, without further consideration.

66. In addition, supporters of Approach 1 might view it as more straight-forward 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). This might be the case in some more complex transactions that involve several parties. .

67. Supporters of Approach 1 might also suggest that they think it is appropriate for a lessor to recognize profit and revenue on a lease when the lessor has transferred substantially all the risks and rewards incidental to ownership of the underlying asset. For example, in **Example 1** presented above with respect to Approach 2, supporters of Approach 1 would conclude that it would provide useful information for the dealer lessor to recognize selling profit and revenue on the lease transaction at lease commencement. Accordingly, they would view the transfer of substantially all the risks *and* rewards incidental to asset ownership as an appropriate concept to use to determine when to recognize selling profit and sales or product revenue in the context of a lease, regardless of the concept used in the revenue recognition guidance.

Reasons to support Approach 2

68. The main reason to support Approach 2 is that it retains, in most material respects, existing lessor accounting while also aligning the lessor accounting guidance to the forthcoming revenue recognition standard. Accordingly, Approach 2 would *retain* the link that exists between the existing leases and revenue standards in this respect. Approach 2 would prohibit the recognition of selling profit and sales or product revenue resulting from a Type A lease when the corresponding requirements for revenue recognition in the forthcoming revenue recognition standard are not met. Approach 1 and Approach 2 would achieve nearly identical results if adopted based on current practice. However, given the ever-changing business landscape, new leasing models may emerge that would not necessarily mean that this would always be the case. Adoption of Approach 2 would ensure that lessors would recognize selling profit and revenue from a lease only on the same basis as the recognition of those items resulting from outright sales. At the same time, Approach 2 would still maintain an appropriate and understood framework for determining when the best

representation of the lessor’s involvement in the lease is to account for the lease as a financial transaction.

69. In assessing Approach 2 as compared to Approach 1, the staff note that both existing U.S. GAAP and IFRS require additional evaluation by the lessor with respect to accounting for ―sales-type‖ leases. Accordingly, Approach 2 is no different from existing U.S. GAAP and IFRS in this respect. By way of example, under existing U.S. GAAP, a real estate lessor must consider the revenue recognition requirements in ASC Subtopic 360-20, and account for the transaction in the same manner as a seller of the same property. Under IFRS, a manufacturer or dealer lessor follows its policy for outright sales in recognizing the selling profit on finance leases. In saying that, this generally does not result in any incremental effort or difference in outcome because IAS 17 determines whether a lease is effectively an installment sale using the same transfer of risks and rewards principle in IAS 18 *Revenue*.

70. In addition, use of the transfer of control concept in the forthcoming revenue recognition standard 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. A lease exists only when the lessee has the ability to direct the use, and obtain substantially all the potential economic benefits from use, of the underlying asset throughout the lease term. Accordingly, determining whether a lease exists is largely consistent with determining whether a lessor has transferred a good in the forthcoming revenue recognition standard. Approach 2 would require a lessor to assess whether it has sold the underlying asset using a transfer of control concept, which is also the concept used to determine that a lease exists.

(b) In the 2013 ED for sale and leaseback transactions, the Boards decided that the seller-lessee should determine whether a sale has occurred based on the transfer of control principle in the forthcoming revenue recognition standard. Approach 2 would ensure consistency in concept as to how a seller-lessee determines whether a sale has occurred in a sale and leaseback and how a lessor determines whether a lease is effectively an installment sale.

71. Regarding cost and complexity, the staff think that there would not be significant incremental costs or complexity in applying Approach 2 as compared to Approach 1. This is because:

(a) The incremental assessment required by Approach 2 would apply only to leases already determined to be Type A *and* that also give rise to selling profit.

(b) The incremental analysis relies only upon information already obtained and assessed for lease classification as Type A or Type B. The incremental analysis merely excludes consideration of a portion of that information (that is, information with respect to third-party involvement in the lease).

72. 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 to outright sales under the forthcoming revenue recognition standard.

Staff recommendations

73. 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. This is 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, who would classify more leases as Type A leases than under existing requirements. This is the case even though the staff recommendation in Agenda Paper 3D/FASB Memo 271 would significantly reduce the costs of applying Type A accounting compared to the

2013 ED. 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 are not recommending that the Boards adopt Approach 3.

74. Upon consideration of Approaches 1 and 2 (as well as 2A), the staff recommend that the Boards adopt Approach 2. The staff think that there are substantial benefits from aligning the requirements for sale accounting in the forthcoming revenue recognition standard and the final leases standard. An entity would determine when it has sold the underlying asset in a lease contract on the same basis as it would in a revenue contract. Approach 2 would also, therefore, retain the link that exists between existing U.S. GAAP and IFRS revenue and leasing guidance. That existing guidance aligns the recognition of selling profit and revenue for –sales-type‖ leases with the recognition of those amounts in a revenue contract. The staff think it would be preferable to define a sale of the underlying asset in the final leases guidance on the same basis as that in the forthcoming revenue recognition standard. The staff think that Approach 2 requires only a modest amount of incremental complexity for some leases (that is, only those Type A leases that give rise to selling profit and for which there is third party involvement) as compared to Approach 1 in order to achieve the above-outlined benefits.

Question: Lessor Accounting Model

Which lessor accounting model do the Boards prefer?

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.

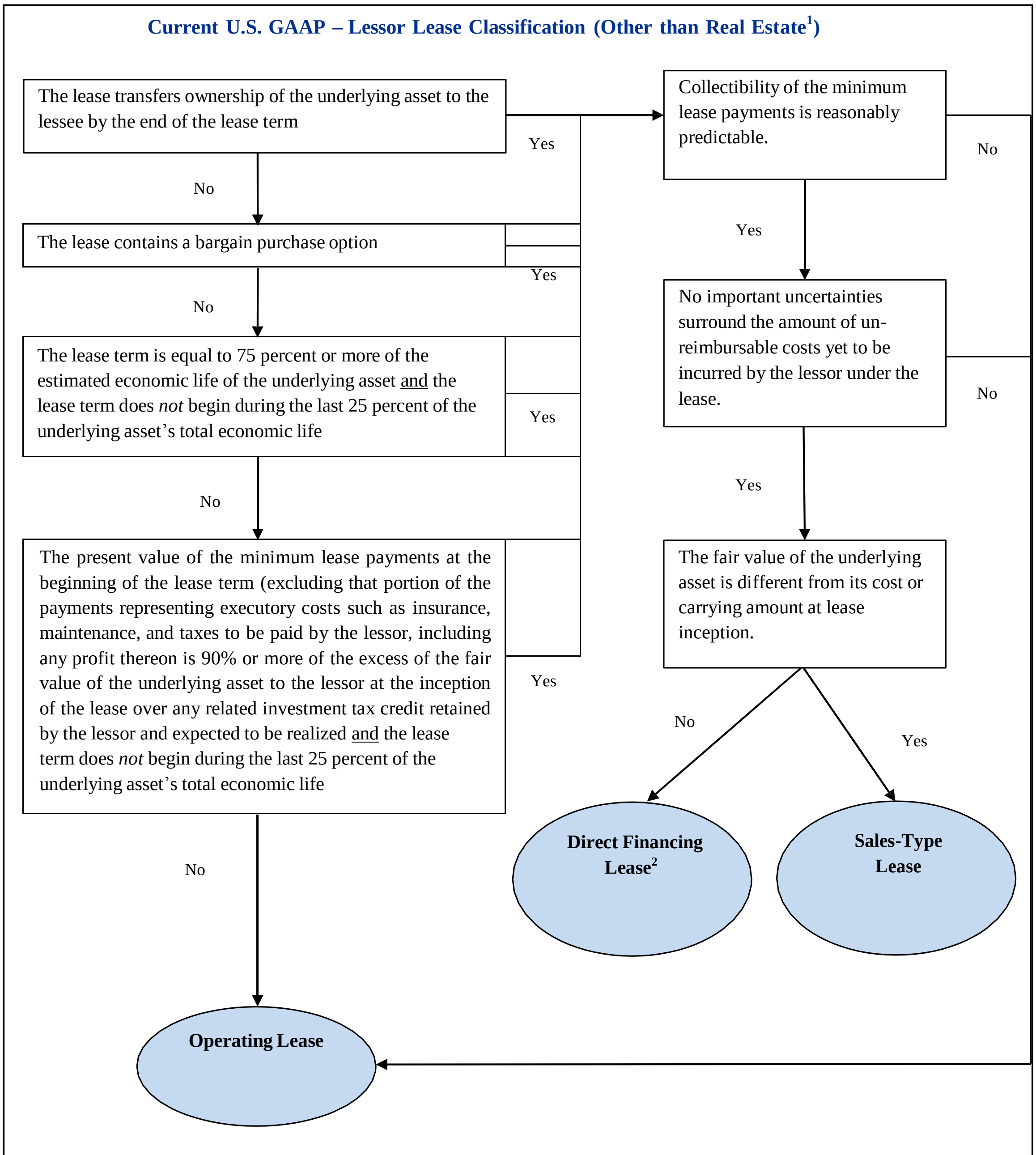
18. Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted. Detailed calculations are required for this assessment only if the classification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

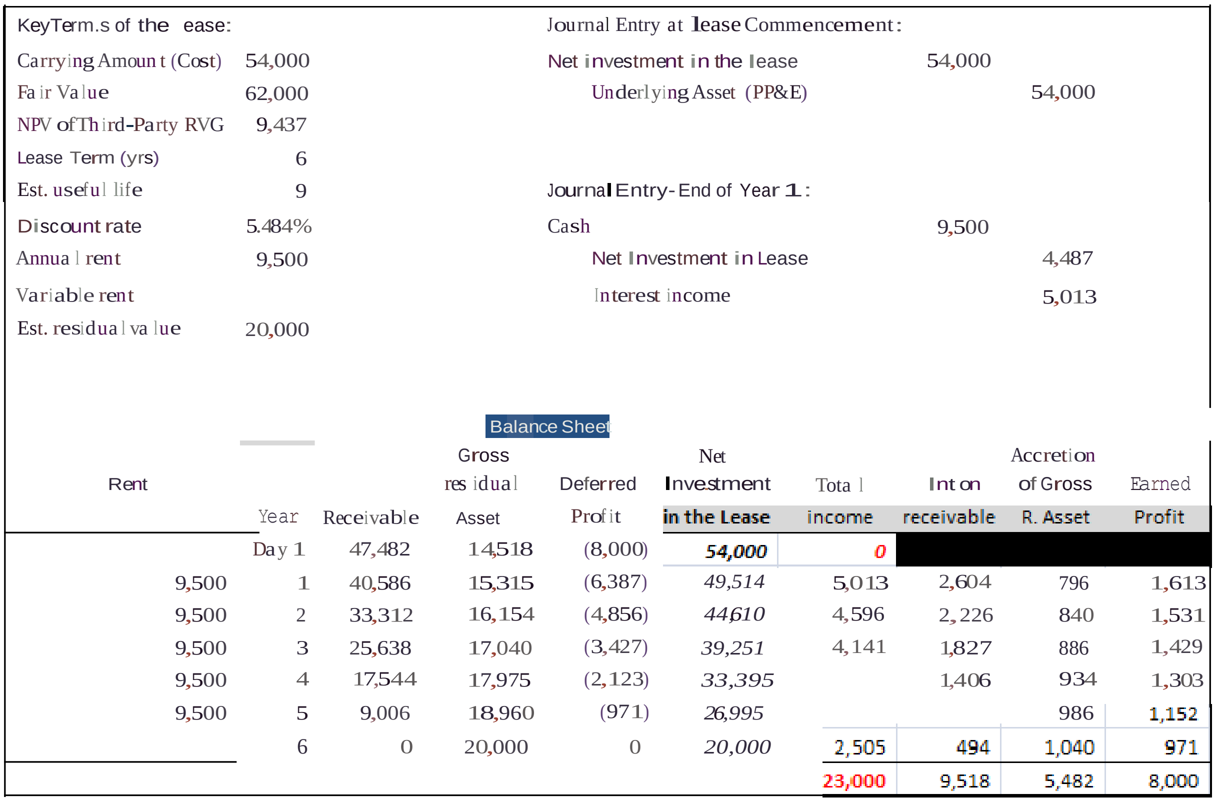

Current U.S. GAAP – Lessor Lease Classification (Other than Real Estate1)
The lease transfers ownership of the underlying asset to the lessee by the end of the lease term
Yes
No
The lease contains a bargain purchase option
Yes
No
The lease term is equal to 75 percent or more of the estimated economic life of the underlying asset and the lease term does not begin during the last 25 percent of the underlying asset's total economic life
Yes
No
The present value of the minimum lease payments at the beginning of the lease term (excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon is 90% or more of the excess of the fair value of the underlying asset to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized and the lease term does not begin during the last 25 percent of the underlying asset's total economic life
Yes
No
Collectibility of the minimum lease payments is reasonably predictable.
No
Yes
No important uncertainties surround the amount of un-reimbursable costs yet to be incurred by the lessor under the lease.
No
Yes
The fair value of the underlying asset is different from its cost or carrying amount at lease inception.
No
Yes
Direct Financing Lease2
Sales-Type Lease
Operating Lease

[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.

APPENDIX B: Application of Approach 2 *(assumes Boards adopt Approach B in Agenda Paper 3DIFASB Memo* 271)

Type A lease that gives rise to seHing pro.fiJ but does not tranifer control to the Jessee



KeyTerm.s of the ease:

Carrying Amount (Cost)	54,000
Fair Value	62,000
NPV of Third-Party RVG	9,437
Lease Term (yrs)	6
Est. useful life	9
Discount rate	5.484%
Annual rent	9,500
Variable rent	
Est. residual value	20,000

Journal Entry at lease Commencement:

Net investment in the lease	54,000	
Underlying Asset (PP&E)		54,000

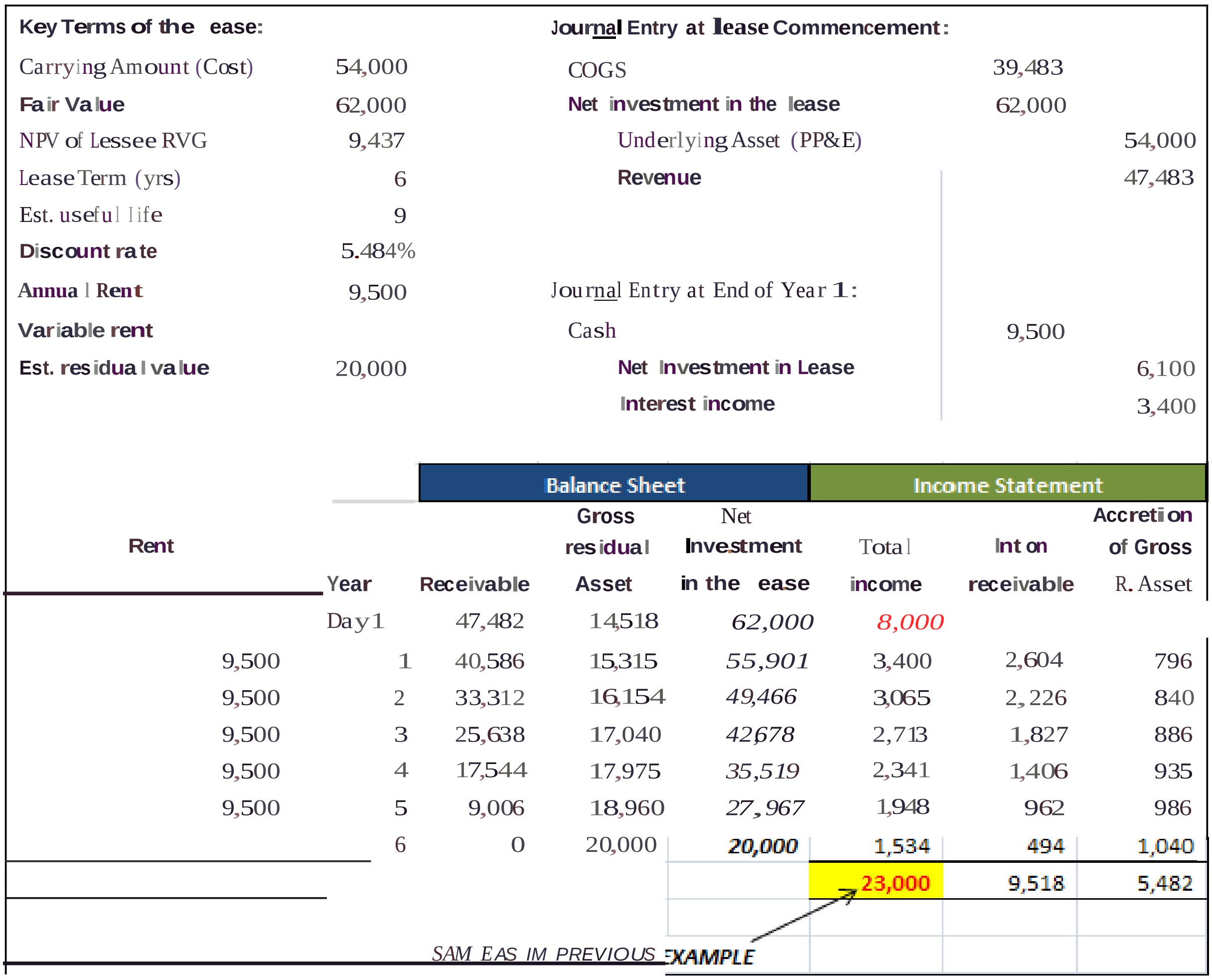
Journal Entry- End of Year 1:

Cash	9,500	
Net Investment in Lease		4,487
Interest income		5,013

Balance Sheet

Rent	Year	Receivable	Gross residual Asset	Deferred Profit	Net Investment in the Lease	Total income	Int on receivable	Accretion of Gross R. Asset	Earned Profit
	Day 1	47,482	14,518	(8,000)	*54,000*	*0*	[redacted]	[redacted]	[redacted]
9,500	1	40,586	15,315	(6,387)	*49,514*	5,013	2,604	796	1,613
9,500	2	33,312	16,154	(4,856)	*44,610*	4,596	2,226	840	1,531
9,500	3	25,638	17,040	(3,427)	*39,251*	4,141	1,827	886	1,429
9,500	4	17,544	17,975	(2,123)	*33,395*		1,406	934	1,303
9,500	5	9,006	18,960	(971)	*26,995*			986	1,152
	6	0	20,000	0	*20,000*	2,505	494	1,040	971
						23,000	9,518	5,482	8,000

Type A lease that gives rise to selling profit and transfers control to the lessee:



Key Terms of the ease:	
Carrying Amount (Cost)	54,000
Fair Value	62,000
NPV of Lessee RVG	9,437
Lease Term (yrs)	6
Est. useful life	9
Discount rate	5.484%
Annual Rent	9,500
Variable rent	
Est. residual value	20,000

Journal Entry at lease Commencement:		
COGS	39,483	
Net investment in the lease	62,000	
Underlying Asset (PP&E)		54,000
Revenue		47,483

Journal Entry at End of Year 1:		
Cash	9,500	
Net Investment in Lease		6,100
Interest income		3,400

		Balance Sheet			Income Statement		
Rent	**Year**	**Receivable**	**Gross residual Asset**	Net **Investment in the ease**	Total **income**	**Int on receivable**	**Accretion of Gross** R. Asset
	Day1	47,482	14518	*62,000*	*8,000*		
9,500	1	40,586	15,315	*55,901*	3,400	2,604	796
9,500	2	33,312	16,154	*49,466*	3,065	2, 226	840
9,500	3	25,638	17,040	*42,678*	2,713	1,827	886
9,500	4	17,544	17,975	*35,519*	2,341	1,406	935
9,500	5	9,006	18,960	*27, 967*	1,948	962	986
	6	0	20,000	***20,000***	1,534	494	1,040
					23,000	9,518	5,482

SAM EAS IM PREVIOUS EXAMPLE

APPENDIX C: Alternative development of Approach 2 (Approach 2A)

C1. The rationale for Approach 2A would be, primarily, to more closely align the principle used for lease classification with the principle of control used in the forthcoming revenue recognition standard. At the same time, the approach would also consider the effect of third-party agreements (for example, residual value guarantees or asset buyback agreements) in determining the appropriate characterization of the lessor's position in the lease as either:

(a) Operating in nature – in which case the lessor would account for the lease in accordance with operating lease accounting; or

(b) Financial in nature – in which case the lessor would recognize a net investment in the lease equal to the carrying value of the underlying asset. The lessor would recognize income on the lease based on a pattern reflecting a constant periodic return on its net financial investment in the lease (that is, based on the effective interest method), consistent with existing IFRS finance lease accounting.

C2. The staff note that the result of Approach 2A is in concept the same as under existing U.S. GAAP and IFRS. A contract written as a lease can be simply an operating-type lease (for example, a three-year lease of a long-lived piece of equipment), a financial transaction (for example, a bank lessor purchasing an asset solely for the purpose of leasing it to a lessee in order to earn financial income), or an installment sale. Approach 2A is intended to distinguish between those three possibilities, and ensure the determination as to which leases are effectively sales conforms to the requirements for a sale in the Boards' forthcoming revenue recognition standard.

C3. Accordingly, Approach 2A would stipulate that a lease is effectively an installment sale (and, therefore, not a lease) when the contract:

(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) The lessee otherwise obtains control of the underlying asset as a result of the lease (that is, the lessee has the ability to direct the use of and obtain substantially all the remaining benefits from the asset). Situations that individually or in combination would normally lead to a conclusion that the lessee would obtain control of the underlying asset as a result of the lease 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 guaranteed by the lessee 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.

C4. A lessor would account for effective sales in the same manner as under existing IFRS and U.S. GAAP for ―sales-type‖ leases. This would mean that a lessor would recognize any selling profit (or loss) on the underlying asset at lease commencement. A lessor would recognize interest income on its net investment in the lease over the lease term using the effective interest method.

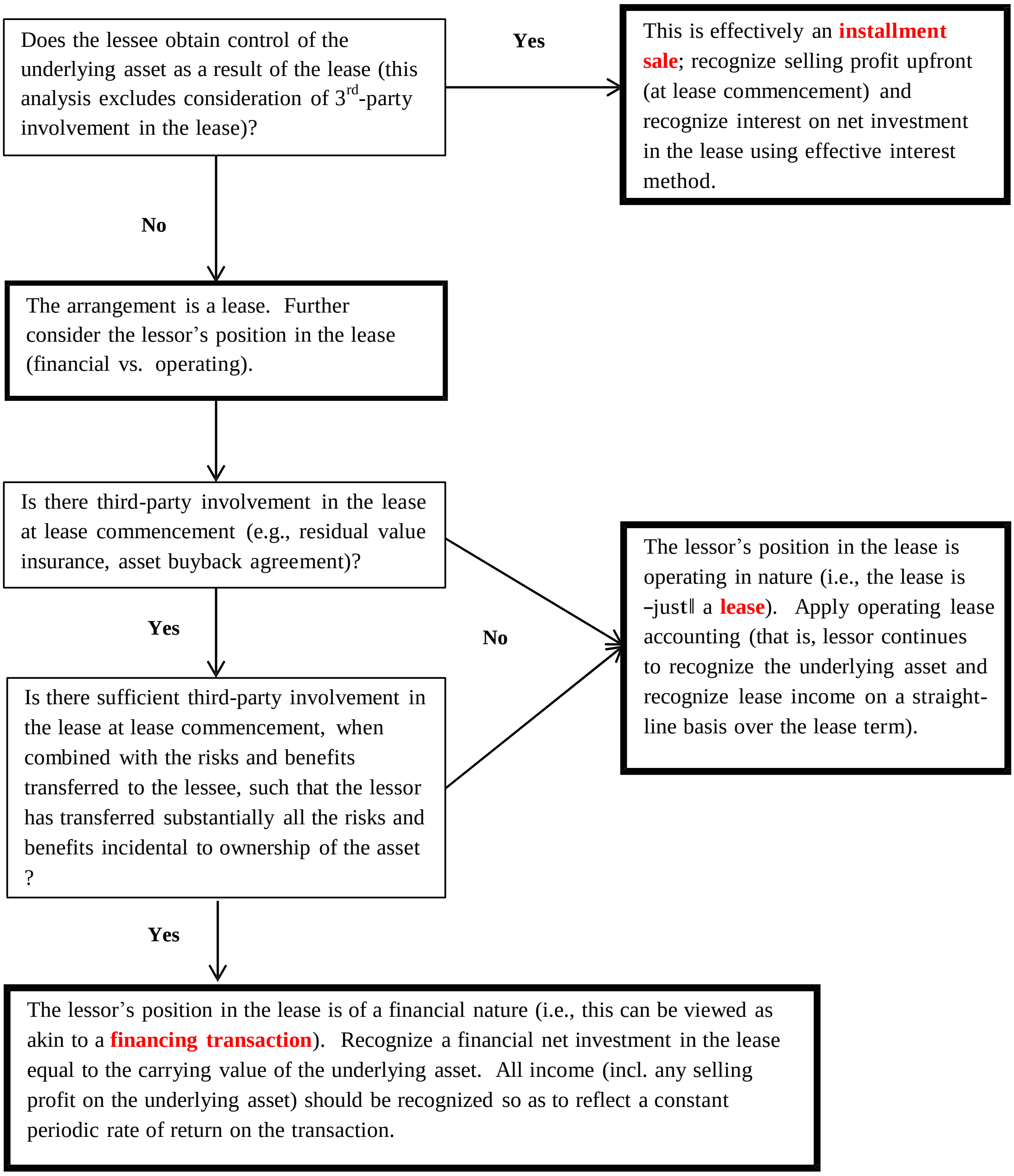
C5. For all remaining leases (that is, those that are not effectively sales), a lessor would evaluate whether third-party involvement in the lease changes the character of the lessor's position in the lease from one of owning the underlying asset to one of having a financial investment in the lease.

C6. A lessor would account for a lease for which there is insufficient third-party involvement to alter the character of the lessor's position under the operating lease model (that is, a Type B lease).

C7. *Sufficient* third-party involvement would be characterized as third-party involvement that, when combined with the risks and benefits of the underlying asset transferred to the lessee, transfers substantially all the risks and benefits incidental to asset ownership to one or more parties other than the lessor (for example, when the sum of the present value of the lease payments plus any portion of the estimated residual value guaranteed by the lessee or any unrelated third-party is substantially all the fair value of the underlying asset).

C8. A lessor would classify a lease for which the most appropriate characterization of the lessor's position in the lease is one of a financial investment as a Type A lease. For such a lease, at lease commencement, a lessor would recognize a net investment in the lease equal to the underlying asset's carrying value. A lessor would recognize income on the lease based on a pattern reflecting a constant periodic return on the lessor's net investment in the finance lease (that is, based on the effective interest method).

C9. The following flowchart (next page) depicts how a lessor would apply Approach 2A:



Does the lessee obtain control of the underlying asset as a result of the lease (this analysis excludes consideration of 3rd-party involvement in the lease)?

This is effectively an **installment sale**; recognize selling profit upfront (at lease commencement) and recognize interest on net investment in the lease using effective interest method.

The arrangement is a lease. Further consider the lessor's position in the lease (financial vs. operating).

Is there third-party involvement in the lease at lease commencement (e.g., residual value insurance, asset buyback agreement)?

Is there sufficient third-party involvement in the lease at lease commencement, when combined with the risks and benefits transferred to the lessee, such that the lessor has transferred substantially all the risks and benefits incidental to ownership of the asset ?

The lessor's position in the lease is operating in nature (i.e., the lease is –just‖ a **lease**). Apply operating lease accounting (that is, lessor continues to recognize the underlying asset and recognize lease income on a straight-line basis over the lease term).

The lessor's position in the lease is of a financial nature (i.e., this can be viewed as akin to a **financing transaction**). Recognize a financial net investment in the lease equal to the carrying value of the underlying asset. All income (incl. any selling profit on the underlying asset) should be recognized so as to reflect a constant periodic rate of return on the transaction.