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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 the March 2014 Agenda Paper 3C/FASB Memo 270: 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, subject to possible simplifications.

   (b) Approach B—To eliminate the receivable and residual approach proposed in the 2013 ED and instead apply an approach substantially equivalent to existing IFRS finance lease accounting (and U.S. GAAP sales-type/direct-financing lease accounting) to all Type A leases, subject to potential minor drafting improvements. A lessor would be required to present lease receivables separately from residual assets either on the balance sheet or in the notes.

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

Approach	Receivable	Residual Asset	Unearned Profit on the Residual Asset
A	Reported Separately	Reported Separately	Yes – Reported as part of Net Residual Asset
B	Included in the Net Investment in the Lease* *But separately presented either on the balance sheet or in the footnotes	Included in the Net Investment in the Lease* *But separately presented either on the balance sheet or in the footnotes	No Unearned Profit

4. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Background to Type A lessor accounting

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

   (d) Lessor Type A accounting approaches

   (e) Staff recommendations

   (f) 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* (based on the definition of lease payments in the Boards' revised exposure draft on leases issued in May 2013 – the ―2013 ED‖).

Summary of staff recommendations

5. The staff recommend Approach B with respect to lessor accounting for Type A leases, regardless of the lessor accounting model selected in the March 2014 Agenda Paper 3C/FASB Memo 270. Approach B retains existing finance lease accounting.

However, the staff also recommend that a lessor present lease receivables and residual assets for Type A leases separately either in the balance sheet or in the notes.

Background to Type A lessor accounting

6. The 2013 ED prescribed a receivable and residual approach for Type A leases of lessors. Under this approach, 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.

7. 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.

8. 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

9. Agenda Paper 3B/FASB Memo 263: Lessor Type A Accounting, from the January 2014 joint meeting, summarized the feedback received on the receivable and residual approach for Type A lessor leases proposed in the 2013 ED in comment letters and at other outreach activities. That summary is not repeated in this paper, but is incorporated herein by reference.

Lessor Type A accounting approaches

10. On the basis of the feedback received on the 2013 ED and the discussions at the January 2014 joint Board meeting, 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

11. 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.

12. The 2013 ED proposed that 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).

13. The decision to propose the receivable and residual approach to Type A leases of lessors in the 2013 ED stemmed from the Boards' decision on where to draw the line between Type A and Type B leases. The lease classification proposals in the 2013 ED would result in a lessor applying the receivable and residual approach to a much larger population of leases than the population to which finance (IFRS) and sales-type/direct financing (U.S. GAAP) lease accounting applies under existing guidance. Therefore, 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 lessor accounting approaches in the March 2014 Agenda Paper 3C/FASB Memo 270 the Boards support).

14. If the Boards adopt Approach 1 or Approach 2 (that is, an approach generally consistent with existing lessor accounting lease classification) in the March 2014 Agenda Paper 3C/FASB Memo 270, the staff think that the costs of applying the receivable and residual approach would likely outweigh the benefits for the following reasons:

   (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. This is 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 small. Under both Approach 1 and Approach 2, the population of Type A leases would align closely to the population of existing finance (IFRS) and sales-type/direct financing (U.S. GAAP) leases. For many of those leases, there may be no residual asset because the lease is a ‗full-payout' lease (that is, a lease for which the present value of the lease payments equals the fair value of the underlying asset). 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. 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.

15. If the Boards adopt Approach 3 (that is, the lessor business model approach) in the March 2014 Agenda Paper 3C/FASB Memo 270, 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

16. 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 and updates (existing IFRS finance lease accounting is substantially equivalent to existing U.S. GAAP lessor accounting for sales-type and direct-financing leases). Further, this approach would require lessors to separately present lease receivables and residual assets either on the balance sheet or in the notes.

17. Therefore, if a lease is classified as a Type A lease, a lessor would recognize its net investment in the lease and would not continue to recognize the underlying asset in its balance sheet. The lessor would measure the net investment in the lease at the present value of the lease payments plus the present value of any residual value. The lessor would also recognize interest income on the net investment in the lease over the lease term using the effective interest method, and any selling profit or loss 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

> **Note:** If the Boards adopt Approach 2 in the March 2014 Agenda Paper 3C/FASB Memo 270 and as explained more fully therein, lessors would recognize selling profit and –gross‖ revenue (that is, revenue and cost of goods sold separately) at lease commencement only if the lessee obtains control of the underlying asset as a result of the lease, consistent with the requirements for a sale in the forthcoming revenue recognition standard. If a Type A lease gives rise to selling profit (or loss), but does not transfer control of the underlying asset to the lessee, any selling profit would be deferred at lease commencement and recognized as income over the lease term in such a manner so as to produce, when combined with the interest income on the net investment in the lease, a constant periodic rate of return on the lease.

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

19. If the Boards adopt Approach 1 or Approach 2 in the March 2014 Agenda Paper 3C/FASB Memo 270, the staff think that, from a cost-benefit perspective, it is

preferable to adopt Approach B in this paper (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 Approach B. Approach B would still provide additional residual asset information that users have said would be beneficial either on the balance sheet or in the notes (as noted above, users have generally not expressed a preference as to whether this information should be presented on the balance sheet or in the notes).

(b) Retaining existing finance lease accounting would result in substantively lower costs for lessors than adopting the receivable and residual approach. Lessors would incur incremental costs to implement new systems and/or processes to apply the new approach, while lessors would not incur such costs to retain existing finance lease accounting.

20. If the Boards adopt Approach 3 (the lessor business model approach) in the March 2014 Agenda Paper 3C/FASB Memo 270, there is a greater incentive to support Approach A in this paper. This is because Approach 3 would result in some lessors applying Type A accounting to leases for which there is a significant residual asset (for example, a 3-year car lease). Consequently, there would likely be a greater benefit from accounting for the lease receivable and the residual asset separately as would be the case under Approach A in this paper. 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 (that is, a lessor would recognize the entire profit on the underlying asset at lease commencement even when the residual asset is 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 the underlying asset in the lease close to or at lease commencement.

Staff recommendations

21. The staff recommend Approach B with respect to lessor accounting for Type A leases, regardless of the lessor accounting model selected in the March 2014 Agenda Paper 3C/FASB Memo 270. Approach B retains existing finance lease accounting. However, the staff also recommend that a lessor present lease receivables and residual assets for Type A leases separately either in the balance sheet or in the notes.

22. If the Boards prefer Approach 1 or Approach 2 in the March 2014 Agenda Paper 3C/FASB Memo 270, 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.

23. The staff also recommend Approach B even if the Boards prefer Approach 3 in the March 2014 Agenda Paper 3C/FASB Memo 270. 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). Nonetheless, 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.

Question: Lessor Type A Accounting
Do the Boards agree with the staff recommendation, Approach B (existing finance lease approach but with separate presentation of lease receivables and residual assets either on the balance sheet or in the notes)? If not, do the Boards prefer Approach A (receivable and residual approach) or another approach?

APPENDIX A

Example of application of "receivable and residual approach"

lease term in years	
Interest rate	
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	220

Workings:

Total Selling 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	**925**	**761**	**587**	**403**	**207**	**-**	
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**	
Interest on receivable		56	46	36	24	13	
Interest on residual asset		5	5	5	5	6	
Interest Income		61	51	41	29	19	
Profit/Gain at lease commencement	**46**						
Total Lease I	**46**	**61**	**51**	**41**	**29**	**19**	**247**

Example of application of Approach B (existing finance/sales-type lease accounting)

lease term in years	
Interest rate	
FV of underlying asset	**1,000**
Cost of underlying asset (for lessor)	950
Estimated residual value	100
Guaranteed residual value	
Unguaranteed residual value	100
PVof estimated residual value	75
Portion of asset consumed (90%)	900
lease	220

Workings:

Total Selling Profit = 1,000 - 950 = 50

Periods		**1**	2	3	4	5	
Lessor accounting							
Balance Sheet							
Lease payments receivable	*925*	*761*	*587*	*403*	*207*		
Residual asset	*75*	*80*	*85*	*90*	*95*	*100*	
Net investment in the lease	**1,000**	**841**	**672**	**493**	**302**	**100**	
Interest on receivable		56	46	36	24	13	
Interest on residual asset		5	5	5	5	6	
Interest Income		61	51	41	29	19	
Profit at lease commencement	**50**						
Total Lease Income	**50**	**61**	**51**	**41**	**29**	**19**	**251**