Leaseurope

The Voice of Leasing and Automotive Rental in Europe

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The following note was communicated to the IASB prior to an ad-hoc discussion of the Board held on 19 May 2010 on when to apply different models for lessor accounting. In an effort to contribute to this discussion and provide rapid feedback to the Boards, the note highlights key points that have previously been raised in official Leaseurope comment letters to the IASB and FASB. The note does not represent an official Leaseurope view on the outcome of these discussions. The Federation will communicate these views to the Boards at a later stage.

When should the de-recognition model be applied?

During their discussions of the last two days, the Boards came across situations where some felt the de-recognition approach to lessor accounting may not be the appropriate model for lessors to apply. Some felt that the performance obligation model may provide better information.

We agree that there are circumstances where the de-recognition model is not appropriate. This is where the business model is not dependent on the achievement of a given residual value. This is in particular the case for very short term leases and property leases, i.e. two areas where the Boards <u>have already taken decisions</u> to exclude such leases from the general lessor accounting model.

- <u>Short term leases:</u> (e.g. daily car rentals, aircraft rentals below one year): the Boards have already decided that lessors providing leases with a maximum possible lease term of 12 months will have the "optional concession" to apply operating lease accounting.
- <u>Property leases:</u> the Boards have already decided to exclude investment property, where the fair value option is applied, from the scope of lessor accounting (i.e. they would apply operating lease accounting with fair value asset measurement).

We would suggest that the <u>only</u> remaining category where de-recognition would not be appropriate would be for leases on property other than investment property e.g. a lease of a part of an otherwise owner-occupied building. In such cases existing operating lease accounting could easily be applied, thus leaving the entire underlying asset on the owner's balance sheet.

<u>All other types of existing operating leases can very well be accounted for under the de-recognition model.</u>

We do not believe that performance obligation approach can ever be a suitable model for lease accounting, as the possible existence of future performance obligations on the part of the lessor can never justify the creation of a spurious performance obligation equal to the discounted value of the entire rental flow.

These future performance obligations may appear at first glance to have some substance in the examples raised during the May IASB/FASB meeting of a property lessor being obligated to clear snow, mow lawns or maintain lifts, or any lessor being obligated to pay a personal property tax. However, these are simply service elements of the rental which until now have systematically been presented to and by the Boards as being excluded from rentals before discounting them to find the initial value of the right of use, of the lessee's liability and of the lessor's lease receivable. In the discussions of the last two days, the Boards slipped to an entirely new concept of "services that are totally integral to the lease", presumably meaning that they cannot be separated from the rest of the rental, such that they would generate a day-one profit that would subsequently be reversed as these services were provided and paid for.

Beyond the fact that this concept has never been discussed under the performance obligation model, we have three reactions:

- This new concept is a fallacy. Most services (even if essential) in property are paid for through a periodic service charge and are obviously separable from the rest of the rent. Above all, no sensible lessor of any sort (property or otherwise) will sign a lease with an all-inclusive rental that covers services whose cost cannot be reliably estimated.
- Investment property has been excluded from the lessor accounting model. Therefore, why are (misleading) examples from the property world driving the debate on an accounting standard that does not concern them?
- If obligations to clear snow (that has not yet fallen) or pay a personal property tax (that is not yet due) in future periods constitute performance obligations for the owner of an asset that leases it out, why do they not receive the same treatment in the case of the owner of an asset that occupies or uses it for its own purposes?

Lastly, during the May meeting, some Board members were unclear on how to deal with changes in assessments of contingent rentals under the de-recognition model and felt that only the performance obligation model could handle leases with such features. The difficulty in dealing with such rentals is simply a consequence of the Boards' decision that lessors should include contingent rentals in their receivables in the first place. The Boards had lengthy debates on how to allocate changes in contingent rental estimates under the performance obligation model too. We have pointed out in the past that contingent rentals that are in the control of the lessee (e.g. performance and usage linked rentals) do not represent assets for lessors any more than they represent liabilities for lessees. The Boards could easily solve this issue on the lessor side by not including estimates of contingent rentals (other than those linked to indexes or rates) in the lessor's receivable. They should simply be recognised as period gains/losses.

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