

## **Lessor Model – Key issues and considerations relating to July 2011 IASB redeliberations**

### **Background**

- 1 At their July 2011 meeting, the IASB and FASB tentatively decided that a lessor should apply a single lessor accounting model – the ‘receivable and residual’ accounting approach (except for short-term leases to which a lessor elects not to apply the ‘receivable and residual’ accounting approach, and leases of investment property measured at fair value, which are out of scope of the proposed Standard).
- 2 This paper outlines key issues identified by AASB staff in relation to the ‘residual and receivable’ approach discussed by the IASB at its July 2011 meeting.
- 3 Staff recommend raising the key issues outlined in this agenda paper with the IASB staff for consideration in their drafting of the revised Leases Exposure Draft.

### **Introduction**

- 4 Applying the ‘receivable and residual’ approach the lessor would:
  - (a) recognise a right to receive lease payments (lease receivable) and a residual asset at the date of the commencement of the lease;
  - (b) initially measure the lease receivable at the sum of the present value of the lease payments, discounted using the rate that the lessor charges the lessee;
  - (c) if profit is ‘reasonably assured’:
    - (i) initially measure the residual asset as an allocation of the carrying amount of the underlying asset;  
  
[Carrying amount of underlying asset – (carrying amount of underlying asset \* lease receivable / FV of underlying asset)]
    - (ii) subsequently measure the residual asset by accreting it over the lease term using the rate that the lessor charges the lessee. At the end of the lease term the carrying amount of the residual asset would be the allocated estimated value of the residual asset at the end of the lease term;

- (iii) recognise profit at the date of the commencement of the lease. The profit would be measured as any difference between the previous carrying amount of the underlying asset and the sum of the lease receivable and the residual asset recognised initially;

[Lease receivable + residual asset – carrying amount of underlying asset]

- (d) if profit is *not* ‘reasonably assured’:

- (i) subject to (e), initially measure the residual asset as the difference between the carrying amount of the underlying asset and the lease receivable;

[Carrying amount of underlying asset – lease receivable]

- (ii) subsequently measure the residual asset by accreting it using a constant rate of return to an amount equivalent to the underlying asset’s carrying amount at the end of the lease term as if the underlying asset had been subject to depreciation;

- (iii) no profit is recognised at lease commencement. Profit is recognised on the right-of-use asset transferred to the lessee over the lease term; and

- (e) irrespective of whether or not profit is ‘reasonably assured’, if the lease receivable is greater than the carrying amount of the underlying asset at the date of the commencement of the lease, the lessor would recognise, as a minimum, the difference between those two amounts as profit at that date.

5 The focus of this paper is on the implications of 4(c) and 4(d).

## **Key issues<sup>1</sup>**

### *Calculation of the residual asset – general [4(c) and 4(d)]*

- 6 Application of the ‘receivable and residual’ accounting approach as outlined in the July 2011 IASB Staff Paper 5G ‘Lessor Accounting’ appears to result in the subsequent measurement of a residual asset that has no conceptual basis.
- 7 Although this is not a new issue on initial recognition (as the residual asset at initial recognition under paragraph 4(c)(i) is equivalent to that recognised under the partial derecognition approach), subsequent to initial recognition the residual asset is accreted based on either:
- (a) the discount rate implicit in the lease (if profit is reasonably assured) [4(c)(ii)], or
  - (b) a constant rate of return resulting in the residual asset being recognised at a carrying amount at the end of the lease term as if it had been subject to depreciation (if profit is not reasonably assured) [4(d)(ii)].
- 8 This gives rise to a number of issues.
- (a) No conceptual basis is provided as to why profit should be recognised over time in relation to the residual asset. The ‘receivable and residual’ approach results in a hybrid between the ‘full derecognition’ approach and the ‘partial derecognition’ approach. That is, on entering the lease the lessor recognises the profit that would otherwise have been recognised by applying the ‘partial derecognition’ approach, but then goes on to recognise profit over the lease term equal to the ‘full derecognition’ approach. AASB staff consider that the application of such a hybrid approach results in a profit recognition pattern that does not have a robust conceptual basis (discussed further in paragraph 12 below).
  - (b) Page 17 of IASB Agenda Paper 5G notes that ‘the residual represents the right to the cash flows that the lessor expects to receive at the end of the lease term

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<sup>1</sup> Note that the interaction with the Revenue Recognition proposals is not considered in this paper as the IASB staff are bringing back to a future IASB meeting the issue of what ‘reasonably assured’ means. The reasonably assured criterion is used in both the Revenue Recognition and Leases projects.

that will ultimately be realised through sale, residual value guarantees, or re-lease of the underlying asset. Consequently, some lessors view the residual asset to be more akin to a financial asset'. AASB staff disagree with treating the residual asset as a financial asset and consider that a residual asset is the rights in the underlying asset that the lessor retains. This potential difference in views as to what the residual asset represents influences the discussion as to the appropriate measurement model. AASB staff consider it to be inappropriate to measure non-financial assets at amortised cost applying the effective interest method.

*Profit on entering the lease [4(c)(i) and 4(d)(i)]*

- 9 AASB staff do not disagree with profit being recognised on commencement of the lease; however, we would like to highlight that, due to the calculation method for a residual asset it is not possible for an entity to make a *loss* on entering a lease.
- 10 For example, assume an entity enters into a 20 year lease of a building in return for \$1 lease payments per year (present value of all lease payments = \$10). The fair value and carrying value of the building at the time of entering the lease is \$1000, and it has an expected residual value of \$250. The useful life of the building is 40 years. The lease receivable is \$10 and the residual asset would be initially measured at \$990<sup>2</sup> (irrespective of whether profit is reasonably assured, as the carrying value = fair value at the time of entering the lease). No loss would be recognised on day 1 as a result of entering into the below-market lease arrangement. Although this may be an extreme example, the same outcome (i.e. no loss recognition on day 1) occurs in all circumstances. That is, based on the calculations in 4(c) and 4(d) above, a loss on entering a lease can never occur.
- 11 Any loss would be recognised only via the impairment of the residual asset. AASB staff do not think that describing such a loss as an impairment loss would reflect the economics of the transaction. AASB staff consider that the loss relates to the derecognition of the asset and should be recognised at the time of derecognition and presented as such in the income statement.

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<sup>2</sup> Calculated as either  $[(1000-(1000*10/1000))=990]$  or  $[1000-10=990]$ .

*Calculation of the residual asset when profit is not reasonably assured [4(d)(ii)]*

- 12 Subsequent to initial recognition the residual asset is measured at an amount that does not reflect cost, amortised cost applying the effective interest method or fair value. Consistent with our comment in paragraph 8(b), we think it is a hybrid value with no conceptual basis and does not reflect the economics of the transaction.
- 13 AASB staff question what the residual asset represents at the end of each period during the lease term. The rate of return does not represent the discount rate in the lease, so AASB staff query what the rate of return represents.
- 14 AASB staff disagree with accreting the residual asset using a constant rate of return resulting in the residual asset being measured at a carrying amount at the end of the lease term as if it had been subject to depreciation. We note that this method will in the vast majority of circumstances result in a higher residual asset at the end of the lease term than the method applied if profit is reasonably assured. The outcome of this is that overall profit, over the term of the lease, in circumstances where profit is not reasonably assured will be *higher* than if profit is reasonably assured. This outcome is counter intuitive.

**Example – Manufacturer/dealer lessor<sup>3</sup>**

A manufacturer lessor leases equipment to a lessee for 3 years. The asset has a useful life of 6 years. The carrying amount of the equipment (cost) is CU100; and its fair value at lease commencement is CU120. The estimated residual at the end of the lease term is CU55. (The present value of that estimated residual value is CU46.) The lessee pays CU28 annually. (The present value of those lease payments at lease commencement is CU74).

**IASB re-deliberations July 2011 –**

**Assume profit is reasonably assured – lease receivable is not greater than the underlying asset**

Year	Lease receivable	Residual asset	Profit	ROA	Lease payments	Interest revenue	Residual asset accretion
0	74	38 <sup>4</sup>	12 <sup>5</sup>				
1	51	41	7 <sup>6</sup>	6.4%	28	5	2 <sup>7</sup>
2	26	43	6		28	3	3
3	0	46	4		28	2	3
		<b>Total</b>	<b>30</b>				

**IASB re-deliberations July 2011 –**

**Assume profit is not reasonably assured – lease receivable is not greater than the underlying asset**

Year	Lease receivable	Residual asset	Profit	ROA	Lease payments	Interest revenue	Residual asset accretion
0	74	26 <sup>8</sup>	0				
1	51	33	12	28% <sup>9</sup>	28	5	7 <sup>10</sup>
2	26	43	13		28	3	9
3	0	55	14		28	2	12
		<b>Total</b>	<b>39</b>				

<sup>3</sup> Adapted from July 2011 IASB Agenda paper 5G paragraph 39.

<sup>4</sup> Carrying amount of underlying asset *less* (carrying amount of underlying asset \* lease receivable / FV of underlying asset) [4(c)(i)]

<sup>5</sup> Lease receivable + residual value – carrying amount of underlying asset [4(c)(iii)]

<sup>6</sup> Interest revenue + residual asset accretion

<sup>7</sup> Residual asset \* discount rate [4(c)(ii)]

<sup>8</sup> Carrying amount of underlying asset – lease receivable [4(d)(i)]

<sup>9</sup> Constant rate of return that results in the residual asset = CU55 at the end of the lease term (that is, the carrying amount of the asset at the end of the lease term as if it had been subject to depreciation) [4(d)(ii)].

<sup>10</sup> Accretion of the residual asset using a constant rate of return to an amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation [4(d)(ii)].

**Partial derecognition approach (ED proposed approach)**

Consistent with the ‘receivable and residual’ approach, the partial derecognition approach requires a lessor determines the amount derecognised and the initial carrying amount of the residual asset by allocating the carrying amount of the underlying asset at the commencement of the lease in proportion to the fair value of the rights that have been transferred and the fair value of the rights that have been retained by the lessor.

Therefore, the amount derecognised by the lessor is the carrying amount of the underlying asset multiplied by the fair value of the right to receive lease payments divided by the fair value of the underlying asset (all determined at the commencement of the lease).

The residual asset at an allocated amount of the carrying amount of the underlying asset. The residual asset would *not* be subsequently accreted over the lease term.

Year	Lease receivable	Residual asset	Profit	ROA	Lease payments	Interest revenue	Residual asset accretion
0	74	38 <sup>11</sup>	12				
1	51	38	5	n/a	28	5	0
2	26	38	3		28	3	0
3	0	38	2		28	2	0
		<b>Total</b>	<b>22</b>				

**Full derecognition approach (AASB preferred approach – rejected in the ED)**

A full derecognition approach would result in the lessor derecognising the full carrying amount of the leased asset and recognising a receivable and a residual value asset at fair value to reflect that it exchanged the underlying asset for a receivable and its residual value asset.

This model is essentially the same, from a statement of financial position perspective, as the approach used for finance leases in AASB 117. However, under AASB 117 the residual asset is not separately presented, rather the net investment in the lease is presented.<sup>12</sup>

Year	Lease receivable	Residual asset	Profit	ROA	Lease payments	Interest revenue	Residual asset accretion
0	74	46 <sup>13</sup>	20 <sup>14</sup>				
1	51	46	5	n/a	28	5	0
2	26	46	3		28	3	0
3	0	46	2		28	2	0
		<b>Total</b>	<b>30</b>				

<sup>11</sup> Carrying amount of underlying asset – (carrying amount x lease receivable / FV of underlying asset)

<sup>12</sup> The net investment in the lease is defined in AASB 117 paragraph 4 as the gross investment in the lease discounted at the interest rate implicit in the lease. The gross investment in the lease is the aggregate of: (a) the minimum lease payments receivable by the lessor under a finance lease; and any unguaranteed residual value accruing to the lessor.

<sup>13</sup> Fair value of underlying asset – lease receivable

<sup>14</sup> Fair value of underlying asset – carrying value of underlying asset