

IFRS Developments

Boards to re-expose leases, and propose a new approach for lessors

What you need to know

- ▶ The Boards decided to re-expose the proposed leases standard.
- ▶ The Boards are developing a new approach to lessor accounting that is significantly different from current accounting and the proposals in last year's exposure draft.
- ▶ Accounting would be significantly more complex than the current lessor model.
- ▶ Lease receivables would be recognised for all leases (except short-term leases), a portion of the carrying amount of the underlying leased asset would be re-characterised as a residual asset and the remainder would be derecognised.
- ▶ The timing and pattern of lessor profit recognition would depend on whether the profit in the lease is "reasonably assured".

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) decided to formally expose their joint leases proposal for a second time because they have made significant changes to the model they proposed last year. Their decision will give constituents a chance to comment on the changes.

Re-exposure of the leases standard will give constituents a chance to express their views on the changes proposed by the Boards.

The Boards have also made significant decisions about lessor accounting. The Boards decided that lessors should apply a single approach to all leases, with a few exceptions. This represents a significant change from current lease accounting and the proposals in last year's exposure draft (ED).

The Boards still need to discuss other lessor-specific issues, including the interaction with the financial instruments project, changes in lease agreements, residual value guarantees, impairment, financial statement presentation, disclosure and transition.

All of the decisions made by the Boards to date are tentative and will not be finalised until the Boards approve a final standard.

Lessors would apply a single approach to all leases with a few exceptions. Current operating lease accounting would be eliminated except for certain short-term leases.

Lessor accounting

Under the model proposed in the ED¹, lessors would apply one of two approaches based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. Feedback on the ED's lessor accounting model was mixed. Some favoured having one approach only. Others questioned whether the proposal represented an improvement over existing requirements for lessors and encouraged the Boards to retain the current model.

The Boards recently agreed that lessors should apply a single approach, the "receivable and residual" approach, to all leases, subject to the following two exceptions:

- ▶ **Investment properties** – Lessors would not apply the lessor model to leases of investment properties that are measured at fair value.
- ▶ **Short-term leases** – Lessors could make an accounting policy election to apply current operating lease accounting to short-term leases. A short-term lease would have a maximum possible lease term, including any options to renew, of 12 months.

The Boards previously made decisions on other key lessor concepts, including the definition of a lease, lease term, lease payments and discount rate. The Boards decided that lessors would be required to separate all non-lease components (including services and executory costs) and lease components using the allocation method proposed in the joint revenue recognition project (i.e., on a relative selling price basis in most cases).

Receivable and residual approach

Under the receivable and residual approach, upon commencement of the lease, the lessor would:

- ▶ Recognise a lease receivable for the lessor's right to receive lease payments
- ▶ Allocate the carrying value of the underlying asset being leased between the portion related to the right of use granted to the lessee and the portion retained by the lessor (i.e., the residual asset)
- ▶ Recognise profit, if profit is reasonably assured, or any indicated loss

The lease receivable would be initially measured at the present value of the lease payments over the lease term discounted using the rate the lessor charges the lessee. The lessor would determine the lease term and lease payments using the same principles applied by the lessee (e.g., exclude usage-based contingent rents).²

¹ For additional detail about the IASB ED *Leases*, refer to *Proposed accounting for leases* (November 2010) or *Supplement to IFRS Outlook, Proposed accounting changes for leases* (Issue 79, August 2010).

² For further information on other leases project redeliberation decisions, see our *Applying IFRS: Lessee model comes together as leases project progresses* (July 2011).

The allocation of the carrying amount of the underlying asset would be based on the ratio of the initially measured lease receivable to the fair value of the underlying asset being leased. If the profit under the lease is reasonably assured, the residual asset recognised is initially measured as follows:

$$\text{Carrying amount of underlying asset} - \left(\text{Carrying amount of underlying asset} \times \left(\frac{\text{Lease receivable}}{\text{Fair value of underlying asset}} \right) \right)$$

The portion of the carrying amount of the underlying asset allocated to the right of use granted to the lessee would be derecognised.

At the commencement of the lease, profit (or loss) would be recognised for the difference between the lease receivable recognised and the portion of the carrying amount of the underlying asset derecognised. Under current finance lease accounting, initial profit recognised reflects the profit on the sale of the entire asset, not just the portion leased. The receivable and residual approach would generally result in lower initial profits being recognised for this type of lease.

Over the term of the lease, the lessor would recognise interest income from the right to receive payments and accrete the residual asset. Both the interest income and accretion income would be calculated using the rate the lessor charges the lessee.

The Boards intend to align the lessor model with principles developed in the joint revenue recognition project.

Illustration 1: Receivable and residual approach

Assume a lessor manufactures a machine for CU7,500 and enters into a three-year lease for the machine with a lessee. At lease commencement, the machine has a fair value of CU10,000; the annual rent is CU2,400, due at the end of each year. The lessor estimates that the machine's expected residual value at the end of the lease term will be CU4,770. The present value of the lease payments discounted at 7.9% (the interest rate implicit in the lease) is CU6,200.

The following table illustrates the amounts recognised under the receivable and residual approach.

Period	Lease receivable	Residual asset	Profit recognised ^B	Cash receipts
Commencement	CU6,200	CU2,850 ^A	CU1,550	–
Year 1	CU4,288	CU3,074	712	CU2,400
Year 2	CU2,225	CU3,316	579	2,400
Year 3	–	CU3,577 ^C	436	2,400
Total			CU3,277	CU7,200

A Residual asset is initially measured based on the allocated cost approach [CU7,500 - (CU7,500 x (CU6,200 / CU10,000))].

B At commencement, profit is recognised for the difference between the lease receivable recognised (CU6,200) and the portion of the carrying amount of the underlying asset derecognised (underlying asset of CU7,500 less the residual asset of CU2,850). Profit recognised over the term of the lease is comprised of interest income from the lease receivable and accretion of the residual asset.

C The carrying amount of the residual asset at the end of the lease term would not represent either the expected value or the amortised cost of the underlying asset at the end of the lease.

The lessor would recognise profit upon commencement only when that profit is reasonably assured. The reasonably assured threshold is intended to align the recognition of profit by lessors with principles developed by the Boards in their joint revenue recognition project. The Boards plan to clarify how to apply the reasonably assured principle to lease contracts.

The Boards discussed instances in which profit may not be reasonably assured, such as when the residual value at the end of the lease term or the day one fair value of the underlying asset cannot be estimated. They indicated that lessors would rely on experience or other persuasive evidence, assuming that experience is predictive of the outcome of the lease contract in question, for such estimates.

If the profit is not reasonably assured, no profit would be recognised at lease commencement and the residual asset would be initially measured as the difference between the lease receivable and the carrying value of the underlying asset. The residual asset would be accreted over the lease term to an ending amount equivalent to the underlying asset's carrying amount at the end of the lease term as if it had been subject to depreciation using its original depreciable life and salvage value. That is, the lessor would recognise income, using a constant rate of return, over the lease term to accrete the residual asset to the amount that the underlying asset would have been measured at if it had remained on the balance sheet of the lessor and been subject to depreciation. Interest income on the lease receivable would be recognised over the lease term using the interest rate the lessor charges the lessee.

How we see it

We support the Boards' decision to re-expose and strongly encourage companies to re-evaluate the proposed revised model and provide feedback to the Boards.

Questions remain about how to apply the receivable and residual approach to lessor accounting. Additional guidance and clarification is expected over the coming months as the Boards prepare an updated proposal for re-exposure. We expect that the exposure draft will be available later this year.

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