

Operating lease accounting survives for some real estate lessors

What you need to know

- ▶ Under IFRS, lessors with leases of investment property, including investment property measured at cost, would apply operating lease accounting.
- ▶ For leases that do not qualify for one of the exceptions, the lessor would recognise a lease receivable, allocate the carrying value of the underlying asset being leased between the right of use granted to the lessee and the portion retained by the lessor, and recognise profit.
- ▶ No additional requirements (e.g., that profit must be reasonably assured) would need to be met to recognise profit upon the commencement of the lease.

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards), at their meeting on 19 October 2011, significantly modified the proposed accounting for lessors that they had agreed in July 2011.¹ The Boards made these changes based on further deliberations and feedback from constituents.

The Boards had decided that lessors would apply a single approach – the receivable and residual approach – to all leases, except short-term leases and leases of investment property that is measured at fair value. In their October 2011 meeting, the Boards created a new exception for leases of investment property measured by lessors at cost, and decided that those lessors would apply current operating lease accounting.

For leases that would be subject to the receivable and residual approach, the Boards also modified the method that would be used to calculate accretion income recognised over the lease term. In addition, the Boards removed the threshold that profit must be reasonably assured for entities applying the receivable and residual approach to recognise the profit related to the right of use granted to the lessee upon lease commencement.

This publication discusses tentative decisions made by the Boards. They expect to issue a new exposure draft in the first quarter of 2012.

The receivable and residual approach to lessor accounting would not apply to leases of investment properties.

¹ July 2011 Board decisions on lessor approach are summarised in our *IFRS Developments, Boards to re-expose leases, and propose a new approach for lessors* (Issue 10, July 2011).

Under the receivable and residual approach, lessors would recognise profit (if any) on the right of use granted to the lessee for all leases at lease commencement.

Lessor accounting

The Boards agreed that lessors should apply the receivable and residual approach to all leases other than:

- ▶ Leases of investment property – leases of property that meets the definition of investment property in IAS 40 *Investment Property*, including investment property measured at cost, would be accounted for as operating leases.
- ▶ Short-term leases – lessors could make an accounting policy election to apply operating lease accounting to leases with a maximum possible lease term, including any options to renew, of 12 months or less.

How we see it

The Boards' decision to exclude all lessors of investment properties from the receivable and residual approach would likely result in many real estate lessors continuing to use operating lease accounting.

Given their decision that lessors should apply operating lease accounting to leases of investment properties, the Boards will likely receive requests to reconsider previous decisions on lessee accounting, such as requiring a single income statement recognition model for all leases, including leases of real estate. In addition, many equipment lessors will likely question why the exception is limited to leases of investment property.

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 (cost derecognised) and the portion retained by the lessor (i.e., the residual asset)

- ▶ Measure the total profit, if any, inherent in the underlying asset (i.e., the difference between the fair value and the carrying amount of the underlying asset) and recognise the portion of the profit related to the right of use granted to the lessee (portion leased)

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. Lessors would determine the lease term and lease payments using the same principles applied by lessees², except that amounts to be received under residual value guarantees would not be recognised until the end of the lease.

The carrying amount of the underlying asset would be allocated between the portion leased and the residual asset. The allocation method would be based on the ratio of the present value of the lease payments to the fair value of the underlying asset being leased. However, the Boards may refine the methods used to determine this allocation.

The amount remaining on the lessor's balance sheet (i.e., the residual asset) would be initially measured as the carrying amount of the underlying asset less the cost derecognised. For example, using the allocation method described above, if the lease receivable is 70% of the fair value of the underlying asset, 70% of the underlying asset's carrying amount would be derecognised and 30% of the carrying amount would be the residual asset.

At the commencement of the lease, profit would be recognised for the difference between the lease receivable recognised and the cost derecognised. This profit would represent the profit related to the leased portion of the asset.

² Applying IFRS, Lessee model comes together as leases project progresses (July 2011)

For example, if the total profit (i.e., the difference between the fair value and the carrying amount of the underlying asset) was CU100 and 70% of the underlying asset's carrying amount was derecognised, CU70 of profit would be recognised upon commencement of the lease.

Under current finance lease accounting, because of the way the residual is calculated, initial profit recognised reflects the profit on the sale of the entire asset, not just the portion leased.

Under the proposal, the residual asset, which would be initially measured using the allocation method described previously, would be considered to consist of two components: the gross residual and the deferred profit.

The separate components are necessary for the purpose of calculating accretion income to be recognised over the lease term. The gross residual would be the present value of the expected fair value of the underlying asset at the end of the lease using the rate the lessor charges the lessee. The deferred profit (i.e., the portion of the total profit not recognised) would reduce the gross residual. That is, the recognised residual asset would be equivalent to the gross residual less the deferred profit.

Over the term of the lease, the lessor would recognise interest income on the lease receivable and accretion of the gross residual. Both the interest and accretion would be calculated using the rate the lessor charges the lessee. The deferred profit would not change throughout the lease. Therefore, at the end of the lease the residual asset would be equal to the originally estimated expected fair value of the underlying asset less the deferred profit.

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 fair value at the end of the lease term will be CU4,770. The present value of the lease payments and expected fair value of the underlying asset at the end of the lease discounted at the interest rate implicit in the lease (approximately 7.9%) are CU6,200 and CU3,800, respectively.

The following table illustrates the amounts recognised throughout the lease:

Period	Lease receivable	Gross residual	Deferred profit	Residual assets	Profit recognised	Cash received
Initial	CU6,200	CU3,800	CU(950) ^A	CU2,850 ^B	CU1,550 ^C	CU –
Year 1	CU4,288	CU4,099	CU(950)	CU3,149	787 ^D	2,400
Year 2	CU2,225	CU4,422	CU(950)	CU3,472	660	2,400
Year 3	CU –	CU4,770	CU(950)	CU3,820	523	2,400
Total					CU3,520	CU7,200

A Could be calculated as the difference between the gross residual and the residual asset (CU3,800 – CU2,850) or as the profit not recognised (CU2,500 – CU1,550).

B Initially measured based on the allocation of carrying amount [CU7,500 – CU7,500 * (CU6,200/CU10,000)].

C Profit is recognised for the difference between the lease receivable recognised (CU6,200) and the cost derecognised (CU7,500 – CU2,850). This represents 62% (CU6,200 / CU10,000) of the total profit.

D Profit recognised over the term of the lease is calculated using the rate implicit in the lease (7.9%).

How we see it

It is unclear whether the Boards plan to deliberate any other significant issues prior to issuing the new exposure draft.

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