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Project	<b>Leases</b>
Topic	<b>Application guidance on when to use the performance obligation or derecognition approaches</b>

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## Background and purpose of paper

1. At the June 2010 joint meeting, the Boards tentatively decided to adopt a hybrid approach to lessor accounting. Under this hybrid approach, the performance obligation approach would be applied to leases that expose the lessor to significant risks and benefits associated with the underlying asset. The derecognition approach would be applied to leases that do not expose the lessor to significant risks and benefits associated with the underlying asset.
2. The preballot draft/staff draft of the leases exposure draft (ED) that was circulated on 30 June 2010 includes draft application guidance describing when a lessor should apply which lessor accounting approach. The draft guidance is reproduced in the appendix to this paper.
3. The purpose of this paper is to obtain feedback on the proposed guidance. If the Boards have editorial comments on the draft application guidance, please provide them to the staff outside the joint Board meeting. The staff would like to focus on substantive issues during the joint July Board meeting.
4. The comment period for the preballot draft/staff draft of the ED closes on 14 July 2010. The staff will provide the Boards with a summary of comments received on the application guidance ahead of the joint July Board meeting.

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This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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## Questions for the Boards

### *Timing of assessment*

5. The draft application guidance requires the lessor to determine at inception of the lease whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset. The lessor does not subsequently reassess that determination.
6. The staff notes that requiring reassessment of whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset would be costly and complex for preparers to apply. Changing the accounting models part way through a lease term also would result in significant changes to the amounts reported in the financial statements, which may be difficult for users to understand.
7. In addition, the staff notes that this approach is consistent with existing leases guidance, which requires entities to determine lease classification at lease inception.

#### **Question 1**

The staff recommends that the lessor be required to determine at inception of the lease whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset. That determination would not subsequently be reassessed.

Do the Boards agree?

### ***Factors to consider when determining whether a lease exposes the lessor to significant risks and benefits associated with the underlying asset***

8. The draft application guidance sets out the following factors that should be considered in determining whether a lease exposes the lessor to significant risks and benefits associated with the underlying asset:
  - (a) the lessor's business model.
  - (b) the lessor's exposure to risks and benefits associated with the underlying asset at the end of the lease.

- (c) whether there are significant contingent rentals.
  - (d) the nature of the underlying asset.
  - (e) whether the fair value of the lease payments equals or exceeds the fair value of the underlying asset.
  - (f) whether the lessor has an obligation to provide material non-distinct services.
9. Because the proposed approach is intended to be principles based, the draft application guidance also states that one or more of those indicators is not conclusive to a determination of whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset.
10. The following sections briefly explain each of those factors.

*Business model*

11. At the June 2010 Board meeting, some Board members suggested that a lessor business model could be used to help determine whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset. For example, an entity whose business it is to lease the same asset to several different lessees over the asset's useful life is likely to be exposed to significant risks and benefits associated with that asset. Conversely, an entity whose business model exposes the lessor mainly to credit risk is unlikely to be exposed to significant risks and benefits associated with the underlying asset.
12. The draft application guidance explains how that business model concept could be used to help determine if a lessor is exposed to significant risks and benefits associated with the underlying asset.

*The lessor's exposure to risks and benefits associated with the underlying asset at the end of the lease*

13. If a lessor's exposure to the risks and benefits associated with the underlying asset at the end of the lease are not expected to be significant, then it is unlikely that the lessor's overall exposure to the underlying asset will be significant.

14. The draft application guidance sets out two examples of situations in which a lessor's exposure to the risks and benefits associated with the underlying asset at the end of the lease may not be significant:
  - (a) When the lease covers a major part of the economic life of the asset
  - (b) When the lessee provides a residual value guarantee that covers substantially all of the expected fair value of the underlying asset.
15. Because the application guidance is intended to be principles based, it does not specify what constitutes a major part of the economic life of an asset.
16. The draft application guidance states that residual value guarantees provided by parties other than the lessee should not be considered in determining whether the lessor's exposure to the underlying asset is significant. That is because guarantees provided by an entity other than the lessee do not form part of the lease agreement. That approach is consistent with the proposed approach to third-party residual value guarantees in the exposure draft (third-party residual value guarantees are not included in expected lease payments). The existence of a residual value guarantee does not remove a lessor's exposure to residual value risk. Instead, it provides insurance against that risk.
17. However, it could be argued that the approach to third-party residual value guarantees results in similar transactions being accounted for differently. A lessor who has obtained a residual value guarantee from a third party may have a similar exposure to the risks and benefits associated with the underlying asset as an entity that has been provided with a residual value guarantee by the lessee. If the third-party residual value guarantee is ignored in determining the lessor's exposure to risks and benefits, it could result in one transaction being accounted for under the derecognition approach and another being accounted for under the performance obligation approach. The staff also notes that residual value guarantees from third parties are considered under existing leases guidance when determining lease classification.
18. The staff recommends that third party residual value guarantees not be considered in determining whether a lessor is exposed to significant risks and

benefits associated with the underlying asset. This is consistent with the draft application guidance and with the proposed approach to third-party residual value guarantees in the exposure draft

**Question 2**

Should residual value guarantees provided by parties other than the lessee be considered in determining whether a lessor is exposed to significant risks and benefits associated with the underlying asset?

19. The draft application guidance states that the lessor should consider the present value of the lessor's interest in the residual asset at inception of the lease when it assesses its exposure to the risks and benefits associated with the underlying asset. The staff notes that considering the present value of a lessor's interest in the residual asset is consistent with existing classification guidance on leases.
20. The draft application guidance goes on to discuss the treatment of long-term leases of land and states that some very long-term leases of land may result in the lessor transferring the significant risks and benefits associated with the land to the lessee at inception of the lease. That is because the present value of the lessor's interest in the land at the end of a very long-term lease may not be significant. If the lessor concludes that it is not exposed to significant risks and benefits associated with the land, it will apply the derecognition approach to that lease.
21. However, some staff members think that even in very long-term leases of land, the lessor retains significant risks and benefits associated with the land. Consequently, they think it would be inappropriate for lessors to apply the derecognition approach to lessor accounting and remove land leased under long-term leases from their financial statements. Those staff members recommend removing the discussion of long-term land leases from the draft application guidance.

**Question 3**

Should the guidance regarding the treatment of long-term leases of land be retained in the draft application guidance?

*Significant contingent rentals*

22. Some forms of contingent rental arrangements expose the lessor to significant risks and benefits associated with the underlying asset. For example, usage-based payments may expose the lessor to significant risks and benefits associated with the underlying asset if they are significant. Rentals that are contingent on the performance of the lessee or the underlying asset also may expose the lessor to significant risks and benefits associated with the underlying asset.
23. However, some other forms of contingent rentals, for example, rentals linked to interest rates or other indices, may not expose the lessor to risks and benefits associated with the underlying asset.
24. The draft application guidance discusses these factors.

*The nature of the underlying asset*

25. If only the lessee can use a highly specialised asset or if the asset is vital to the lessee's operations, then the lessor may not be exposed to the significant risks and benefits associated with the underlying asset. That is because the lessee may be economically compelled to exercise options in the lease or renegotiate the lease at the end of the existing contract term.

*The fair value of the lease payment equals or exceeds the fair value of the underlying asset*

26. If the fair value of the lease payments equals or exceeds the fair value of the underlying asset, the lessor may not be exposed to significant risks and benefits associated with the underlying asset. However, as set out in the draft guidance, that may not always be the case.

*A lessor's obligation to provide material non-distinct services*

27. The existence of material non-distinct services may indicate that a lessor is still exposed to the risks and benefits associated with the underlying asset. If so, the lessor should apply the performance obligation approach. However, guidance on how to split non-distinct services from lease payments will probably still be

required because the existence of non-distinct services will not always indicate that the lessor has retained significant risks and benefits associated with the underlying asset.

**Question 4**

Do you support the factors to consider in determining whether a lessor is exposed to significant risks and benefits associated with the underlying asset proposed by the staff?

If not, which factors would you remove or change?

Are there additional factors that should be considered?

## **Appendix – Application guidance on when to use the performance obligation or derecognition approaches**

A1. The following is an extract from the preballot draft/staff draft of the leases ED distributed on 30 June 2010:

### **Lessor: when to use the performance obligation or derecognition approaches**

1. A lessor should determine at the date of inception of a lease whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset, based on all relevant facts and circumstances. The lessor does not subsequently reassess this determination.
2. A lessor that is exposed to significant risks and benefits associated with the underlying asset is unlikely to have satisfied its performance obligation to the lessee in full at the date of commencement of the lease. Consequently, a lessor would apply the performance obligation approach to such leases. A lessor that is not exposed to significant risks and benefits associated with the underlying asset is likely to have satisfied its performance obligation to the lessee in full at the date of commencement of the lease and would apply the derecognition approach.
3. A lessor considers the following when it determines whether a lease exposes the lessor to significant risks and benefits associated with the underlying asset:
  - (a) the lessor's business model (see paragraphs 5 and 6).
  - (b) the lessor's exposure to risks and benefits associated with the underlying asset at the end of the lease (see paragraphs 7 and 8).
  - (c) whether there are significant contingent rentals (9 and 10).
  - (d) the nature of the underlying asset. If only the lessee can use a highly specialised asset or if the asset is vital to the lessee's operations then the lessor may not be exposed to the significant risks and benefits associated with the underlying asset.



- (e) whether the fair value of the lease payments equals or exceeds the fair value of the underlying asset. In some cases, a lessor may not be exposed to significant risks and benefits associated with the underlying asset when the fair value of the lease payments equals or exceeds the fair value of the underlying asset. However, in other situations (eg some short-term equipment leases) the lessee will be willing to pay more than the fair value of the underlying asset because of the convenience of leasing the asset rather than owning it.
  - (f) whether the lessor has an obligation to provide material non-distinct services. A lessor that is required to provide material non-distinct services may be exposed to significant risks and benefits associated with the underlying asset.
4. The existence of one or more indicators is not conclusive to a determination of whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset.

***Business model***

5. In many situations, it is apparent from the lessor's business model that the lease exposes the lessor to significant risks and benefits associated with the underlying asset. For example, some lessors' business model is to lease an underlying asset (typically real estate or short-term equipment) to several different lessees over the asset's useful life. Such lessors are likely to be exposed to significant risks and benefits associated with such underlying assets. Consequently, the lessor will not have satisfied its performance obligation at the date of commencement of the lease.
6. If, however, a lessor's business model exposes the lessor mainly to credit risk, the lessor is unlikely to be exposed to significant risks and benefits associated with the underlying asset. Consequently, the lessor's performance obligation to the lessee is likely to have been satisfied at the date of commencement of the lease. Many financial institutions apply a business model of this type.

***Lessor's exposure to risks and benefits associated with the underlying asset at the end of the lease***

7. If, at the end of the lease, a lessor has insignificant exposure to the risks and benefits associated with the underlying asset, then the lease may not expose the lessor to significant risks and benefits associated with the underlying asset. This may be the case if:
- (a) a major part of the economic life of the underlying asset is covered by the lease term. In determining whether the lease term will cover the major part of the economic life of an asset, the lessor considers the effect of terminations options and options to extend the lease. The existence of a termination option may mean that the lessor is exposed to significant risks and benefits associated with the underlying asset unless any termination penalties are such that they compensate the lessor for its exposure to that risk. Options to extend a lease would not normally be considered in determining whether a lease covers a major part of the economic life of the asset unless the lessee is economically compelled to exercise them (for example, because of the specialised nature of the underlying asset or the pricing of the rentals during the optional period).
  - (b) the lessee provides a residual value guarantee that covers substantially all the expected fair value of the underlying asset at the end of the lease. Residual value guarantees provided by parties other than the lessee are not part of the lease agreement and should not be considered in determining whether the lessor is exposed to significant risks and benefits associated with the underlying asset.
8. A lessor considers the present value of the lessor's interest in the residual asset at inception of the lease when it determines the significance of its exposure to the risks and benefits associated with the underlying asset at the end of the lease. Because land is a non-depreciating asset it is likely that at the end of a long-term lease, the lessor's interest in the land will be significant. However, if the present value of the lessor's interest in the land (determined at inception of the lease) is

not significant then lessor's exposure to risks and benefits associated with the underlying asset at the end of the lease may not be significant.

***Significant contingent rentals***

9. Some forms of contingent rentals expose the lessor to risks and benefits associated with the underlying asset. For example, rentals that are contingent on usage of the asset or the performance of the asset (eg sales from a particular retail site) may expose the lessor to risks and benefits associated with the underlying asset. Consequently, if contingent rentals of this type are a significant element of the lease the lessor may be exposed to significant risks and benefits associated with the underlying asset.
10. Other forms of contingent rentals (eg rentals linked to variable interest rates) do not expose the lessor to significant risks and benefits associated with the underlying asset. In the case of rentals linked to variable market interest rates, the contingent element of the payment exposes the lessor to interest rate risk rather than the risks associated with the underlying asset.