IASB/FASB Meeting 21 July 2010

IASB Agenda reference 2G

Staff Paper

FASB Agenda reference 118

Project **Leases**

Topic **Hybrid approach – Proposed wording for the split**

Introduction

1. Following the joint meeting on Monday, a group of Board members have worked with staff to develop some alternative wording for the split between the performance obligation approach and the derecognition approach. We have developed two slightly different drafts which we would like to discuss with you at today's meeting.

Proposed wording

Differences between Alternatives A and B are highlighted

Alternative A:

Objective: A lessor shall account for a lease contract based on whether the lessor retains exposure to material risks and benefits associated with:

1. the underlying asset (whole asset if lease is for a portion) over the asset's useful life; or
2. material non-distinct services embedded in the lease contract

For purposes of this assessment, risks associated with the counterparty credit risk of the lessee shall not be considered.

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

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

In considering whether the lessor retains exposure to material risks and benefits, the lessor should consider both the risks and benefits arising from the lease contract and risks and benefits associated with the underlying asset (whole asset if lease is for a portion) after the end of the lease term.

A lessor that retains exposure to material risks and benefits shall apply the performance obligation approach to such leases. A lessor that does not retain exposure to material risks and benefits shall apply the derecognition approach.

The assessment of which approach to apply shall be made at the inception of the lease and is not subsequently reassessed.

A lessor shall consider the following factors when determining whether it retains its exposure to risks and benefits:

- The existence of significant contingent rentals based on the use or performance of the underlying asset
- The existence of options to extend or terminate the lease
- The existence of material non-distinct services
- The lease term in relation to the useful life of the asset
- The lessor's exposure to the underlying asset at the end of the lease term. In making this assessment the lessor shall consider the present value of the underlying asset at the end of the lease term. In addition, the lessor should consider the effect that residual value guarantees provided at inception by the lessee or third parties have on its exposure to risks and benefits. In general, a residual value guarantee will reduce a lessor's exposure to downside risk but may leave the lessor with the potential to benefit from increases in the expected value of the underlying asset at the end of the lease.
- Whether the contractual minimum lease payments approximates the fair value of the underlying asset.

In most cases an entity's business model will be indicative of whether a derecognition or a performance obligation approach would be appropriate.

(a) the derecognition approach is likely to be appropriate where the entity's business model is primarily the provision of finance, where the profit of that business unit is derived from interest income and the principal risk associated with the business activity is credit risk.

(b) The performance obligation approach is likely to be appropriate where the entity's business model is primarily to generate a return from the active management of the underlying assets either from leasing these assets to multiple lessees during their life or from use or sale of the asset at the end of the lease. The lessor may also generate a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset. In this business model the principal risk associated with the business activity is asset risk.

Alternative B:

Objective: A lessor shall account for a lease contract based on whether the lessor's exposure to risks and benefits associated with the underlying asset (whole asset if lease is for a portion) would have a material effect on the total return derived from that asset. In considering the total return derived from the asset, the lessor should consider both the cash flows arising from the lease contract and cash flows associated with the underlying asset (whole asset if lease is for a portion) after the end of the lease term.

For purposes of this assessment, risks associated with the counterparty credit risk of the lessee shall not be considered.

A lessor shall apply the performance obligation approach if the lessor's exposure to the risks and benefits associated with the underlying asset has a material impact on the total

return derived from that asset. If a lessor's exposure to the risks and benefits does not have a material impact on the total return derived from the asset, the derecognition approach shall be applied.

The assessment of which approach to apply shall be made at the inception of the lease and is not subsequently reassessed.

A lessor shall consider the following factors when determining whether its exposure to the risks and benefits associated with the underlying asset has a material impact on the total return derived from that asset:

- The existence of significant contingent rentals based on the use or performance of the underlying asset
- The existence of options to extend or terminate the lease
- The existence of material non-distinct services
- The lease term in relation to the useful life of the asset
- The lessor's exposure to the underlying asset at the end of the lease term. In making this assessment the lessor shall consider the present value of the underlying asset at the end of the lease term. In addition, the lessor should consider the effect that residual value guarantees provided at inception by the lessee or third parties have on its exposure to risks and benefits. In general, a residual value guarantee will reduce a lessor's exposure to downside risk but may leave the lessor with the potential to benefit from increases in the expected value of the underlying asset at the end of the lease.
- Whether the contractual minimum lease payments approximates the fair value of the underlying asset.

In most cases an entity's business model will be indicative of whether a derecognition or a performance obligation approach would be appropriate.

(a) The derecognition approach is likely to be appropriate where the entity's business model is primarily the provision of finance, where the profit of that business unit is derived from interest income and the principal risk associated with the business activity is credit risk.

(b) The performance obligation approach is likely to be appropriate where the entity's business model is primarily to generate a return from the active management of the underlying assets either from leasing these assets to multiple lessees during their life or from use or sale of the asset at the end of the lease. The lessor may also generate a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset. In this business model the principal risk associated with the business activity is asset risk.