
Project	Leases
Topic	FASB Proposed wording for lessor accounting approach

Introduction

1. Following the joint meeting on Wednesday, July 21, a group of FASB members have worked with the FASB staff to develop some alternative wording for the split between the performance obligation approach and the derecognition approach. The FASB staff have developed two slightly different drafts for discussion on Thursday, July 22.
2. The purpose of this paper is to obtain the FASB's agreement to the draft wording set below.
3. This paper has been circulated to the IASB and will be discussed (in conjunction with Agenda Reference 2H/119) with them at a joint meeting on Thursday morning.
4. That staff has considered the approaches discussed below for drafting.

Proposed wording

Alternative A:

Objective: A lessor shall account for a lease contract based on whether the lessor retains exposure to significant risks and benefits associated with the underlying asset (whole asset if lease is for a portion) over the asset's useful life.

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.

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

In considering whether the lessor retains exposure to significant risks and benefits, the lessor should consider both the risks and benefits arising from the lease contract during the lease term 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 significant 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 is short in relation to the useful life of the asset. Therefore, the asset at the end of the lease is substantially unchanged from the asset at the beginning of the lease
- 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

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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 retains exposure to significant risks or benefits associated with the underlying asset either:

1. during the expected term of the current lease contract; or
2. subsequent to the term of the current lease contract by having the expectation or ability to generate significant returns by leasing that asset multiple times subsequent to the current contract.

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

A lessor that retains exposure to significant risks or benefits associated with the underlying leased asset shall apply the performance obligation approach to such leases. A lessor that does not retain exposure to significant risks or benefits associated with the underlying leased asset shall apply the derecognition approach. This assessment shall be made at the inception of the lease and not reassessed subsequently.

A lessor shall consider the following factors when determining whether it retains its exposure to significant risks or benefits associated with the underlying leased asset:

- The existence of significant contingent rentals during the expected lease term that are based on the use or performance of the underlying asset
- The existence of options to extend or terminate the current lease term
- The existence of material non-distinct services provided under the current lease contract
- A lease term that is short in relation to the useful life of the asset

Note: Under Approach B, if a lease is accounted for under the derecognition approach, the residual asset shall be measured initially and subsequently at its fair value with changes in the fair value recognized in net income. That is, the residual asset would be measured similarly to investment property as defined in IAS 40 (and as tentatively decided in the FASB project on investment property accounting).

[The following deleted paragraph could be included but probably is not needed:]

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

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- (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.~~