CPE Article

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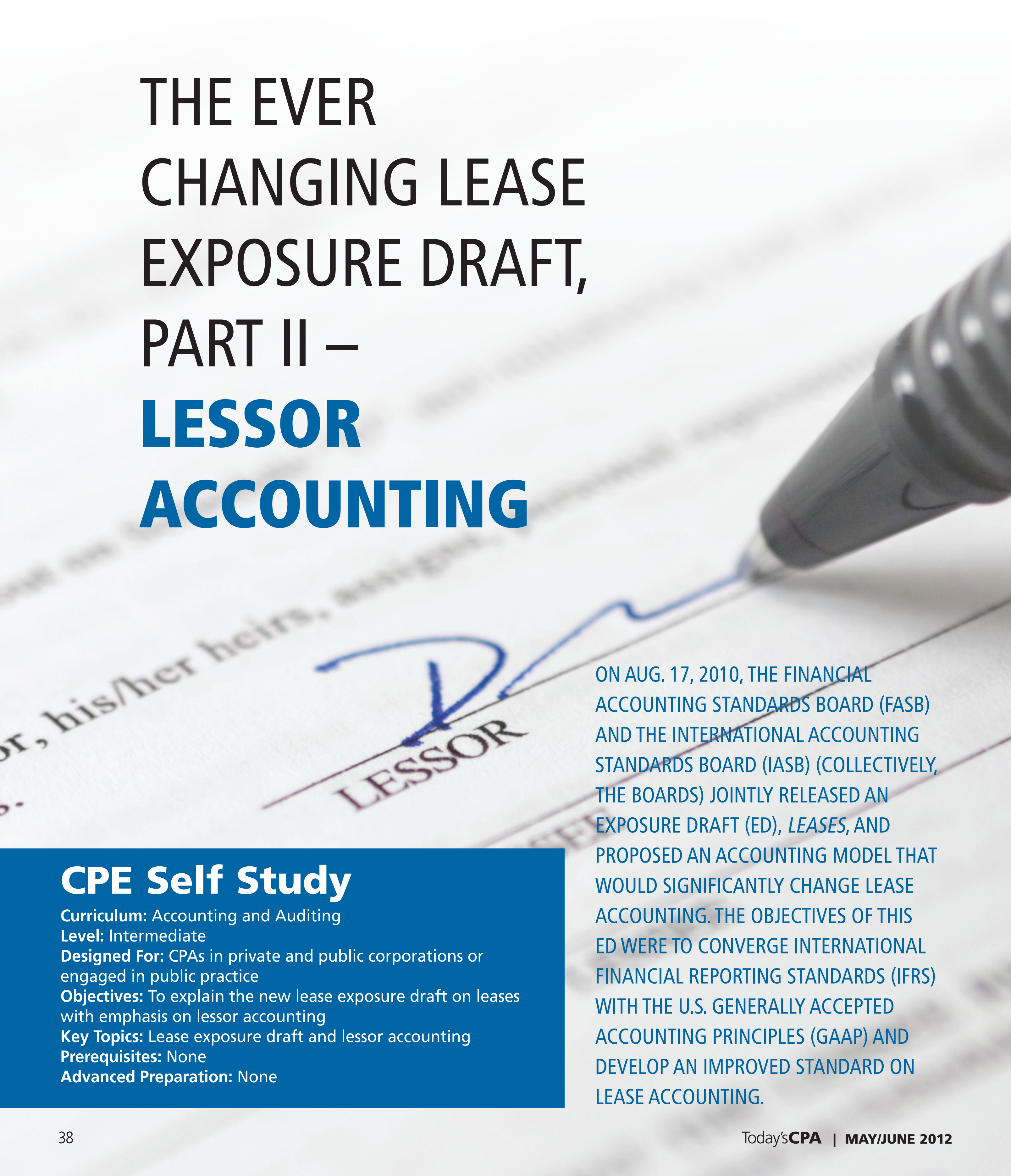
THE EVER CHANGING LEASE EXPOSURE DRAFT, PART II – LESSOR ACCOUNTING



ON AUG. 17, 2010, THE FINANCIAL ACCOUNTING STANDARDS BOARD (FASB) AND THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) (COLLECTIVELY, THE BOARDS) JOINTLY RELEASED AN EXPOSURE DRAFT (ED), *LEASES*, AND PROPOSED AN ACCOUNTING MODEL THAT WOULD SIGNIFICANTLY CHANGE LEASE ACCOUNTING. THE OBJECTIVES OF THIS ED WERE TO CONVERGE INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) WITH THE U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND DEVELOP AN IMPROVED STANDARD ON LEASE ACCOUNTING.

CPE Self Study

Curriculum: Accounting and Auditing
Level: Intermediate
Designed For: CPAs in private and public corporations or engaged in public practice
Objectives: To explain the new lease exposure draft on leases with emphasis on lessor accounting
Key Topics: Lease exposure draft and lessor accounting
Prerequisites: None
Advanced Preparation: None

The proposed model has significant business implications, including impacts on contract negotiations, financial ratios, business systems and processes. The ED addresses both lessee and lessor accounting methods. *Today's CPA*, in its November/December issue, published an article titled, "The Ever Changing Lease Exposure Draft" (Rashty & O'Shaughnessy), which focused mostly on lessee accounting. This article, on the other hand, discusses the lessor accounting model that the Boards have proposed.

The ED initially proposed a hybrid or dual accounting model for lessors. The choice of the model depended on whether the lessor retained exposure to significant risks or benefits associated with the underlying asset. After further re-deliberations, the Boards decided on a single lessor accounting model – the receivable and residual method (R&R), which the authors will discuss in this article.

The Boards received over 770 comment letters in response to their Aug. 17, 2010 ED. The comment period ended on Dec. 15, 2010. The Boards also outreached to users and preparers in different countries and held several roundtable discussions. Many respondents to the ED stated that the lessor accounting proposals need significant further development and refinement, and that lessors would need additional guidance to determine which approach to apply. In addition, many respondents believed that the current lessor accounting model is "not broken" and questioned whether the costs of implementing the new model were accompanied by an improvement in financial reporting.

The Boards announced on July 21, 2011, that they plan to re-expose the ED to provide another opportunity for comments on revisions the Boards had undertaken since the publication of the ED on leasing in August 2010. A revised ED is expected to be issued in the third quarter of 2012, and the final standard is expected to be issued sometime in 2013.

THE EXPOSURE DRAFT

The ED initially proposed a hybrid or dual accounting model for lessors – performance obligation and derecognition approaches:

- Performance obligation approach – The lessor would recognize and initially measure (i) lease assets as a receivable for the expected rental payments and (ii) a corresponding liability as of the date of commencement of the lease. The lessor would recognize income as the performance obligation is reduced over the lease term in addition to recognizing interest income on the receivable.
- Derecognition approach – The lessor would recognize an asset for the right to receive rental payments, remove a portion of the carrying amount of the underlying asset from its statement of financial position, and reclassify it as a residual asset that represents the lessor's rights in the underlying asset that it did not transfer. In addition, the lessor may recognize up-front income and expense in profit or loss.

The choice of model depended on whether the lessor retained exposure to significant risks or benefits associated with the underlying asset. A lessor that retained exposure to significant risks or benefits associated with the underlying asset would have kept the underlying asset on its balance sheet, and recognized a receivable and a performance obligation. If the lessor did not retain exposure to significant risks or benefits, the underlying asset would have been derecognized and replaced with a receivable and a residual asset and profit might be recognized at lease commencement.

SUBSEQUENT REDELIBERATIONS

The Boards tentatively decided in July 2011 that a single lessor accounting model, the R&R method, should apply to all leases. The only exceptions would be short-term leases and leases of investment property measured at fair value.

The proposed model allowed for profit recognition at lease commencement depending on whether the profit was reasonably assured. The staff indicated that it would have further discussions with the Boards regarding the need for additional clarification of the term "reasonably assured." Many Board members indicated that they would prefer this application guidance to be consistent with the definition of "reasonably assured" in the revenue recognition project, but asked the staff to add criteria that would be more appropriate to a leasing environment.

THE LATEST DEVELOPMENT

The Boards' staff met in October 2011 and reversed their earlier decision and tentatively decided to remove the requirement that a day-one profit should be recognized in the income statement only if it passes a "reasonably assured" test. They agreed that the profit related to the lease receivable would be recognized in income at the commencement of the lease. The deferred profit (i.e., the portion of the total profit not recognized) would reduce the gross residual. That is, the recognized residual asset at the end of the lease agreement would be equivalent to the gross residual less the deferred profit.

Additionally, the staff has proposed three different approaches to the accounting for the residual asset based on the feedback that the Boards had received in their outreach activities. All three approaches would have a different way to calculate the residual asset, and therefore would result in a different measurement of any profit at lease commencement. In all three approaches, however, the lessor would measure profit at lease commencement if the carrying amount of the underlying asset is less than the sum of (i) the initial measurement of the lease receivable and (ii) the initial measurement of the residual asset.

A detailed analysis and discussion of these three approaches is beyond the scope of this article, but they may impact the final proposed approach to the R&R model.

Furthermore, the Boards tentatively decided that lessors would not apply this new approach to leases of investment property. The Boards still have some work to do in defining exactly what the term "investment property" would include for purposes of this exclusion.

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Moreover, the Boards also tentatively decided that both lessees and lessors could follow either a full retrospective approach or a modified retrospective approach in transition. The modified retrospective approach would provide specific relief from some of the more difficult aspects of the full retrospective transition approach and is designed to reduce transition costs. Either of the transition approaches agreed to by the Boards would avoid the recognition of a disproportionate amount of lease expense in the periods immediately following transition that would have been recognized under the Boards' original proposal.

THE PROPOSED REVISED R&R MODEL

In the proposed revised R&R model, the profit and residual asset will be measured as follows at lease commencement:

- Profit = (lease receivable + residual asset) – carrying amount of underlying asset.
- Residual asset = carrying amount of the underlying asset – [(present value of lease receivable ÷ fair value of the underlying asset) × carrying amount of the underlying asset].

The residual asset is subsequently accreted, using the interest rate that lessor charges the lessee and is reflected as interest income.

The lease receivable would be initially measured at the present value 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 lessees. The amounts to be received under residual value guarantees would not be recognized until the end of the lease. (The illustration of this article has not depicted this provision of the ED.)

SHORT-TERM LEASES

Short-term leases are leases that have a maximum possible lease term, including options to renew or extend, of 12 months or less. Short-term leases can use a simplified form of accounting and lessors are permitted to elect, on an individual lease basis, to not recognize assets or liabilities arising from short-term leases nor derecognize any portion of the underlying property. In other words, lessors can elect to treat short-term leases as operating leases.

ILLUSTRATION

The following illustration reflects the two different lessor accounting scenarios that the ED has proposed:

- Fair value of the underlying asset is equal to the carrying value.

- Fair value of the underlying asset is greater than the carrying value.

The assumptions used in this illustration are as follows:

- Entity R (the lessor) enters into a three-year lease agreement for equipment with Entity E (the lessee).
- The carrying value (CV) of the equipment is $37,000 at the commencement of the lease and has a residual value of $5,000 at the end of three years.
- For the scenario whereby the fair value (FV) equals the carrying value (CV), the lessor will charge the lessee a monthly lease payment of $1,000 in arrears, which is equal to a 6.08 percent return, the implicit rate in the lease agreement. The lease receivable, $32,832, is equal to the present value of the lease payments discounted at 6.08 percent.
- For the scenarios whereby the fair value (FV) is greater than the carrying value (CV), the fair value is $40,000 and the lessor will charge the lessee a monthly lease payment of $1,091 in arrears, which is equal to a 6.08 percent return, the rate implicit in the lease agreement. The $35,820 lease receivable is equal to the present value of the lease payments discounted at 6.08 percent.

EXHIBIT 1: RECEIVABLE AND RESIDUAL APPROACH – JOURNAL ENTRIES
FAIR VALUE EQUALS CARRYING VALUE

Year	Cash	Lease Receivable	Residual Asset	Underlying Asset	Lease Revenue	Interest Income
0	$ -	$32,832 (B)	$4,168 (C)	($37,000)	$ -	$ -
1	$12,000 (A)	($10,287) (D)	$261 (E)	$ -	($1,713) (D)	($261) (E)
2	$12,000 (A)	($10,931) (D)	$277 (E)	$ -	($1,069) (D)	($277) (E)
3	$12,000 (A)	($11,614) (D)	$294 (E)	$ -	($386) (D)	($294) (E)

(A) Annual lease payments of $1,000 per month.
(B) Lease receivable is equal to the present value of an ordinary annuity of $1,000 discounted at 6.08% over 36 months.
(C) Residual asset represents the rights to the underlying asset retained by the lessor and is equal to CV – (CV X (LR/FV)) or $37,000 – ($37,000 X ($32,832/$37,000)) = $4,168.
(D) Represents the lease revenue on the lease receivable, which is amortized using the effective method at 6.08%.
(E) The residual asset is accreted using 6.08% interest rate to arrive at $5,000 residual value at the end of the lease.

EXHIBIT 1A: RECEIVABLE AND RESIDUAL APPROACH – SELECTED ACCOUNT BALANCES
FAIR VALUE EQUALS CARRYING VALUE

	R&R MODEL			OPERATING LEASE MODEL	
Year	Lease Receivable	Residual Asset	Total Profit	Underlying Asset	Total Profit
0	$32,832 (A)	$4,168 (B)	$ -	$37,000 (E)	$ -
1	$22,545 (C)	$4,429 (D)	$1,973 (D)	$26,333 (E)	$1,333 (F)
2	$11,614 (C)	$4,706 (D)	$1,346 (D)	$15,667 (E)	$1,333 (F)
3	$ - (C)	$5,000 (D)	$681 (D)	$5,000 (E)	$1,334 (F)
	Total		**$ 4,000**		**$ 4,000**

(A) Lease receivable is equal to the present value of $1,000 discounted at 6.08% over 36 months.
(B) Residual asset represents the rights to the underlying asset retained by the lessor CV – (CV X (LR/FV)) or $37,000 – ($37,000 X ($32,832/$37,000)) = $4,168.
(C) The lease receivable is amortized using the effective interest method at 6.08%.
(D) The residual asset is accreted using 6.08% interest rate and accreted using a constant rate to arrive at the residual value at the end of the lease.
(E) Represents the book value of the equipment, cost less depreciation of $10,667 (($37,000 less 5,000) / 3) per year.
(F) Annual lease payments of $12,000 less depreciation of $10,667.

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Lessor Accounting

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Not surprisingly, Exhibits 1 and 1a reveal the same total profits under both the R&R model when fair value equals the carrying value and the operating lease model, but the R&R model profit is front loaded. At the beginning of the lease, the R&R model begins with assets equal to $37,000, the lease receivable of $32,832 and residual asset of $4,168, and end with assets equal to $5,000, the lease receivable of $0 and a residual asset of $5,000. With the R&R model, income is based on the interest earned at 6.08 percent on the lease receivable and amortized to zero by the end of the lease and the amount of residual asset is accreted to its residual value of $5,000 using 6.08 percent. The operating lease model derives the lease payment of $1,000 based upon the 6.08 percent interest rate (the rate the lessor charges the lessee). This rate is applied to a beginning balance of $37,000 to arrive at the residual value of $5,000.

EXHIBIT 2: RECEIVABLE AND RESIDUAL APPROACH – JOURNAL ENTRIES
FAIR VALUE GREATER THAN CARRYING VALUE

Year	Cash	Lease Receivable	Residual Asset	Underlying Asset	Lease Revenue	Interest Income
0	$ -	$35,820 (B)	$3,866 (C)	($37,000)	$ -	($2,686) (E)
1	$13,092 (A)	($11,224) (D)	$242 (F)	$ -	($1,868) (D)	($242) (F)
2	$13,092 (A)	($11,925) (D)	$257 (F)	$ -	($1,167) (D)	($257) (F)
3	$13,092 (A)	($12,671) (D)	$273 (F)	$ -	($421) (D)	($273) (F)

(A) Annual lease payments of $1,091 per month.
(B) Lease receivable is equal to the present value of an ordinary annuity of $1,091 discounted at 6.08% over 36 months.
(C) Residual asset represents the rights to the underlying asset retained by the lessor and is equal to CV – (CV X (LR/FV)) or $37,000 – ($37,000 X ($35,820/$40,000)) = $3,866.
(D) Represents the lease revenue on the lease receivable, which is amortized using the effective method at 6.08%.
(E) Represents profit at the inception of the lease (LR – (CV – RA)) = ($35,820 – ($37,000 - $3,866) = $2,686.
(F) The residual asset is accreted using 6.08% interest rate to arrive at $4,639 residual value at the end of the lease. The accretion is considered interest income.

EXHIBIT 2A: RECEIVABLE AND RESIDUAL APPROACH – SELECTED ACCOUNT BALANCES
FAIR VALUE GREATER THAN CARRYING VALUE

	R&R MODEL			OPERATING LEASE MODEL	
Year	Lease Receivable	Residual Asset	Total Profit	Underlying Asset	Total Profit
0	$35,820 (A)	$3,866 (B)	$2,686 (H)	$37,000 (F)	$ -
1	$24,596 (C)	$4,108 (D)	$2,110 (E)	$26,333 (F)	$2,425 (G)
2	$12,671 (C)	$4,365 (D)	$1,424 (E)	$15,667 (F)	$2,425 (G)
3	$ - (C)	$4,639 (D)	$694 (E)	$5,000 (F)	$2,425 (G)
	Total		**$6,914**		**$7,275**

(A) Lease receivable is equal to the present value of $1,091 discounted at 6.08% over 36 months.
(B) Residual asset represents the rights to the underlying asset retained by the lessor CV – (CV X (LR/FV)) or $37,000 – ($37,000 X ($35,820/$40,000)) = $3,866.
(C) The lease receivable is amortized using the effective interest method at 6.08%.
(D) Represents the residual asset plus accretion.
(E) Equals lease revenue plus any accretion (interest income).
(F) Represents the book value of the equipment, cost less depreciation of $10,667 (($37,000 less $5,000) / 3) per year.
(G) Annual lease payments of $13,092 less depreciation of $10,667.
(H) Represents profit at the inception (LR – (CV – RA)) = ($35,820 – ($37,000 - $3,866) = $2,686.

Exhibits 2 and 2a indicate that, although the R&R model when fair value is greater than carrying value produces a profit of $2,686 at the inception of the lease, the residual asset initially valued is less than that of the R&R model applied when fair value is equal to carrying value (only $3,866 vs. $4,168). The residual asset is based on a $37,000 cost rather than a $40,000 fair value [CV – (CV X (LR/FV))].

This produces a lower residual value of the underlying asset at the end of the lease by $361 ($5,000 residual value less $4,639). The overall profit is also lower by an equivalent amount ($361).

On the other hand, the operating lease model earns profit based on the fair value. The operating lease model derives the lease payment of $1,091 based on the rate charged by the lessor to the lessee (in this case, the implicit rate of the lease, 6.08 percent) applied to a beginning balance of $40,000 (fair value) to arrive at the residual value of $5,000.

FURTHER DELIBERATIONS

The Boards have made it clear that they do not have complete and final thoughts on lessee or lessor accounting at this time. Some questions remain to be resolved and are subject to further deliberations. The Boards plan to re-expose the proposed guidance and continue with deliberations. This outreach indicates that the Boards intend to issue a quality standard and are cognizant of the views of their constituents.

A complete summary of the Boards' deliberations on the leases project is available on FASB's website at www.fasb.org or IASB's website at www.ifrs.org. ■

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Today's CPA offers the self-study exam below for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. Mail the completed test by **June 30, 2012**, to TSCPA for grading. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TSCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade. The answers for this exam will be posted in the next issue of *Today's CPA*. Answers to last issue's self-study exam: 1. c 2. b 3. c 4. d 5. b 6. a 7. c 8. d 9. a 10. a

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(Please check one.) 5=excellent 4=good 3=average 2=below average 1=poor

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The Ever Changing Lease Exposure Draft, Part II – Lessor Accounting

BY JOSEF RASHTY, MS, CPA, AND JOHN O'SHAUGHNESSY, PH.D., CPA (INACTIVE)

1 The initial Exposure Draft issued in August 2010 proposed a dual accounting model for lessors based on who bears the significant risks or benefits of the underlying asset. The two approaches were titled:

A. Sales-type and Operating approaches
B. Direct Financing and Performance Obligation approaches
C. Residual and Direct Financing approaches
D. Performance Obligation and Derecognition approaches

2 The Boards tentatively decided in July 2011 that a single lessor accounting model, the R&R method, should apply to all leases. The only exceptions to the R&R method would be short-term leases and:

A. operating leases
B. leases of inventory
C. leases of investment property measured at fair value
D. leases of real property

3 Short-term leases are leases that have a maximum possible lease term:

A. of 12 months or less, including bargain purchase options
B. of 12 months or less
C. of 12 months or less, including options to renew or extend
D. of 12 months or less, including options to renew or extend up to a maximum of 24 months

4 When using the Receivable and Residual approach, the residual asset recognized on the lessor's balance sheet represents:

A. rights to the underlying asset retained by the lessee
B. rights to the underlying asset retained by the lessor
C. rights to the lease receivable
D. present value of the lease payments

5 When using the Receivable and Residual approach and when fair value equals carrying value, the residual asset value at the end of the lease term is equal to:

A. the residual value of the underlying asset
B. zero
C. the initial value of the residual asset at the inception of the lease
D. not enough information to determine answer

6 The calculation of profit using the R&R model is:

A. (lease receivable + residual asset) – carrying amount of underlying asset
B. (present value of lease receivable ÷ fair value of the underlying asset) X carrying amount of the underlying asset
C. (lease receivable ÷ fair value) X carrying amount of underlying asset
D. (lease receivable ÷ fair value) X residual asset

The assumptions used in the questions below are as follows:

PERIOD	PRESENT VALUE OF $1 DISCOUNTED AT 7.50%
1	0.9302
2	0.8653
3	0.8050
TOTAL	2.6005

The lessor entered into a three-year lease agreement for equipment with the lessee. The carrying value (CV) of the equipment is $28,420 at the commencement of the lease and has a residual value of $3,000 at the end of three years. The fair value (FV) equals the carrying value (CV). The lessor will charge the lessee an annual lease payment of $10,000 in arrears, which is equal to a 7.5 percent return, the implicit rate in the lease agreement.

7 Given the above assumptions, how much is the amount of the lease receivable at the inception of the lease?

A. $25,024 C. $27,004
B. $28,420 D. $26,005

8 How much is the amount of the residual asset at the inception of the lease?

A. $2,415 C. $1,113
B. $1,563 D. $2,670

9 How much is the interest income resulting from accretion for the first year of the lease?

A. $211 C. $891
B. $1,950 D. $181

Additional assumptions – assume the fair value (FV) is greater than the carrying value (CV). The fair value is $35,000, the carrying value (CV) of the equipment is still $28,420 and the lessor will charge the lessee an annual lease payment of $12,530 in arrears, which is equal to a 7.5 percent return, the rate implicit in the lease agreement.

10 How much is the profit at the inception of the lease?

A. $1,962 C. $6,126
B. $5,583 D. $3,530