

Investor Perspectives

Stephen Cooper: Lessor accounting—what really are the lessor's assets?



Lessor accounting presented particular problems for the IASB when developing the exposure draft (ED) on leases. Two quite different approaches to the treatment of the underlying asset were developed and each had its supporters, with no easy answer as to which was preferable. This contrasts with lessee accounting, where the basic approach is clear: the recognition of a liability for the commitment arising from a lease contract and a corresponding asset representing the right to use the underlying asset. Of course lessee accounting is not without its difficulties, but these essentially relate to the details of what to capitalise such as whether to include contingent rentals or optional lease periods and how to measure the related income statement expense items. However, for lessor accounting there is a more fundamental question of selecting the basic model itself.

We developed two alternative methods for lessor accounting: the derecognition approach and the performance obligation approach. In both methods, the lessor recognises a receivable for the right to receive lease payments from the lessee, which corresponds to the obligation (liability) recognised by the lessee. However, the two approaches deal rather differently with the remainder of the lessor's interest in the underlying asset. The two approaches are briefly explained below.

- **Derecognition approach:** this approach views the lessor as having transferred the economic benefits of the underlying asset to the lessee. Consequently, the right-of-use granted to the lessee is regarded as a partial disposal of the underlying asset held by the lessor. As a result, when the lease commences, the carrying amount of the underlying asset is reduced to reflect this partial

disposal, and a new asset equal to the present value of the lease receivable is recognised. The difference between these two amounts could result in a gain for the lessor. In effect, at the inception of the lease, the carrying amount of the leased asset is replaced by a right to receive rental income over the lease term and a residual interest in the underlying asset.

- Performance obligation approach: this approach views the underlying asset as a continuing economic resource of the lessor. Consequently, the existence of the lease does not affect the accounting for the underlying asset on the lessor's balance sheet, which remains at its previous carrying amount with related depreciation being expensed. However, the lease contract additionally results in the recognition of a receivable for the right to receive rental income and a corresponding lease liability representing the obligation to provide the lessee with the right to use the asset over the lease term. Over the lease term, interest income is recognised on the receivable and lease income is recognised as the lease liability is satisfied.

Over the full life of a leased asset, the net income recognised by a lessor must be the same irrespective of the accounting. However, the two approaches described above produce different balance sheet amounts through the life of the asset and a different pattern of income recognition.

Interested parties that we have consulted on lessor accounting have mixed views on the two approaches. Many express a preference that, if the lessor accounting model is to be changed, a single approach to lessor accounting should be applied.

Some favour the derecognition approach. They argue that it best reflects the underlying economics of a lease transaction and is consistent with the lessee accounting model. If the lessee has acquired an unconditional right of use representing a portion of the bundle of rights associated with the underlying asset, then it makes sense to recognise the lessor as having disposed of this portion of the asset. Continuing to recognise the full asset on the lessor's balance sheet would seem to be double counting.

Others express concerns about applying the derecognition approach. They support a performance obligation approach, arguing that it provides more useful information when lease terms are short, where the business activity is primarily managing the underlying asset, or where there is significant

uncertainty for the lessor in terms of the length of the lease or the income to be received, because of contingent rental arrangements. They view the derecognition approach as making most sense when the lessor's primary business activity is to provide finance, and the interest in the underlying asset is restricted to the residual asset at the end of the lease term.

Here are three examples where the Board posed the question of which approach was more appropriate.

- Short term lease: assume that a company owns and operates a ship, but as the asset is temporarily surplus to requirements, it is leased to a third party for a period of one year. The derecognition model could lead to a profit being recognised on this deemed 'partial disposal' of the asset. The profit is based upon an assessment of the portion of the carrying amount to be derecognised, which is itself based upon comparing the fair value of the asset at the time of the deemed sale with the value of the lease receivable. The performance obligation approach would keep the carrying amount of the ship unchanged and not recognise any 'disposal' profit.
- Uncertain lease term: assume that a lessor has acquired an asset and leased it to a lessee for a period that is a minority of the asset's life but with an option for the lessee to extend the lease term, and that the lessor considers it likely that the lease term will be extended. In this case, under the derecognition approach, the amount derecognised would take account of the rentals expected to be received in the optional lease period and the profit on sale would accordingly include an amount that might not in fact materialise if the option to extend were not exercised by the lessee.
- Equipment lease: assume that an airline leases aircraft from a bank (the lessor) to use in its operations. The lease terms are for 20 years. Under both approaches the bank would recognise an asset for the right to receive future lease payments. However, under the derecognition approach, the bank would no longer recognise the full cost of the aircraft as property, plant and equipment. In contrast, if the performance obligation approach is applied, the bank would not only recognise the asset for the right to receive future lease payments; the bank would also continue to recognise the full cost of the aircraft as property, plant and equipment.

The issue for investors is which approach to lessor accounting provides you with the most relevant information. Do you think that one approach for lessor accounting should be applied to all leases? (This would include for example, the three lease examples described above, all of which made the IASB pause for thought when developing the ED).

The model for lessor accounting that we describe in the exposure draft includes two approaches to accounting for the underlying asset. Under this model, certain leases, which may include the aircraft lease example above, are accounted for under the derecognition approach. For other leases, such as the short term lease and uncertain lease term examples above, the performance obligation model would be more appropriate. The determining factor given in the ED is whether the lessor retains exposure to significant risks or benefits related to the underlying asset. If this is the case, as it may be in the short term lease and uncertain lease term examples above, then the performance obligation approach would be used. However, the underlying notion is perhaps best described as one of differing business models. This is how it is described in the basis for conclusions to the ED:

BC 27 In most cases an entity's business model will indicate when a derecognition or a performance obligation approach would be appropriate as follows:

- a. The derecognition approach is likely to be appropriate when the entity's business model is primarily the provision of finance, because the profit of that business is derived from interest income and the principal risk associated with the business is credit risk.*
- b. The performance obligation approach is likely to be appropriate when 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 that business model the principal risk is asset risk.*

We are very interested in how investors view lessor activity and what method for lessor accounting would help you best understand the financial position and performance of lessors. In particular, does the determining factor discussed above for the choice of lessor accounting method make sense?.

Stephen Cooper is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.