Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Outline of a Lessor Accounting Model

Dear Sir David,

Leaseurope has made its concerns with the IASB/FASB's preliminary views on a right to use model for lessees known to the Boards in its comment letter on the Leases Discussion Paper. In particular, Leaseurope takes the view that the proposed model is excessively complex and that any additional benefits it may provide to users of accounts would be outweighed by the costs it would impose on preparers. Consequently, although Leaseurope has reservations on the model itself, if the basic right of use model for lessees is reconfirmed, we urge the Boards to reconsider many aspects of the approach set out in the Discussion Paper so that a significant degree of simplification for lessees is achieved.

This being said, Leaseurope is committed to assisting the Boards in developing a high quality new lease accounting standard that covers both lessee and lessor accounting. To this effect, we propose below the outlines of a future approach to lessor accounting based on a dual model. Given that there has been little time available to conduct the extensive consultation of our members that would be required to present a detailed model, this paper reflects the European leasing industry's preliminary, high-level views on lessor accounting. Certain aspects of the model will undoubtedly require refinement going forward. We would be happy to engage with the Boards and their staff in the coming weeks and months to develop the model further.

Lastly, we wish to point out that, although this paper focuses exclusively on lessor accounting, it will be necessary to revisit decisions taken on the lessee side accordingly. It must be ensured that a given lease is treated consistently within a new lease accounting framework. Generally speaking, we recommend that during their planned re-deliberations, the Boards look at all aspects of lease accounting from the point of view of both the lessee and lessor in order to develop an informed and coherent model for lease accounting. As indicated previously to the Boards, we maintain that the results of these deliberations should be reflected in a new, comprehensive discussion paper covering both sides of lease accounting.

Please do not hesitate to contact us or Leaseurope staff (Jacqueline Mills, j.mills@leaseurope.org - +32 2 778 05 66) for any questions you may have on this paper.

Yours sincerely,

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LEASEUROPE DIRECTOR GENERAL

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EFRAG
European Commission

Leaseurope

Outline of a Lessor Accounting Model

Different lessor business models

The term leasing covers a wide range of contracts that can be distinguished. Different contracts demand different activities, and hence there are *different* lessor types with appropriate experience and skill sets providing these products and operating in diverse markets.

In particular, lessors can have varying degrees of involvement with the leased asset, depending on the level of asset risk they wish to bear. The higher the asset risk, the more firms have to establish asset management practices to control this risk. The focus of the business can vary from a form of financing where the asset simply fulfils a security function, through a middle ground where assets are made available to lessees for a portion of their useful life to very short term rentals or multiple leases of a larger asset, where the lessor retains and manages all the risks related to the asset.

Criteria for distinguishing between the business models

As a result, it is not possible to fit all leases into one single lessor accounting model. Instead, different models should apply according to whether the lessor is acting as what could be described as an “asset financier” or an “asset manager”. The criteria for distinguishing between these types of models should be based on the nature of the lease. If the key indicators for the lease are a fixed return on capital invested and a contractual yield, this could be a sign that the lessor is acting as an “asset financier”, for example. However, if the key indicators used in running the business are asset usage rates and per period income, where leases are for relatively short periods allowing multiple leases of the same asset or where leases could be for a portion of a larger asset (e.g. the rental of a single floor in a building that is wholly owned by the lessor), this could be a sign that the lessor is instead acting as an “asset manager”. It may also be possible that the same firm acts as an asset financier or an asset manager for different assets, in which case the appropriate model should be applied according to the type of lease.

Lessor accounting for asset managers

Short term rental companies, for example daily car rental firms, would typically fall under the category of asset managers, as would investment property lessors. For such leases, the lessor should continue to recognise and depreciate the leased asset on their balance sheet as is the case today. Revenue would be recognised as rentals are received. A fair value option should be made available for those companies that lease assets with long useful lives (e.g. property). As a result, cases where a fully depreciated asset still generates a rental stream would be rare and in such situations the lessor would also simply recognise revenue as rentals are receivable.

Lessor accounting for asset financiers

Other leases would fall under the asset financier category. The accounting model to be applied to this category would involve the lessor derecognising the leased asset and recognising an asset for its residual rights in the leased item at the end of the lease term (if any), the so-called derecognition model. This model is consistent with the Boards' preliminary views on lessee accounting and avoids the creation of multiple assets when applied to a sub-lease situation, the acid test of a well functioning approach to lease accounting. We also believe this approach to be consistent with the Derecognition Exposure Draft as the performance of the residual asset is not dependant on the performance of the element derecognised. Moreover, it is in line with the Basis for Conclusions of the aforementioned Exposure Draft, which states that "two parties cannot control the same asset simultaneously"[1]

Under this model, the residual asset is accreted at the rate inherent in the lease so that it equates to the expected residual value at the end of the lease term.

The lessor recognises an asset (a receivable) for its right to receive rental payments. As the lessor does not control lessee decisions to exercise options or factors underlying any contingent rental payments potentially associated with the lease, its receivable should be limited to the lessee's committed lease payments in order to avoid overstating the asset.

Revenue recognition for asset financiers

Once this basic model is established, it is then a question of determining under which circumstances lessors would be eligible to recognise sales-type revenue; interest income would be in all cases recognised over the lease term.

In the case of third party leases, the recognition of sales profit is not an issue. If a third party lessor (bank or finance company) has purchased an asset to be leased onwards, there is a clear indication of the cost of the asset. It should not be possible to derecognise more than this cost, as this could only be achieved by discounting rentals at a rate lower than the one used to calculate the rental payments. This would clearly be inappropriate and the rate used to discount future rentals should therefore be the implicit rate of the lease. If an asset is recovered at the end of the lease term at its residual value and then leased a second time, the residual value should be used as the cost, and the same reasoning applied.

In the case of a manufacturer lessor, the derecognition model should lead to the recognition of a receivable plus a residual (if any) greater than the manufacturing cost of the asset. If the lessor has no residual, then it has effectively sold the physical asset. Such a case appears to be relatively straightforward and the lessor should recognise its manufacturing profit up front. If the manufacturer does not derecognise the entire asset and has a residual, it has sold a quantum corresponding to the right to use the asset. As control of that right has been transferred to the lessee, the lessor should be able to recognise any gain on that sale upfront. In both cases, the gain should be equal to the difference between the arm's length (observable) retail price and the manufacturing cost of the asset. Such an approach is consistent with the Revenue Recognition Discussion Paper to the extent that the right of use asset is considered to be a good. It is also consistent with a manufacturer's business model where it sells equivalent assets for cash (or cash equivalent) consideration.

[1] BC18, Exposure Draft ED/2009/3, Derecognition, Proposed Amendments to IAS 39 and IFRS 7