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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**Board Meeting:** 17 October 2006, London

**Project:** Annual improvement process

**Topic:** Contingent rents  
(Agenda Paper 18B)

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1. The IFRIC have recommended that the following issue would be most appropriately resolved via the annual improvements process (as agreed by the Board in July 2006).

*Issue:* In IAS 17 *Leases*, should contingent rents relating to operating leases be recognised as incurred or amortised on a straight line basis?

2. The purpose of this paper is to propose that the above issue be added to the Board's annual improvements project, to provide analysis on that issue and to propose a solution.

#### *Staff recommendation*

3. The staff recommends:
  - that the Board add the issue described in paragraph 1 to the annual improvements project; and

- that contingent rents be recognised as incurred / earned rather than on a straight line basis over the lease term.

### *Structure of the paper*

4. The background to this issue, staff analysis and proposed drafting of amendments have been presented in the main body of this paper. Appendix A contains an analysis relative to the agenda criteria set out in the IASB Due Process Handbook.

### *Background*

5. In July 2006, the IFRIC was asked ‘to consider whether an estimate of contingent rentals payable / receivable under an operating lease should be included in the total lease payments / lease income to be recognised on a straight-line basis over the lease term’.
6. The IFRIC noted that ‘although the Standard is unclear on this issue, this has not, in general, led to contingent rentals being included in the amount to be recognised on a straight line basis over the lease term. Accordingly, the IFRIC decided not to add this issue to its agenda but to recommend to the Board that IAS 17 be amended to clarify the approach intended by the Standard’.
7. Paragraphs 4, 33 and 50 of IAS 17 are reproduced below:
  4. “Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).”
  33. “Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit.”
  50. “Lease income from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.”
8. IAS 17.4 states that contingent rents are a component of lease payments. As such, paragraphs 33 and 50 indicate that they should be estimated at the

inception of the lease and recognised on a straight-line basis (or other systematic basis) over the lease term.

9. However, in practice, most constituents recognise contingent rents as they are incurred or earned. This treatment appears to have developed from interpretation of IAS 17.25 which deals with the subsequent measurement of finance leases in the financial statements of lessees.
10. IAS 17.25 states 'contingent rents shall be charged as expenses in the periods in which they are incurred'. There is no similar statement in IAS 17 with regard to operating leases. However, constituents have adopted this approach for operating leases on the basis of consistency. They believe that the reference to lease payments in paragraphs 33 and 50 of IAS 17 should be read as lease payments excluding contingent rentals. This has led to contingent rentals being recognised in the periods in which they are earned / incurred.

#### **Staff analysis**

11. Note: The analysis below considers contingent rents from the perspective of the lessee. The staff expects that contingent rents receivable by a lessor would be treated in a manner consistent with this analysis.

*Should contingent rents be recognised as incurred or on a straight line basis?*

12. There is a project being undertaken by the IASB at present to improve the accounting for leases. This project is intended to rectify what many believe to be failings of the current leasing standard. Consequently, the staff believe that it would be inappropriate to introduce a new method of accounting for contingent rents. As such, the staff have only explored the possibility of recognising contingent rents as incurred or on a straight line basis for the purpose of this issue.
13. **Recognising contingent rents as incurred** - Recognising contingent rents as incurred is easier than estimating contingent rents at the inception of the lease and recognising the expense on a straight line basis (or other systematic basis). This is the approach adopted in practice.

14. Current practice and US GAAP are aligned in the treatment of contingent rents. FASB Statement of Financial Accounting Standards No. 29 *Determining Contingent Rentals* (which is an amendment to Statement of Financial Accounting Standards No. 13 *Leases*) prescribes that contingent rents are recognised as incurred. The principle reason given for this is difficulties in measuring the contingent rents at the commencement of the lease.
15. IAS 17 recognises contingent rents relating to finance lease liabilities as they are incurred. Constituents believe it would be inconsistent to recognise contingent rents on a straight-line basis for operating leases and as incurred for finance leases.
16. The staff believe that the theoretical argument for including estimates of contingent rentals in the measurement of finance leases is probably stronger than the argument for including estimated contingent rentals in the income/expense recognised in respect of operating leases. This is because finance leases give rise to financial assets / liabilities which are normally recorded on initial recognition at fair value. IAS 17, however, explicitly excludes contingent rentals from the measurement of finance lease assets and liabilities. It would therefore be strange to require estimates of contingent rentals to be included in the income / expense recognised on a straight line basis in respect of operating leases when this approach is not adopted for finance leases.
17. **Recognising contingent rents on a straight line basis** - Estimating contingent rents at the commencement of the lease and recognising them over the lease term would be consistent with underlying assumption set out in the framework regarding accrual accounting. Under this basis, ‘the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate’.<sup>1</sup> Contingent rents occur as a result of entering into the lease, therefore,

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<sup>1</sup> From the Framework for the Preparation and Presentation of Financial Statements, Paragraph 22.

these rents should be recognised over the term of the lease and not as incurred. This is the approach suggested by a literal interpretation of IAS 17.

18. If contingent rents are to be recognised over the term of the lease (rather than as incurred), they should be recognised on a consistent basis with other operating lease expenses. That is, they should be recognised on a straight-line basis over the term of the lease (unless a more systematic basis is representative of the time pattern of the users benefit).
19. It could be argued that it is difficult to measure rent that is contingent on a 'future amount or factor other than the passing of time'.<sup>2</sup> Estimating contingent rents at the commencement of the lease may involve a high degree of subjectivity; as such the reliability of the information may be reduced.
20. Recognising contingent rents as incurred would remove any difficulties associated with measuring the contingent rent component of lease payments at the commencement of the lease. However, as with provisions recognised in accordance with IAS 37, it is only in extreme cases that management would be unable to prepare a reliable estimate of contingent rents at the commencement of the lease. Therefore, it would be unlikely that contingent rents could not be estimated at the commencement of the lease.
21. The staff note that whilst it is more appropriate to recognise contingent rents on a straight-line basis under the current framework, the requirements of IAS 17 prohibit discounting for operating lease expenses. Hence, the amount that would be recognised on a straight-line basis over the lease term for contingent rents would be the gross amount. Using a gross amount ignores the impact of the time value of money and does not reflect the actual pattern of benefit to the entity. However, this issue is representative of the problems inherent within IAS 17.

## **Summary**

22. A literal interpretation of IAS 17 would lead to inconsistency in the treatment of contingent rents for finance and operating leases. Current practice has been

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<sup>2</sup> IAS 17.4

to recognise contingent rents relating to operating leases in the manner prescribed for finance leases (ie, as incurred).

23. The staff believe that amending IAS 17 to change from current practice would not be appropriate given that there is a fundamental review of the standard being conducted. As a result, the staff believe that it would be more appropriate at this time to improve the consistency of wording and hence application of IAS 17.

### **Staff recommendation**

24. Requiring contingent rents to be recognised as incurred will ensure there is consistent treatment of contingent rents across different types of lease. It will also remove any potential divergence in practice and align the standard with current accepted practice and US GAAP.
25. The staff recommend that contingent rents be recognised as incurred / earned rather than on a straight line basis over the lease term.
26. **Does the Board agree?**

### *Drafting*

27. The following revisions are proposed to IAS 17 *Leases* should the Board agree with the staff recommendations:

### **Operating leases**

**33 Lease payments (excluding costs for services, taxes to be paid by and reimbursed to the lessor and contingent rent)<sup>3</sup> under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.<sup>4</sup> Contingent rents shall be recognised as expenses in the periods in which they are incurred.**

34 For operating leases, lease payments (excluding costs for services such as insurance and maintenance, taxes to be paid by and reimbursed to the lessor and contingent rents) are recognised as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

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<sup>3</sup> Reference to services and taxes has been included to ensure consistency with minimum lease payments definition.

<sup>4</sup> See also SIC-15 *Operating Leases—Incentives*.

## Subsequent measurement

- 39 **The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. Contingent rents shall be recognised as income in the periods in which they are earned.**
- 40 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the lessor's net investment in the finance lease. Lease payments relating to the period, excluding costs for services and contingent rents, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

## Operating leases

- 50 **Lease income (excluding receipts for services provided, taxes paid by and reimbursed to the lessor and contingent rent) from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.<sup>5</sup> Contingent rents shall be recognised as income in the periods in which they are earned.**
- 51 Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance, taxes to be paid by and reimbursed to the lessor and contingent rents) is recognised on a straight-line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

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<sup>5</sup> See also SIC-15 *Operating Leases—Incentives*.

## Appendix A - IASB agenda criteria

A1. The draft IASB due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda. Each of these is considered in the table below:

The relevance to users of the information involved and the reliability of information that could be provided	<p>The resolution of this issue is relevant to all entities that have operating leases with contingent rents.</p> <p>Current accepted practice is not, strictly speaking, in accordance with the requirements of the standard. Clarifying this issue will increase the reliability of this information as it will achieve a consistency in reporting.</p>
Existing guidance	<p>Existing guidance is unclear on this issue. Practice has diverged from the literal requirements of the standard in favour of an interpretation based on consistency with the requirements for finance leases.</p>
Possibility of increasing convergence	<p>US GAAP addresses this issue in Statement of Financial Accounting Standards No. 29 <i>Determining Contingent Rentals</i>. This standard states that contingent rents should be recognised as incurred / earned.</p>
Quality of the standards to be developed	<p>The staff view is that the proposed amendments will improve the consistency of IAS 17.</p> <p>This project is limited in scope and is not urgent. A solution is presented in this paper to minimise the time taken at the Board.</p>
Resource constraints	<p>This amendment has a limited scope, as such, there is not likely that there will be a significant amount of resource (internally or externally) required subsequent to this meeting.</p>