International
Accounting Standards
Board

Financial Accounting
Standards Board

This document is provided as a convenience to observers at IASB/FASB joint international working group meeting on leasing, to assist them in following the working group's discussion. It does not represent an official position of the IASB or the FASB. IASB and FASB Board positions are set out in their respective Standards.

Note: These notes are based on the staff paper prepared for the IASB/FASB working group. Paragraph numbers correspond to paragraph numbers used in the staff paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Meeting: **Joint International Working Group on Leasing**
15 February 2007, London

Topic: **ANALYSIS OF DIFFERENT ACCOUNTING MODELS FOR A LEASE WITH A LESSEE OPTION TO RENEW**
(Agenda Paper 10)

Introduction

1. The purpose of this paper is to examine how the accounting models described in paper 6 would treat a lessee option to extend the lease term.

2. The analysis in this paper is based upon the lease described in agenda paper 9. That is, a piece of machinery is leased for a fixed, non-cancellable term of three years; the economic life of the machinery is ten years. At the end of the first 3 years (the primary period), the lessee has the right to extend the lease for an additional 2 years (the secondary period). Lease payments are due at regular intervals over the primary period and, if the option is exercised by the lessee, over the secondary period; amounts payable in both the primary and secondary periods are fixed in the original lease agreement.

3. In paper 6, the staff described an accounting model (the right of use model) that recognises the assets and liabilities identified in a simple lease contract. This paper examines a number of different approaches to incorporating a lessee option into this right of use accounting model.

4. This paper then examines briefly how the three other models described in paper 6 would treat lessee options. That is:

    a. The whole asset model;

    b. The executory contract model; and

    c. The model adopted in current standards;

5. Appendix 1 to this paper illustrates each of these models with a numerical example.

The right of use model

6. The staff have considered several different ways in which an option to renew a lease contract could be incorporated in to the right of use model. Each of these different approaches is analysed below.

Option recognition approach

7. Under this approach, the lessee recognises its right to use the machinery for the primary period only. The lessee's option to extend the lease term is recognised as a separate asset. The lessor recognises a receivable in respect of its right to receive payments over the primary period of the lease. The lessor's right to receive payment for the lessee's option to extend the lease is included in the right to receive payments. In addition, the lessor recognises a liability in respect of its obligation to stand ready to permit the lessee to use the machinery over the secondary period.

8. The assets and liabilities recognised in under this model can be summarised as follows:

Assets and liabilities recognised by lessor	Assets and liabilities recognised by lessee
Receivable in respect of payments over the primary period (includes receipt in respect of option premium)	Liability to make payments over the primary period (includes obligation to pay option premium)
-	Right to use the machine over the primary period
Liability in respect of the stand-ready obligation to permit use of the machinery in the secondary period	Option to renew the lease at the end of the primary period
Interest in residual	-

9. The assets and liabilities recognised under this approach are the same as those identified in paper 9. Although there may be significant measurement issues associated with recognising the option, the staff recommend that this approach be developed further.

Alternative approaches

10. The staff have considered a number of alternative ways in which an option to extend the lease could be incorporated into a right of use model—namely:

- The control approach;
- The expected outcome approach; and
- The disclosure approach.

11. Each of these approaches is considered briefly below. However, as none of them result in the recognition of the assets and liabilities identified in paper 9, the staff have not, at this stage, developed these models further.

Control approach

12. This approach starts from the basis that the lessee has, by virtue of the option, the right to control the use of the machinery over both the primary and secondary lease periods—that is, although it can choose whether or not to extend the lease, it has the right to do so. The right to use the asset during the secondary term is therefore included in the asset recognised by the lessee. If this is the case, the assets and liabilities recognised would be as follows:

Assets and liabilities recognised by lessee
Liability to make payments over primary lease term (includes option premium)
Liability to make payments over the secondary lease term
Right to use the machine during the primary lease term
Right to use the machine over the secondary lease term

13. The assets/liabilities recognised by the lessor could (i) mirror those recognised by the lessee or (ii) reflect the fact that the lessor has no right to enforce payment in respect of the secondary period until the lessee option is exercised:

(i) Lessor mirrors lessee accounting	(ii) Lessor does not mirror lessee accounting
Receivable in respect of payments over primary lease term (includes option premium)	Receivable in respect of payments over primary lease term (includes option premium)
Receivable in respect of payments over secondary lease term	-
Interest in residual	Interest in residual

14. Although it can be argued that the lessee controls the right to use the machinery during both the primary and secondary period, the staff believes that the lessee has no right to use the machinery during the secondary period until the option is actually exercised. The lessee has the right to call for the right of use (for which it will agree to pay additional rentals) but does not have an absolute right of use in respect of the secondary period.

15. In addition, it is clear that until the lessee exercises its option to extend the lease, the lessee has no obligation to make payments during the secondary period.

16. This control-based approach, therefore, results in the lessee recognising rights and obligations that do not meet the asset and liability definitions.

17. Similarly, if lessor accounting mirrors lessee accounting, the lessor recognises an asset representing its right to payments over the secondary lease term. However, until the lessee exercises its option to extend the lease, the lessor has no present right to these payments.

Expected outcome approach

18. A second approach would be to base recognition of the lessee's right to use the asset during the secondary period, and the corresponding obligation, on the expected outcome. For example, if it is believed that it is probable (i.e. more likely than not) the lessee will exercise its option to extend the lease, assets and liabilities in respect of the secondary period are recognised in full. If exercise of the option is not thought probable, no assets or liabilities would be recognised in respect of the secondary period.

19. However, even where exercise of the option to extend the lease is considered not merely probable but highly probable, the lessee does not have an unconditional right to use the asset in the secondary period; nor does the lessee have an obligation to make rental payments during the secondary period. The lessee could choose not to exercise its option and return the asset at the end of the primary term. Consequently, if recognition of rights and obligations in respect of the secondary period is based upon the expected outcome, assets and liabilities that do not meet the framework or CON6 definitions will be recognised.

20. As with the control approach described above, lessor accounting could either mirror the lessee accounting or reflect the fact that the lessor has no right to enforce payment in respect of the secondary period until the lessee option is exercised. Once again, if the lessor accounting mirrors the lessee accounting, assets and liabilities that do not meet the framework definitions may be recognised.

Disclosure approach

21. Whilst recognition and measurement are separate steps in the process of reflecting an asset in the financial statements, some might argue that recognition of the option as an asset involves measurement problems since the option is not usually separately priced as part of the leasing transaction, and no market in such options exists. Accordingly, no separate asset or liability should be recognised in respect of the option, but

disclosure should be made of the lessee's rights and lessor's obligations under the option.

22. However, the staff believe that the lessee has rights in respect of the secondary period that meet the definition of an asset which should be recognised. Whether these rights are recognised as a separate asset or are included in the measurement of the right to use for the primary period will be considered at a later stage. However, simply disclosing the existence of the option does not fully capture the lessee's rights.

Questions for working group members

- **Do you agree that the option recognition approach described above recognises the assets and liabilities identified when a lease contract includes a lessee option to renew? If not, why not?**
- **What practical issues need to be considered if an option to renew a lease is recognised as proposed in this approach?**

The whole asset model

Treatment of option

23. Under the whole asset model, no additional assets or liabilities are recognised when the lessee has an option to extend the lease as the lessee has already recognised the full economic potential of the machinery on its balance sheet. However, as discussed in paper 9, the staff believe that the right to call for the use of the machinery in the secondary period is an asset of the lessee. In addition, the lessor has a stand-ready obligation to provide the right of use in the secondary period that meets the definition of a liability. Consequently, this approach fails to recognise the separate assets and liabilities identified in paper 9.

24. Under some leases, the lessee has an option to purchase the machinery at the end of the lease term. Some would argue that where such an option exists, the lessee controls the machinery for the whole of its life. Consequently, it can be argued that the lessee should recognise the machinery as an asset, rather than the right to use that machinery

and an option to acquire the machinery. However, until the lessee exercises its option to acquire the machinery, the lessee does not have an unconditional right to the economic benefits derivable from the use of the machinery after the end of the primary lease term. That is, an option to acquire machinery is not the same as the machinery itself. Until the option to acquire the machinery is exercised, the lessee's asset is the option, not the machinery.

The executory contract model

Treatment of options

25. Under this model, the lessee recognises no assets or liabilities in respect of the lease contact nor does it recognise any assets in respect of the option to renew. However, the lessee's rights and obligations under the lease contract (including any renewal options) are disclosed in the financial statements. The lessor recognises a physical asset in respect of the machinery but no liability is recognised for the lessor's obligation to stand ready to grant the lessor a right to use the machinery during the secondary period.

26. Once again, this model fails to recognise the assets and liabilities identified in paper 9.

The model adopted in the current standards

Treatment of options

27. Under the model adopted in the current standards, additional rentals payable if a lessee exercises an option to extend a lease are included in the measurement of a finance lease if it is considered reasonably certain at inception of the lease that the option will be exercised. Options to extend the lease are not recognised at all if the lease is classified as an operating lease.

28. Whether the lease is classified as a finance lease or an operating lease, options to extend the lease give rise to assets and liabilities that meet the framework and CON 6 definitions. Consequently, the staff believe that this approach does not faithfully represent the assets and liabilities arising in this lease contract.

Appendix 1 - Summary of lease models

Note:
The measurement basis used in each of these examples is for illustration purposes only. The figures used have been extracted from a more comprehensive example that will be used when discussing measurement issues.

This example assumes the following fact pattern:[1]

- Three year lease of an item of machinery
- Initial cost = CU 10,000
- Annual rental = CU 2,474 (in arrears)
- Option to extend to 5 years at the same rental
- Residual value at the end of year 3 = CU 5,121 (PV = CU 3,847)
- Residual value at end of year 5 = CU 1,000 (PV = CU 622)
- PV of 5 year's rental payments = CU 9,378
- PV of 3 year's rental payments = CU 6153

Model:	**Right of use – recognition of option**	**Whole asset**[2]	**Finance lease**[3]	**Executory/ operating**
LESSEE				
Machinery[4]	6,153 – X[5]	1,0000	6,153	nil
Option	X			
Obligation to pay rentals	(6,153)	(6,153) (see note)	(6,153)	nil*
Obligation to return		(3,847) (see note)		
LESSOR				
Right to receive rentals	6,153	9,378		nil*
Interest in residual	3,847	622		
Option	(X)			
Net investment in lease			10,000	
Machinery				10,000

[1] In practice a 3 year lease with an option to extend for a further 2 years is likely to be priced differently from a 5 year lease.
[2] Under the whole asset model the obligation to pay rentals could be the full CU 9,378 or the amount the entity is actually obliged to pay, CU 6,153; and the obligation to return the machinery could be either CU 622 or CU 3,847 to correspond.
[3] In practice a lease like this would be unlikely to be classified as a finance lease.
[4] The nature of the lessee's asset will depend upon the accounting model adopted.
[5] The value of the option is shown as X.