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: **OPTIONS TO TERMINATE A LEASE (Agenda Paper 11)**

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1. Paper 9 analyses the rights and obligations that arise when the lessee has an option under the lease agreement to extend the lease term. This paper compares the conclusions reached in paper 9 with the rights and obligations that arise when the lease arrangement contains a provision giving the lessee the option to terminate the lease before the end of the lease term.
2. This paper does not consider the measurement of options to extend or terminate a lease.

Are options to terminate economically the same as options to extend?

3. A simple lease arrangement that includes an option to extend the term might provide the lessee with very similar rights as a lease for a longer term that gives the lessee the option to terminate. For example, lease arrangements that provide for:
   a. an initial term of five years and the option to extend for a further three years at the same rental, or

b. a term of eight years, but with the right to terminate after five years with no penalty

are essentially the same—the lessee is committed to leasing the item and paying rental for the first five years, but has the choice of whether or not to lease the item for a further term of three years.

4. Leases with termination options often include a provision for payment of a penalty if the termination option is exercised. That is, at the termination option date, the lessee has the choice between continuing to lease the item (and paying further rentals), or terminating the lease and paying the termination penalty. It might be argued that a termination penalty of this kind means that the option to terminate cannot be seen as economically equivalent to an option to extend. However, staff believe that there is no economic difference between:
   a. a lease with a term of eight years with a right to terminate after five years on payment of a termination penalty, and
   b. a lease with a term of five years with an option to extend for a further three years, with a penalty payment if the option to extend is not exercised.

   In general, it seems that it is always possible to recast a lease with a termination option as a lease with an extension option. Therefore a termination option should give rise to the same assets and liabilities as the equivalent lease with an extension option.

Expectations of lessee behaviour

5. The analysis above ignores the effect the description of an option may have on the behaviour of the parties to the contract. For example, a lease may be structured as a eight-year lease with an option to terminate after year five rather than a five-year lease with an option to extend as both parties to the contract expect the lease to run for the full eight years.

6. Similarly, lessee inertia may affect the likelihood of an option being exercised. For example, a five-year lease where the lessee is required to take positive action to extend the lease for an additional three years (e.g., by giving notice of its intention to extend the lease) may be less likely to run for the full eight years than a lease that is for eight years with a termination option after year five.

7. However, the staff believes that expectations of whether or not the lessee will exercise options to extend or terminate do not change the contractual rights and obligations arising under the lease, and therefore the assets and liabilities that might be recognised. Lessee behaviour might have an effect on the measurement of these assets and liabilities, and this will be considered in later stages of the project.

Questions for working group members

- **Do you agree that an option to terminate a lease is economically the same as an option to extend? If not, what are the differences?**
- **Does the way the option is expressed in the lease contract—either as an option to extend or as a termination option—alter the behaviour of the parties?**

Does the lessee acquire a right to use for the whole lease term or just up to the termination option date?

8. The question then arises, whether at the beginning of the lease the lessee acquires the right to use the leased property for the whole term of the lease, or only up to the termination option date.

Right of use for the whole term of the lease

9. It could be argued that a lease with an option to terminate gives rise to a right of use for the whole of the lease term, together with an option to forgo that right from the termination option date. At the inception of the lease, there is no difference between the lessee's right to the first period of use (up to the termination option date) and the remainder of the lease term—both rights are present rights of use and are not subject to the lessee exercising an option. The lessee's right for the whole of the lease term therefore meets the definition of an asset in its entirety. This is in contrast to the option to extend the lease term, which gives the lessee the right to *call* for the right of use of the asset in the secondary period. That is, an asset arising from an option to extend the lease is different from an asset arising from the present right to use the item itself. The option would be recognised as a separate asset, but the underlying

right of use for the secondary period would *not* be recognised until the option was exercised.

10. This analysis would lead to the lessee recognising as an asset the right to use the item for the full lease period together with a liability for rentals for the full term of the lease, and a further asset representing the lessee's option to return the item at the termination option date (upon payment of a termination penalty) in exchange for relief from paying the secondary period rentals. Alternatively, the liabilities assumed by the lessee could be analysed as comprising (a) the obligation to make rental payments for the primary period and (b) an obligation in respect of the secondary period that can be settled either by paying rentals in the secondary period or by returning the item at the end of the primary period (together with payment of any termination penalty).

11. This analysis would mean options to terminate would be accounted for differently from options to extend a lease under the right of use approach discussed in earlier papers. In the simple example above, economically equivalent leases of:
    a. An initial term of five years and the option to extend for a further three years at the same rental; the lessee would recognise an asset representing the right to use for five years, a liability for rentals for five years, and a separate asset representing the option to extend the lease.
    b. A term of eight years, but with the right to terminate after five years with no penalty; the lessee would recognise an asset representing the right to use for eight years, and a liability to pay rentals for eight years, and a separate asset representing the right to terminate the lease early.

Right of use for the primary period only

12. An alternative analysis is to assert that a right that is conditional on the holder of the right choosing to accept it is conceptually no different from an optional right. In other words, if the lessee has an option to terminate the lease, it has no absolute right to use the item after the termination option date, but only a conditional right that depends on it *not* exercising the option. This is identical to the situation under an option to extend; the lessee does not have an absolute right to use the item for the secondary period, but one that is dependent on the lessee's choice. The rights and

obligations are identical under an option to terminate and an option to extend; only the labelling of the rights and obligations differs.

13. The staff believes that this analysis more accurately reflects the true nature of the rights and obligations, and therefore concludes that options to terminate leases should be accounted for no differently from options to extend.

Questions for working group members

- **Do you agree that an option to terminate of this kind should be accounted for in the same way as the economically equivalent option to extend? If not, what are the differences that justify a different accounting treatment?**

Termination penalties

14. This analysis is made more complicated where the lease includes termination penalties. Where the lessee has a right to terminate on payment of a termination penalty, the *minimum* obligation that it enters into at the inception of the lease is to pay the rentals up to the termination option date and the termination penalty; there is no way the lessee can avoid paying at least this amount.[1] Therefore, if the accounting is based on treating the option as an option to extend, the obligation that is recognised at inception should be for the primary period rentals plus the termination penalty. Furthermore, the lessee has both an asset representing the right to use the item for the primary period and the option to acquire the right to use the item for the secondary period. If this option is exercised, the lessee at that point enters into an obligation to pay the secondary period rentals but no longer has the obligation to pay the termination penalty.

15. This is illustrated in the following example, which ignores discounting as it implicitly assumes that the value of the item declines evenly over the period of the lease. More complex and realistic examples will be discussed in the section on measurement.

[1] This assumes (as is usually the case) that the termination penalty is less than the rentals over the remaining period of the lease from the termination date.

A lease for 10 years, with an annual rental of CU100, is cancellable after year 5, with a termination penalty payment of CU200.

The lessee recognises an asset of the right of use of CU500, representing the 5 years' unconditional right of use. An obligation of CU700 is recognised, being the lease payments for this unconditional term of CU500, together with the minimum payment the lessee is obliged to make: CU200 (the lower of the remaining lease rentals or the termination penalty).

At inception, the right to choose to acquire use of the item for years 6 to 10 is recognised as a separate asset and measured at CU200. Under this option, the lessee can choose to acquire use of the item for years 6 to 10. To acquire the right to use the item for years 6 to 10 the lessee must pay additional rentals of CU500. However, if the lessee chooses to acquire the use of the asset for the secondary period it will avoid paying the termination penalty of CU200. So choosing to acquire the use of the asset for the secondary period only increases the lessee's obligation by CU300, yet the value of the additional right to use for the secondary period is CU500—this right to choose is therefore valuable and is effectively an 'in the money' option with an exercise price of CU300 and intrinsic value of CU200.

16. Some leases—for example, some leases of photocopiers or similar equipment—contain provisions under which the lessee can terminate at any time on payment of a termination penalty. The lessee effectively has a rolling option, or stream of individual options, to terminate. Termination provisions of this nature present further difficulties; reflecting the minimum obligation of the lessee as being the termination penalty might be seen as intuitively misleading since in most cases these termination options will not be exercised—yet this may be the actual extent of the lessee's obligation at any time.

Questions for working group members

- **What types of termination options and termination penalties arise in practice?**
- **Do you agree that the liability should represent the minimum obligation, the rentals for the primary period plus the termination payment?**
- **Where a lease is terminable by the lessee at any time, is the lessee’s actual obligation limited to the amount of the termination penalty?**