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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**15 May 2007, London**
Project:	**Leases**
Subject:	**Options to Terminate or Extend a Lease (Agenda paper 2A)**

Introduction

1. The purpose of this paper is to (i) identify the rights and obligations that arise when a lease includes a lessee option to extend or terminate the lease; and (ii) analyse whether the rights and obligations identified meet the definitions of assets and liabilities in the IASB Framework and FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6). This paper does not consider the recognition or measurement of the assets and liabilities identified.
2. In order to simplify the analysis, this paper only considers those rights and obligations that exist after the leased item has been delivered to the lessee. Assets and liabilities may arise prior to the delivery of the leased item (for example, when the lease contract is signed). The timing of recognition will be discussed at a later stage of the project.
3. This paper does not deal with other types of options, (e.g. options to acquire additional usage or options to purchase the leased item). These will be dealt with in a separate paper.

4. The first section of this paper describes a number of simplified leases that include lessee options to extend or terminate the lease. The second section of this paper discusses the factors that affect whether an option to terminate or extend a lease is exercised. The paper then discusses whether options to extend a lease give rise to similar rights and obligations to leases that include a lessee right to terminate. The final section of this paper identifies the rights and obligations that arise in a simplified lease that includes a lessee option to extend and analyses which of those rights and obligations meet the definition of assets and liabilities in the Framework and CON 6.

Examples of leases

5. The following section describes leases that include lessee options to extend or terminate the lease.

Leases with an option to extend the lease

6. Lease contracts will often grant to a lessee the right (but not the obligation) to extend the lease beyond the initial lease period ("primary period"). The rental in this secondary period may be a fixed amount specified in the original lease contract or a fair market rent at the beginning of the secondary period. For example, a property lease may provide the lessee with the right to occupy a building for a period of 5 years for a fixed rental. At the end of 5 years, the lease may grant the lessee the right to extend the lease term for another 5 years. The rental payable (or calculation of the rental payable) in this secondary period may be specified in the original lease agreement.

7. At the end of the primary period the lease contract may permit the lessee to end the lease without penalty. Alternatively, the lessee may be required to pay a penalty for not exercising its option to extend the lease. The staff understand that it is uncommon for a lease contract to include a fixed penalty for not exercising an extension option. However, in some jurisdictions it is relatively common for the lessee to provide a residual value guarantee (RVG). Under a RVG, the lessee may be required to make a payment to the lessor at the end of the primary period if the value of the leased item drops below a certain amount and the lessee does not exercise its option to extend. In some leases, RVGs can be viewed as equivalent to

a penalty for not extending the lease (albeit a variable penalty). This may be the case when the guaranteed residual value is set at an artificially high amount. Accounting for residual value guarantees will be considered in more detail at a later stage of the project.

Leases with an option to terminate the lease

8. A lease contract may grant the lessee the right to terminate a lease before the end of the lease period. For example, a lessee may enter into a lease that provides the lessee with the right to use a piece of machinery for a period of 8 years at a fixed rental. The lease may also grant the lessee the right to terminate the lease contract and return the machinery at the end of year 5.

9. 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. This penalty may be a fixed or variable amount. One type of variable penalty (a "make-whole" termination payment), is discussed immediately below.

Leases with a "make-whole" termination payment

10. Generally, under a lease contract, the lessor will be willing to agree to the lessee terminating the lease if the lessee compensates the lessor for the termination (that is the lessor is "made-whole"). These termination clauses can normally be exercised at any point in the lease. The right to cancel the lease contract upon payment of a "make-whole" termination penalty is often written into lease contracts.

11. The exact calculation of the "make-whole" payment will vary. However, the intention is to compensate the lessor for the early termination (i.e. the payment is economically similar to the monetary damages a lessor would expect to receive if the lessee breached the lease contract). The make-whole termination penalty is often calculated as follows:

The present value (PV) of the future rentals under the lease contract
Plus
The PV of the lessor's estimate of the market value of the item at the end of the lease
Less
The market value of the item upon termination

Expressed differently, the termination payment is generally the difference between the lessor's remaining net investment in the lease (under current GAAP) and the proceeds received by the lessor upon remarketing the item.

12. Termination penalties of this type are best illustrated with an example. Consider the following:

    A piece of machinery with a fair value of 825(at the beginning of the lease) is leased for a period of 8 years. The annual rental is 100 payable in advance. The lessee has an option to terminate the lease at any time upon payment of a "make-whole" termination penalty, calculated as described in paragraph 11. The lessor's estimate of the machinery's market value at the end of the lease is 50.

    At the end of year 2, the lessee decides to terminate the lease. On termination, the lessor sells the machinery for 400 (its then market value).

    Ignoring the time value of money, the penalty payable by the lessee at the end of year 2 is 250 - calculated as the rental for years 3 to 8 (600), plus the lessor's estimate of the machinery's market value at the end of the lease (50), less the market value of the item (400) at the end of year 2.

13. For the purposes of this paper it is assumed that a make-whole termination penalty can be viewed simply as a variable termination penalty. However, this paper also discusses whether make-whole termination options are in fact non-genuine options – that is, options that will never have an effect on the rights and obligations or assets and liabilities recognised in the lease contract.

Factors that affect whether an option to extend or terminate a lease is exercised

14. Options to extend or terminate a lease are very different from purely financial options (for example, an option to buy or sell foreign currency or an option to buy or sell an equity instrument). Whether a lessee exercises an option to extend or terminate a lease may depend upon factors other than whether the exercise price of the option is less than the fair value of the rights acquired (or obligations avoided). This section of the paper discusses the factors that might influence the lessee's decision.

Lease description and lessee intent

15. Upon entering into a lease, the lessee may intend to lease the item for a certain period, say eight years. However, it is possible (although perhaps not likely) that the lessee will no longer require the item at the end of year five. Consequently, the lessee may negotiate a termination option that can be exercised at the end of year five. A lease of this type is more likely to be described as an eight-year lease with a termination option rather than a 5-year lease with an option to extend as both parties to the contract expect the lease to run for the full eight years. Consequently, the way the lease is described in the lease contract may provide evidence of the intent of both parties upon signing the lease.

Economic compulsion

16. In certain situations, it can be argued that, although the lessee is not contractually required to exercise an option to extend the lease, it is economically compelled to do so.

17. For example, the lease payments in the first few years of the lease may be so high that the lessee will have effectively paid for the whole of the leased item before the option exercise date. Where this is the case, the rentals in the secondary period may be very small such that leasing the item in the secondary period will almost certainly be the cheapest way of the lessee acquiring the right to use the leased item. That is, the lessee is economically compelled to exercise its option to acquire the right of use in the secondary period (as it has effectively funded the item's use in the secondary period through payments made in the primary period). However, the staff note that, even where the cost of the right to use in the secondary period is very low, the lessee is unlikely to exercise its option to extend the lease term if it does not require the leased item and cannot sub-let.

18. Alternatively, the penalty payable upon termination (or not exercising the option to extend) may be so large that economically, the lessee may be compelled to continue to lease. However, the staff note that, except in the case of non-genuine options (see discussion below) there may still be circumstances (however remote) where the lessee will choose to exercise its option.

19. Another example of possible economic compulsion is where the leased item is a core asset of the reporting entity. For example, a leased production line is likely to be core to the reporting entity's business. Consequently, if the lessee does not

exercise its option to extend the lease, there is likely to be considerable disruption to the entity's business. It is therefore argued that the lessee is economically compelled to extend the lease. The staff agree that in such situations it will be highly probable that the lessee will exercise its option to extend the lease. However, defining what is a core asset may require significant judgement. The staff also note that the lessee may choose not to extend the lease if it has decided to close a facility or change the location of its operations (for example, upon a change of ownership).

20. In addition, where the costs of removing leased items and installing new are significant, it could be argued that the lessee is economically compelled to extend the lease.

Non-genuine options

21. It can be argued that in some lease contracts, options to extend or terminate a lease are non-genuine and should be ignored when analysing the lease. That is, although the contract includes a theoretical option to extend or terminate, they are highly unlikely to be exercised. The staff consider that options where the cost of exiting will <u>always</u> exceed the cost of continuing with the lease should be ignored. For example, if an 8 year lease permits termination of the lease at the end of year 5 upon payment of 4 years of rentals, the cost of continuing with the lease (3 years of rentals) will always be less than the cost of terminating (assuming that the lessee does not incur any additional liabilities through continuing with the lease). In practice, options of this type are likely to be rare.

22. However, there are other types of option that are sometimes argued to be non-genuine - for example, options that are very out of the money. A lease that can be terminated only on payment of a very significant termination penalty could be argued to be effectively non-cancellable. An alternative view is that such options are genuine but that they have a very small value.

23. Make-whole termination options (those described in paragraphs 10 - 13) are sometimes also argued to be non-genuine. A make-whole termination option simply writes into the contractual terms of the lease the fact that the lessor would be willing to negotiate termination of the lease contract (even when the lessee has no right to terminate early) if the lessee compensates the lessor for the termination. Neither party at inception of the lease may intend to exercise the

termination clause. Consequently, it is argued that lease contracts that include a make-whole termination option should be accounted for in the same way as leases that do not explicitly include a lessee right to terminate. However, the staff note that there is a difference between the lessee having a contractual right of termination and not having any such right. It may be the intention of the lessee not to terminate on signing of the lease but this intention may change. In addition, if a lessee breaches the lease contract it would likely incur costs in addition to the "make-whole" payments (for example, legal fees).

Other factors

24. A number of other factors may affect whether a lessee exercises an option to extend or terminate a lease. These include:

- Lessee needs. A lessee may no longer require a leased item so may choose to terminate a lease even when it appears to be on favourable terms.
- Convenience. It may be more convenient for the lessee to continue to use leased items rather than attempt to replace them.
- Search costs. A lessee may continue to use a leased item as it wishes to avoid the costs associated with finding an alternative source for the item.

Are options to extend a lease equivalent to options to terminate?

25. A simple lease arrangement that includes an option to extend the term might provide the lessee with very similar rights to a lease for a longer term that gives the lessee the option to terminate. Consider the following examples:

- A lease with an initial term of five years and the option to extend for a further three years at the same rental; and
- A lease with a term of eight years, but with a lessee right to terminate after five years with no penalty.

26. These two leases 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. In practice, the pricing of these two leases may be different (due, for example, to different expectations of lessee behaviour) – however, this does not change the fact that the lessee has obtained

essentially the same rights and obligations under the two leases. In theory, both leases could be described as an 8 year lease with an option to put the leased item back to the lessor or (alternatively) a 5 year lease with an option to call for an additional 3 years of use from the lessor.

27. It might be argued that a termination penalty (whether it is fixed or variable) means that the option to terminate cannot be seen as economically equivalent to an option to extend. However, it would appear that there is no economic difference between[1]:

- a lease with a term of eight years with a right to terminate after five years on payment of a termination penalty, and
- 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.

28. In general, it seems that it is possible to recast a lease with a termination option as a lease with an extension option.

29. If this analysis is accepted, the staff question whether it is representationally faithful to account differently for the two leases described in paragraph 25 based solely on the description in the lease contract. The analysis in Paper 2B/7B is based upon the assumption that leases with an option to extend should be accounted for in the same way as an equivalent lease with an option to terminate.

Analysis of a simple lease with a lessee option to extend

30. This section of the paper analyses the rights and obligations under a simple lease with an option to extend, and considers whether they meet the definitions of asset and liability in the Framework and CON 6. This analysis is similar to the analysis presented to the Boards at meetings in March, where a lease without an option was discussed.

31. The analysis is based on a lease of machinery for a fixed primary period, where the lessee has the option to extend the lease for a secondary period for the same periodic rentals. No residual value guarantees or other payments are included in the lease agreement.

32. The rights and obligations arising in a lease of this type are as follows:

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[1] Assuming that the rentals are the same and any penalties for termination or non-renewal are the same.

Lessor	Lessee
Unconditional	
• Obligation to permit use of the machinery during the primary period • Right to receive payments during the primary period—includes amount receivable for option premium, though not usually specified as such • Obligation to extend lease if lessee exercises option. • Right to the economic benefits derivable from use of the machinery in the period after the secondary period (this right does not arise from the lease contract but is included for completeness)	• Right to use machinery for the primary period—the right to the economic benefits derivable from use of the machinery • Obligation to make specified payments over the primary period—includes amount payable for option premium, though not usually specified as such • Right to extend lease.

Conditional on lessee not exercising option to extend:	
• Right to return of machinery at the end of the primary period • Right to the economic benefits derivable from use of the machinery in the secondary period.	• Obligation to return the machinery at the end of the primary period.
Conditional on lessee exercising option to extend:	
• Obligation to permit use of the machinery during the secondary period • Right to receive payments during the secondary period • Right to return of machinery at end of secondary period.	• Right to use machinery for the secondary period—the right to the economic benefits derivable from use of the machinery • Obligation to make specified payments over the secondary period • Obligation to return the machinery at the end of the secondary period.

Application of asset and liability definitions

33. The following analysis is based upon applying the conceptual framework definitions of assets and liabilities to the rights and obligations described above. However, certain staff members believe that, if the terms of an option are such that the lessee is likely to renew the lease, the lessee substantively has an unconditional right to use the leased item for both the primary and the secondary period. In addition, the lessee has an unconditional obligation for to make payments for both the primary and secondary period. These staff would recognise

assets and liabilities arising in this lease based upon what they consider to be the substantive rights and obligations.

Lessee assets and liabilities

34. As with the simple lease, the staff believes that the lessee’s unconditional right to use the machinery in the primary period meets the definition of an asset.

35. The lessee’s right to use the machinery in the secondary period is a conditional right. That is, the right is conditional upon exercise of the lessee’s option. Unless and until that option is exercised, this right does not meet the definition of an asset.

36. However, associated with this conditional right is an unconditional right. The lessee has an unconditional right to call for the use of the machinery during the secondary period. This right is controlled by the lessee, arises from a past event (the signing of the lease contract) and gives rise to future economic benefit (the right to use the machinery in the secondary period). Although at any particular point in time this option may be out of the money (that is, the cost of exercising the option may exceed the benefits arising from the right of use in the secondary period), it will, until the exercise date, have time value and hence could give rise to an inflow of economic benefit. Consequently, the lessee’s unconditional right to call for the use of the machinery in the secondary period meets the definition of an asset.

37. This analysis does not alter with the likelihood of the option being exercised. Even if the rentals in the secondary period are low so that the lessee is very likely to exercise the option, the right to use the machinery and the obligation to pay rentals for the secondary period are still conditional until the option is actually exercised (although such an option will be more valuable than one where the rentals are higher).

38. The lessee’s assets arising under this lease contract after the delivery of the machinery can be summarised as follows:

Description of right	Control	Past event	Future economic benefit	Asset?
Unconditional right to use machinery during the primary period	Legally enforceable right to use the machinery during the primary period	The signing of the lease contract and delivery is the past event	Yes	Yes
Unconditional right to call for the use of machinery during the secondary period	Legally enforceable right to call for the use of the machinery during the secondary period	The signing of the lease contract and delivery is the past event	Yes	Yes
Conditional right to use the machinery during the secondary period	The lessee controls the right to use the asset during the secondary period	There is no past event. Right is conditional on exercise of the option.	Yes	No

39. As with the simple lease, the lessee has an unconditional obligation to make payments over the primary period that the staff believes meets the definition of a liability. However, as the Boards have previously discussed (at March meetings), the lessee's obligation to return the machinery at the end of the lease term (whether at the end of the primary period or the secondary period) does not meet the definition of a liability because the lessee is not required to sacrifice any of its economic benefits.

40. The lessee also has a conditional obligation to make payments over the secondary period. However, this obligation does not meet the definition of a liability as the outflow of economic benefit can be avoided if the lessee does not exercise its right to extend the lease.

41. The lessee's liabilities arising under this lease contract after the delivery of the machinery can be summarised as follows:

Description of Obligation	Present obligation	Outflow of economic benefits	Past event	Liability?
Unconditional obligation to make specified payments over the primary period	Obligation established by the lease contract	Cash	Delivery of machinery	Yes
Conditional obligation to return the machinery at the end of the primary period	No present obligation as it is conditional on expiration of the option unexercised	No (unless the decision to forego exercise of the option is regarded as a sacrifice of benefits)	Delivery of machine	No

Conditional obligation to make specified payments over the secondary period	No present obligation as it is conditional on exercise of the option	Outflow of economic benefit can be avoided if the lessee does not exercise its option to extend the lease	No past event	No
Conditional obligation to return the machinery at the end of the secondary period	No present obligation as it is conditional on exercise of the option[2]	No	No past event	No

Lessor assets and liabilities

42. The following table summarises the lessor's rights under a lease with a lessee option and applies the asset definition criteria to those rights.

Description of right	**Control**	**Past event**	**Future economic benefit**	**Asset?**
Unconditional right to receive payments during the primary period	Legally enforceable right to receive payments	Signing of contract and delivery of machinery	Cash	Yes
Unconditional right to the economic benefits deliverable from the use of the machinery in the period after the secondary period (residual rights)	Legal rights over machinery	Original acquisition of rights over the machinery	Yes	Yes
Conditional right to return of machinery at end of primary period	The lessor has no control over the return of the machinery at the end of the primary period	Signing of contract and delivery of machinery	No	No
Either Conditional right to the economic benefits derivable from use of the machinery in the secondary period **Or** Conditional right to receive payments during the secondary period	The lessor controls: • The right to economic benefits deliverable from the machinery in the secondary period if the lessee does not exercise its option to extend the lease; or • The right to receive payments during the secondary period if the lessee exercises its option to extend the lease.	Original acquisition of rights over the machinery Signing of contract and delivery of machinery	Yes Yes	Yes
Conditional right to return of machinery at end of secondary period (this is conditional on the option being exercised, since otherwise the machinery is returned at the end of the primary period)	The lessor has no control over whether lessee exercises its option	Signing of contract and delivery of machinery	No	No

[2] Taken together, there is a present obligation to either return the machinery at the end of the primary period or at the end of the secondary period. However, as neither event results in an outflow of economic benefits, the staff consider that the obligation to return the machinery does not meet the definition of a liability.

43. The lessor's unconditional contractual right to receive payments during the primary period and its right to the economic benefits deliverable from the use of the machinery in the period after the secondary period clearly meet the definition of an asset. They are similar to the assets identified for the simple lease. The lessor's right to have the machinery returned at the end of the lease term (whether at the end of the primary or secondary period) does not meet the definition of an asset because the lessor already has the right to the economic benefits.

44. The rights to the economic benefits derivable from use of the machinery in the secondary period and the right to receive payments in the secondary period are interdependent. The lessor either has a right to the use of the machinery in the secondary period or a contractual right to receive lease payments during the secondary period. If the lessee exercises its option to extend the lease, the lessor will obtain an unconditional contractual right to receive lease payments instead of having the right to use the machinery. In either case, the lessor has an asset, so when considered together this bundle of rights meets the definition of an asset.

45. As for the simple lease discussed at the March Board meeting, the lessor's obligation to permit the use of the machinery by the lessee (either during the primary or the secondary period) does not meet the definition of a liability as it does not result in a future outflow of economic benefit. This is based on the staff's conclusion that the lessee has performed its obligations under the lease upon delivery of the leased item to the lessee.

46. However, the lessor does have an unconditional stand-ready obligation. If the lessee exercises its option to extend the lease, the lessor must grant the lessor a right to use the machinery during the secondary period in return for rental payments. Consequently, the lessor's unconditional obligation to stand ready to grant a right of use to the lessee in the secondary period meets the definition of a liability.

Termination options

47. As discussed above, the staff consider that this analysis applies equally whether the lease is written as a lease with an option to extend, or the equivalent lease with an option to terminate.

48. There are, however, some concerns over the above analysis as applied to termination options. It is unclear why the lessee's right to use the machinery in the

secondary period does not meet the definition of an asset – the expiry of the option to terminate is not an ‘event’ that should be regarded as converting a conditional asset into an unconditional one. Furthermore, the only ‘delivery’ of the machinery by the lessor is at the beginning of the lease; there is no further act of delivery at the beginning of the secondary period. These concerns are discussed further in agenda Paper 2B/7B.