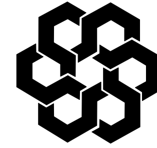

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International Accounting Standards Board

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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: **18 October 2007, London**

Project: **Leases**

Subject: **Variable lease payments (Agenda paper 12B)**

Introduction and Background

1. The purpose of this paper is to seek Board views on recognition and measurement of variable lease payments. In this paper, *variable lease payments* are defined as lease payments that increase or decrease as a result of changes in factors, other than the passage of time, occurring subsequent to the start of the lease. Examples of variable lease payments are rentals linked to an inflation index, rentals based on the sales the lessee achieves from the leased premises, or rentals based on the miles driven in a leased car.

2. Lease payments that vary over time but are fixed in advance are not discussed in this paper. Examples include a 5-year non-cancellable lease where the lessee pays CU 1000 for the first year with increases of 15 percent of the previous lease amount per annum (year 2 would be CU 1000 increased for 15 percent or CU 1150 and year 3 would be CU 1322.5). Another example is 5-year non-cancellable lease that requires no lease payments in year 1, CU 2000 in year 2, CU 3000 in year 3, and CU 5000 per annum in years 4 and 5.

3. The paper focuses principally on the recognition and measurement by lessees. To provide a more complete analysis of the assets and liabilities arising in the leases, recognition by lessors also is addressed, but lessor measurement is not addressed (the Board has not yet considered lessor measurement in a simple lease). Also note that the paper does not address what 'the start of the lease' is – the date of entering into the agreement, date of delivery, or some other point. The Boards had an initial discussion on this issue in June and it will be considered further later; in this paper it may be assumed that entering into the contract and delivery occur simultaneously.

4. This paper assumes that the variable lease terms are substantive. Whether a contractual term is substantive or non-substantive and the implications of this for the right-of-use accounting model will be addressed in a later paper.

5. The approach taken in this paper is to identify the rights and obligations arising from lease contracts with variable lease payment arrangements and analyse whether those rights and obligations meet the definitions of assets and liabilities in CON 6 and the IASB *Framework.*

6. Although the wording of the current IASB and FASB asset definitions are different, the basic concepts underpinning them are very similar. The IASB *Framework* and CON 6 have the following characteristics of an asset in common:

   - There is an economic resource or benefit that the reporting entity controls.
   - It arises out of a past event.
   - Future economic benefits are expected to flow to the entity.

7. Similarly, the wording of the liability definitions contain the same basic characteristics:

   - There exists a present obligation of the reporting entity, leaving it little or no discretion to avoid a future sacrifice.
   - The obligation arises out of a past event.
   - The obligation is expected to result in an outflow of economic benefits.

8. Because of the similarities between the definitions, the staff has used the common characteristics identified above when analysing whether a right or obligation meets the definition of an asset or liability.

9. The staff analysed the promises exchanged and the related rights and obligations arising in a simple leasing arrangement using the following example:

   A piece of machinery is leased for a fixed term of 5 years; the expected life of the machinery is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machinery at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machinery has been delivered; these are fixed amounts that are specified in the original agreement and are payable in advance. No maintenance or other arrangements are entered into.

10. As a result, the following asset and liability were identified for the lessee under this example, which only considered fixed payments:

    - An asset related to the right to use the leased item for the lease term–the right to the economic benefits derivable from use of the item machinery
    - A liability for the obligation to make specified payments over the lease term.

11. In analysing variable lease payments, the staff started with a conceptual analysis of the assets and liabilities that arise, and then considered both conceptually based measurement approaches and practical measurement alternatives. In this analysis, the staff considered existing standards for similar assets and liabilities, as well as whether a different approach is needed for assets and liabilities arising in a lease transaction.

12. The Boards have previously discussed proposals for measuring the lessee's right-to-use asset and its liability for the obligation to make payments over the lease term. The IASB tentatively concluded that the asset should be accounted for at the start of the lease based on guidance applicable to the underlying leased asset (such as PP&E), while the FASB favoured developing a new accounting model (although the FASB did not indicate what that model should be). For the liability, the Boards generally agreed that the accounting should follow the nature of the liability. That is, if the liability is a financial liability (for example, debt), the guidance for financial liabilities should be followed.

13. Based on discussions with constituents, including certain members of the Joint Lease Accounting Working Group, the staff identified three categories of variable lease payments:

    - Category I—Lease payments with a variable factor based on price changes or an index
    - Category II—Lease payments with a variable factor based on the lessee's financial or operating performance from the leased item
    - Category III—Lease payments with a variable factor based on the lessee's usage.

14. However, the staff's analysis indicates that in essence there are only two different types of arrangements – those where the variable rentals are based on factors outside the control of the lessee, and those where the factors are within the control of the entity.

15. An earlier version of this paper was discussed by the Board Advisors on the leasing project in July and amended in the light of that discussion, including a discussion of the lessor's asset and additional analysis of the nature of the lessee's obligation.

Category I—Lease Payments with a Variable Factor Based on Price Changes or an Index

Description

16. The first category of leases are those where the rentals are adjusted in accordance with some underlying price, index, or other variable. For this category, lease payments are typically adjusted at specified dates for changes in market lease rates or other indexes such as LIBOR, prime rate, or the Consumer Price Index (CPI). Lessees often enter into such lease terms to provide a business match between their cash outflows for lease rentals and their cash inflows from sales. A lessee may expect its sales to increase at least by inflation, and by entering into a lease with inflation-linked rentals it can achieve a lower rental in the earlier years, offset by higher rentals in later years payable out of its expected higher cash inflows. In the following analysis the paper considers these simple examples:

- Example A – A lessee enters into a contract with a lessor to lease equipment for a non-cancellable period of five years. The lease payment starts at CU 10,000 per annum and adjusts annually at December 31 by the change in the Consumer Price Index (CPI) for the year.
- Example B – The same lease, except that the rental is adjusted to the current market rental amount for similar new leases at the date of adjustment.

Identification of Assets and Liabilities

17. In each case, at the start of the lease the lessee has the right to use the leased item for the five-year lease term. As noted above, the Boards have tentatively concluded that this right meets the definition of an asset.
18. The staff considers that, in this type of lease, the lessee has an unconditional obligation to pay a variable rental that meets the definition of a liability; the fact that the amount payable is uncertain does not mean there is no present obligation that the lessee has little or no discretion to avoid. The obligation arises out of a past event (the signing of the lease contract) and is expected to result in an outflow of economic benefits (payment of rentals). Only the amount of rentals payable is uncertain.

Staff Recommendation

19. The staff considers that the lessee has the following asset and liability at the start of the lease:
    - An asset reflecting the lessee’s right to use the equipment over the five-year lease term
    - A liability for its unconditional obligations to make fixed payments of CU 10,000 per annum over the 5-year term plus or minus variations in payments based on the annual adjustments to market rates.

Question for the Boards

Do you agree that the lessee has a liability that includes both fixed and variable components of the future rentals?

Recognition and Measurement

20. The staff has considered the alternatives for the recognition and initial and subsequent measurement of this obligation summarised in the following table and discussed more fully below.

21. The conceptually simplest approach is Alternative A1 (both initial and subsequent measurement at fair value); however, alternatives may be preferable both for practical considerations and for consistency with current standards applying to similar liabilities.

<table>
<tr><th>Initial measurement</th><th>Subsequent measurement</th></tr>
<tr><td rowspan="2">Alternative A – Fair value</td><td>Alternative 1 – Fair value</td></tr>
<tr><td>Alternative 2 – The carrying value of the liability is adjusted for changes in expected rental payments. However, the expected rental payments are discounted using the original interest rate (calculated at initial measurement).</td></tr>
<tr><td>Alternative B – Assume that the initial rental payable will be paid in all subsequent years and discount those payments using a market interest rate.</td><td>The carrying value of the liability is adjusted for actual changes in rental payments.</td></tr>
<tr><td>Alternative C – Assume that the initial rental payable will adjust based upon current market factors and discount these payments using a market interest rate.</td><td>The carrying value of the lease payments is adjusted for changes in current market factors</td></tr>
<tr><td colspan="2">Alternative D – Treat as an embedded derivative (under current standards) and separately account for this unless ‘clearly and closely related’ to the host contract</td></tr>
</table>

Alternative A – fair value

22. Under this approach, the lessee would initially recognise and measure the liability (comprising both fixed and variable components) at fair value. The fair value of the liability would take into account the expected changes in the rentals over the term of the lease. For example, in a lease where rentals increased each year in line

with market rentals, the fair value of the liability would take into account forecasts of the future level of rentals, discounting these at current market interest rates.

23. The Boards have tentatively concluded that the lessee's obligation to pay fixed rentals is a financial liability. Financial liabilities are initially measured at fair value under current standards. It would therefore be consistent for the initial measurement of a liability to pay variable rentals also to be at fair value. It can also be argued that fair value is the most relevant measure for liabilities of this type. This alternative captures the variability of the rentals in the measurement of the liability.

24. However, it may be difficult to determine the fair value of the variable liability reliably. For example, predicting market rentals in future periods may not be easy, particularly if the market is volatile and/or the lease term is long. In addition, where the rentals vary with respect to an index such as inflation, it might be argued that recognising the inflation adjustment in the period in which the inflation actually occurs is more relevant.

25. The staff has not considered whether fair value should be an exit value in accordance with FAS 157, or some other variation of current value (although it is not aware of any reason for diverging from the FAS 157 fair value). This question will be brought to the Boards at a future meeting if this approach is supported.

Subsequent measurement under Alternative A

26. If the initial measurement of the liability is at fair value, the staff considers there are two alternatives for its subsequent measurement:

    - ***Alternative A1 –*** Subsequently measure the lessee's liability at fair value. That is, the liability would be adjusted for all expected changes in the amount payable under the lease including changes in market interest rates and the lessee's credit standing.

    - ***Alternative A2*** – The carrying value of the liability is adjusted for changes in expected rental payments. However, the expected rental payments are discounted using the original interest rate (calculated at initial measurement).

27. In each approach, it is necessary to estimate future expected rentals. In some situations, this may be difficult; however, the staff considers that if the initial measurement is at fair value based on forecast rentals, subsequent changes in these

forecasts should be reflected in the measurement of the liability. If changes to rentals were to be recognised only as they actually arose, this could result in liabilities being understated or overstated. (For example, if the second year's rental is originally estimated at 10,050 CU, but because the market rental increases more sharply than expected the rental is actually 10,070 CU, it is necessary in year 2 to recognise not only the additional 20 CU paid, but also the consequential increase in rentals for the remainder of the lease term.)

28. Subsequent measurement at fair value is consistent with the Boards' stated long-term objective of measuring all financial liabilities at fair value. Requiring fair value will ensure that the financial statements reflect the current best estimate of the amount that the lessee will be required to pay under the lease.

29. Although the fair value measurement of Alternative A1 could result in significant volatility in the amount that is charged to the income statement, both from changes in forecasts of rentals and in market interest changes, it can be argued that this volatility represents true changes in market factors that have affected the entity in the period. Alternative A2 would reflect current best estimates of future lease rentals whilst not recognising volatility from changes in market interest rates (including the lessee's credit rating).

30. Alternative A2 is, however, consistent with the Boards' tentative decision to measure fixed lease payment obligations subsequently at amortised cost using the effective interest rate method. Under the effective interest rate method, the carrying values of financial liabilities are adjusted to reflect changes in estimated cash flows, which are then discounted using the original effective interest rate. In their previous discussions on leases with fixed rentals, the Boards tentatively decided that these should be measured in accordance with other financial liabilities and that, in accordance with current standards, subsequent fair value measurement would not be *required,* but would be an option. This alternative would avoid introducing an inconsistency where similar obligations were accounted for differently, depending on whether they arose under a lease contract or not.

Alternative B – recognise changes as they occur

31. Under this approach, the liability is measured initially on the assumption that the initial rental payable will be paid in all subsequent years, and these amounts are

then discounted using a current market interest rate. For example, in the lease described in paragraph 16, the lessee would assume, for the purposes of initial measurement, that the rental in each of the 5 years of the lease will be CU 10,000. These payments would be discounted at a current market interest rate.

32. This approach is simple to apply and the amount can be calculated objectively, without the need for subjective estimates of future rent changes. This approach assumes that the lessee will have minimum payments of CU 10,000 per annum and then captures any variability from the initial rental subsequently; that is, the variable lease payments are not included in the initial measurement of the liability.

33. However, in many situations it may over or under estimate the lessee's liability at the start of the lease. For example, if market lease rates are expected to increase at 20 percent each year during the lease term, the liability recognised would significantly underestimate the payments that the lessee will make over the lease term. A fixed rental lease for an equivalent asset would have initial rentals that would be significantly higher, reflecting the fact that the lessor would not benefit from future price increases over the lease term. It can be argued that Alternative B does not faithfully represent the lessee's economic position, by understating both the extent of the obligation entered into and the value of the right of use that is acquired. It may be possible to mitigate this problem to some extent by disclosures including the basis on which adjustments to the rentals payable are made.

Subsequent measurement under Alternative B

34. The carrying value of the liability is adjusted for actual changes in rental payments. For example, if the rental payment in year 2 increases to CU 11,000, the lessee would assume that the annual rentals in years 3 to 5 would also be CU 11,000. These revised rentals would be discounted at the original market interest rate.

Alternative C – assume current rate of change continues

35. This approach projects future rentals on the assumption that the initial rental payable will adjust based upon current rate of change in market factors (for example, the current rate of inflation) and discounts these payments using a market interest rate. For example, if market lease rates are currently increasing by 5 percent per annum, the lessee would assume, for the purposes of initial measurement, that the rentals in each of 5 years of the lease would be Y1:

CU10,000, Y2: CU 10,500, Y3: CU 11,025 etc. These amounts would be discounted at a current market interest rate.

36. This approach is a compromise between Alternatives A and B. It takes some account of the variable nature of the payments without requiring full fair value measurement. However, this approach may be difficult to apply in situations where market factors are very volatile.

Subsequent measurement under Approach C

37. The carrying value of the liability would be adjusted for changes in current market factors. For example, if the rate of increase of market lease rentals changes from 5 percent to 7 percent, there would be a corresponding increase in the amount of the liability. The revised payments are discounted using the original effective interest rate.

Alternative D – treat as an embedded derivative

38. Lease contracts whose payments change in response to changes in a quoted index or other underlying variable contain embedded derivatives as defined in FAS 133 and IAS 39. Paragraphs 12(a) of FAS 133 and 11(a) of IAS 39 require embedded derivatives to be separated from the host contract (the lease contract for this analysis) and accounted for as a derivative (if the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risk of the host contract).

39. If the embedded derivative was separately accounted for (bifurcated), the lease contract would be split into two elements: an obligation to pay fixed rentals and an embedded derivative.

40. The obligation to pay fixed rentals would be accounted for on a consistent basis with the obligation to pay fixed rentals in a simple lease. That is, in general, it would be initially measured at fair value and subsequently measured at amortised cost using the effective interest rate method (with the option to use fair value through profit and loss).

41. The variable element would be accounted for as a derivative. That is, it would be measured both initially and subsequently at fair value. Note, however, that the standards require that the terms of the embedded derivative that is separated must be such that its initial fair value is zero; in Example A above (paragraph 16), the

separation would not be into a stream of fixed payments of CU 10,000 and a derivative whose cashflows paid the additional rental resulting from indexation, as that derivative would not have a initial fair value of nil. The embedded derivative with initial fair value of nil would be a derivative that exchanges a fixed series of cash flows representing the initial estimate of future increases in the rent for the actual increases in rentals.

42. However, many such embedded derivatives in lease contracts are, under current standards, regarded as closely related to the host contract and not separated – these include certain lease rentals indexed to a consumer price index, lease rentals based on related sales, and lease rentals based on variable interest rates. The question of whether these specific types of arrangement should continue to be regarded as closely related would need to be addressed.

43. However, the staff considers that Alternative A1, fair valuing the whole variable lease obligation, would be a simpler and conceptually better approach than trying to apply existing embedded derivative requirements.

Staff Recommendation

44. The staff considers Alternative A2 to be the most appropriate method, but with A1 as an allowed alternative, as this is most consistent with the treatment of other financial liabilities under existing standards. However, if financial instrument standards were amended to require subsequent measurement at fair value for all financial liabilities, Alternative A1 should then be adopted for variable lease liabilities.

45. The staff has not yet analyzed the accounting for the debit and will provide additional analysis once some tentative decisions have been made on the initial and subsequent measurement of these variable lease payments.

Question for the Boards

Which of the four approaches described above do you prefer and why? Are there any other approaches the staff should consider?

Lessor's Asset

46. Using the same example in paragraph 16, at the start of the lease the lessor has the right to receive lease payments for the 5-year lease term. The Boards have tentatively concluded that this right meets the definition of an asset. The lessor has

an unconditional right to receive the CU 10,000 for year 1 plus the CU 10,000 per annum for years 2 through 5 adjusted annually to reflect market rates at the time of adjustment. The staff considers that, in this type of lease, the lessor has an unconditional right to receive variable rentals that meet the definition of an asset; it is only the amount that is uncertain.

Question for the Boards

Do you agree that the lessor has an asset at the start of the lease that represents its unconditional right to receive CU 10,000 per annum over the 5-year term plus or minus variations in payments based on the annual adjustments to market rates?

Category II—Lease Payments with a Variable Factor Based on the Lessee's Financial or Operating Performance from the Leased Item

Description

47. The second category is lease payments that are conditional on the lessee's financial or operating performance derived from the leased item (a metric). An example of this is a lease of retail property where a fixed lease payment is called for monthly with a contingent lease payment based on a contractually determined percentage linked to the lessee's turnover or profitability at the location. Lessees seek to agree lower fixed rentals with a variable element that increases as their cash inflows increase, to provide business protection against lower than expected cash inflows in future periods. Lessors may be prepared to accept a lower fixed rental in exchange for the possibility of higher rents if the lessee's business is successful. The fixed portion of the lease could be sufficient for the lessor to achieve the low end of a desired return or the lessor may be willing to accept a very low fixed portion if a tenant is well established and historically profitable. Leases where variable payments are based on the lessee's performance as a whole (for example, corporate headquarters where rents are based on consolidated sales for the whole entity) are more in the nature of rents based on an index, and closer to Category I leases discussed above.

48. Consider the following examples:

- Example C: A lessee enters into a five-year non-cancellable lease of a retail property. The lease calls for predetermined fixed lease payments of CU 5,000 per annum for the 5-year lease term and an additional payment each year if the

lessee's sales for that year exceed a specified level, calculated as 15 percent of the excess. The lessee is required under the terms of the lease to keep the retail premises open for business throughout the lease term (such requirements are not uncommon in leases of units in shopping centres, etc.).

- Example D: An identical lease to Example C, except that although the lessee expects to use the premises throughout the lease term there is no enforceable agreement with the lessor that it will in fact do so.

Identification of Assets and Liabilities

49. The staff considers two possible views in which assets and liabilities arise in these examples.

View 1

50. The lessee has the following assets and liabilities:

- Asset representing the right to use the physical item for the term of the lease
- Liability representing the unconditional obligation to pay the fixed amount of rentals: CU 5,000 per annum
- Liability representing an unconditional stand-ready obligation to pay the additional variable rentals.

51. Under this view, the lessor has a financial asset representing both the fixed rentals and the expected amount of variable rentals.

52. The staff considers that this view correctly represents the rights and obligations arising in Example C, where the lessor is able to enforce the use of the property by the lessee. However, where the lessor is not able to enforce use of the physical asset by the lessee (Example D above), the position is less clear. The lessee's obligation for the fixed rentals remain; but as the lessee has no obligation to use the physical item, there would seem to be no obligation to pay rentals based on sales that arise only if the item is used. There would usually be strong economic reasons why the lessee would wish to use the asset, but there is no external party who can force the lessee to use the physical item.

53. In order for View 1 to apply to Example D, it is necessary to argue that although the condition triggering the stand-ready obligation is under the control of the lessee, there is nevertheless a present obligation to make variable payments *if* the

lessee decides to use the asset. That is, the lessee has an unconditional stand-ready obligation to make the additional payments *if* it decides to use the asset. Although this obligation arises out of a present contract, the fact that while the lessee still has the ability to choose whether or not to use the leased property and hence trigger the obligation means that it is not, in the staff's view, a liability. An alternative analysis of Example D is as follows.

View 2

54. The lessee has, at the commencement of the lease, an unconditional obligation to pay CU 5,000 per annum that meets the definition of a liability. All other payments are not present obligations since they are conditional on the lessee using the leased property to generate sales; and the lessee is not obliged to do this. A present obligation for the variable rentals arises only as and when the lessee decides to use the leased property, and only for the period for which the lessee is then committed to use the property – for example, if the lessee decides day by day whether to use the leased property, the present obligation, and hence the liability, is for that day's use only. Under this view, the lessee also has an asset representing its rights over the leased property; but this cannot be described simply as a 'right to use' the item since it can only actually use the item if it incurs additional obligations. This asset is therefore more accurately thought of as a 'right to acquire a right' to use the physical item.

55. The lessor has an asset representing the fixed rentals, but no longer has a right to the future variable rentals, since these might not in fact arise. It does, however, have a contractual right to receive rentals *if* the lessee decides to use the asset. This contractual right does not meet the definition of a financial instrument (since it does not give rise to both an asset and a liability), but might be considered to be an intangible asset.

56. The arguments for considering that View 2 correctly reflects the assets and liabilities for Example D are that the lessee has no commitment to use the physical item (and as a consequence incur the obligation to pay variable rentals), merely an optional right to do so – even if it is an optional right that, in many circumstances, is highly likely to be exercised. At the commencement of the lease term, the lessee is not obliged to make the additional lease payments; rather, it chooses to incur these when it exercises its option to use the leased property.

57. However, there are several arguments for considering that View 1 more closely reflects the economics of most transactions of this type:

- It is unlikely that the lessee will regard itself as having complete control over whether to use the item or not, since the economic penalty for not doing so may be significant (the fixed rentals would then be expended for no purpose, and the whole point of entering into the lease would be negated). Both lessee and lessor might consider that the lessee does not, commercially, have any real choice but to continue to use the leased property.
- The assumption that the lessee is a going concern implies that it will not cease business, and this might be contradicted by an assumption that the lessee could stop using the leased item at any time.
- The staff also notes that there may often be practical difficulties in deciding whether or not the lessee has an obligation to use the leased property.
- Other obligations (such as post-retirement medical benefits) are recognised as a liability even though the employer has the legal right to cease these benefits at any time.

58. It also can be argued that View 2 provides less useful information since it ignores the likely cash outflows and corresponding right of use acquired (although disclosure of the contingent element would provide this information). Both are understated in comparison to the economic reality of the lease. In an extreme case, if all the lease rentals were contingent on usage, no asset or liability would be recognised at the commencement of the lease term.

Staff Recommendation

59. The staff considers that View 1 reflects the assets and liabilities arising in Example C, and also the economics of Example D. However, it is less clear in Example D that there is actually a liability for the full amount of the variable rentals at the commencement of the lease; View 2, which recognises a liability for these rentals only to the extent that the lessee is actually committed to paying them, may be a more correct analysis.

Questions for the Boards

In Example C, where the lessee can be required to use the leased property, do the Boards agree that the lessee has a liability for conditional rentals (View 1)?

Do the Boards consider that there is a distinction between Examples C and D, where the lessor cannot be required by the lessor to use the leased property? If so, do the Boards consider that the lessee's obligation for the conditional rentals arises at commencement (View 1) or as the leased property is used (View 2)?

Initial and Subsequent Recognition and Measurement

60. Under View 1, the lessee has an unconditional stand-ready obligation to pay variable rentals in addition to the obligation to pay fixed rentals. The staff considers that the analysis of the recognition and measurement of these obligations is the same as for the variable rentals under Category I.

61. The staff notes that estimating expected future payments when the payments depend upon the performance of the entity may be more difficult than estimating future rentals that are based on market factors. As a result, fair value measurement will often present greater practical difficulties for Category II types of arrangements. However, the staff considers that in principle, the basis of measurement should be the same as for Category I variable leases.

62. Under View 2, the staff considers that the lessee has an initial obligation for the fixed rentals only. The initial and subsequent measurement of that liability should be consistent with the measurement of the obligation to pay fixed rentals under a simple lease, as previously discussed by the Boards (that is, consistent with the measurement of financial liabilities generally; under current standards, this would be initial measurement at fair value and subsequent measurement at amortised cost using the effective interest rate, with an option to fair value). However, the lessee should consider the point where the variable payments result in a current obligation and meet the definition of a liability. At that time, the lessee will have an additional liability for the variable payment, which should be recognized consistent with Category I variable leases.

Questions for the Boards

If variable lease payments are recognised (under View 1), should they be measured on the same basis as Category I variable rentals?

If variable lease payments are not recognised (under View 2), should only fixed rentals be measured on the same basis as a simple lease with fixed rentals (in the same way as other financial liabilities)?

Lessor's Asset

63. In Example C, the lessor has a right to receive both the fixed rental and the variable rental based on usage, since it is able to require the lessee to use the leased item and therefore obliged to pay the additional variable rentals.

64. In Example D, it might be argued that the lessor's right to the additional variable rentals is now contingent on the lessee actually using the asset; accordingly, this does not represent an asset since the future benefits are not under the control of the lessor until the lessee uses the leased item. However, although the lessor cannot control the outcome of the promise to pay variable rentals, it nevertheless controls that promise. That is, cash inflows are capable of arising as a consequence of future sales, which will result in the inflow of rental to the lessor (a similar example is analysed in the papers on the definition of asset in the Conceptual Framework project).

65. Therefore, the staff thinks that at the beginning of the lease term the lessor has an asset for both the fixed and variable payments receivable, but notes that under View 2, the lessee does not have a liability for these additional amounts (except to the extent that the item is actually used) and, therefore, the right to rentals is not a financial instrument (since this must be an asset of one party and a liability of the other).

Question for the Boards

> *Do you agree that the lessor has an asset for the full amount of the rentals under both Examples C and D?*

Category III—Lease Payments with a Variable Factor Based on the Lessee's Usage

66. The third category is lease payments that are conditional on the lessee's usage of the leased item. Examples include car leases where the lease payment is fixed with an additional amount due if the lessee exceeds a contractually specified mileage and leases of copier equipment where the lease payments are fixed with an additional amount due for each copy made over a contractually specified number. Usage limits are often included by lessors to protect the value of the residual asset; the resale value of the leased car or equipment is often an important part of the lessor's overall return on the lease, and excessive use by the lessee over

the lease term will reduce this resale value. Lessors often include an additional charge in the lease terms for usage above this limit to compensate for the fall in value. Leases of this nature offer lessees the ability to obtain additional use from the leased item without the need for renegotiation or entering into a new lease.

67. To identify the rights and obligations along with the associated assets and liabilities under a lease within this category, assume that a lessee leases major construction equipment for a fixed term of 5 years with fixed payments at CU 50,000 per annum under a non-cancellable lease with the lessor. If the lessee exceeds a contractually determined threshold for hours used per year (the contingency resets each year), the lessee is required to make additional payments based on a predetermined amount per hour over the threshold.

Identification of Assets and Liabilities

68. At the start of the lease, the lessee has the right to use the leased item for the five-year lease term. As noted above, the Boards have tentatively concluded that this right meets the definition of an asset.

69. There are two ways in which the lessee's right of use and obligations to make payments can be viewed:

    - ***View 1*** – The lessee has an unconditional obligation to pay a rental, with both a fixed and variable component, that meets the definition of a liability; only the amount is uncertain. It has a corresponding asset representing the right to use the leased item for the whole of the lease term.

    - ***View 2*** – The lessee has an unconditional obligation to pay the fixed rentals only (CU 50,000 per annum) that meets the definition of a liability. All other payments are not present obligations. It has an asset representing the right to use the leased item up to the end of the lease term or the usage limit (whichever occurs sooner) and a separate asset representing its option to obtain further use of the leased item once the usage limit is reached, up to the end of the lease term. When that limit is reached, a liability arises for the additional usage, but only for the amount actually used at the measurement date (that is, on a 'pay as you go' basis).

Staff Recommendation

70. In this category of lease, the lessee has the discretion to avoid an outflow of economic benefits associated with additional usage by opting not to use the leased item once the usage limit has been reached. That is, the number of miles that a lessee drives or the number of copies that a lessee makes is at its discretion. Only when the lessee uses the leased item above the required threshold does a liability arises for the variable lease payments. The staff views this as similar to an option to extend a lease, with the difference that the additional right to use that the lessee has the option to acquire is measured in usage terms (for example, miles driven or copies made) rather than time. Consequently, the staff considers that at the beginning of the lease term the lessee does not have a present obligation for the variable portion of the lease payments. Hence, the lessee's obligation to make payments in respect of additional usage does not meet the definition of a liability. The staff therefore supports View 2.

71. The staff notes, however, that not recognizing a liability for the variable portion of the lease payments (under View 2) could result in structuring opportunities. Where it is highly probable that the lessee will use the asset (for example, the asset is a core asset), the lease could be structured so as to minimise the liability recognised. This could be done by structuring the lease to have a small fixed element. At the start of the lease both parties would expect significant variable rentals to be paid. However, this would not be reflected in the financial statements.

Question for the Boards

Do you agree that the lessee has no obligation for the additional usage at the commencement of the lease, but has an asset representing an option to acquire additional usage rights (View 2)?

Initial and Subsequent Recognition and Measurement

72. If the Boards believe that the lessee has an obligation for the fixed rentals only (View 2), then initial and subsequent measurement of that liability should be consistent with the measurement of the obligation to pay fixed rentals under as simple lease (that is, initial measurement at fair value and subsequent measurement (generally) at amortised cost using the effective interest rate. A liability for the variable element of the rentals would only be recognised when the

lessee cannot avoid the obligation, which generally would be when the lessee's usage exceeds the contractually established threshold. This additional liability would reflect only the actual usage of the leased item, and therefore would be measured based on the additional rental for that usage; in most cases this amount would not be difficult to determine.

73. The recognition and measurement of the option to purchase additional usage will be addressed at the same time as other options. The staff considers that, as with options to extend and terminate leases (discussed by the Board in June), the measurement of such options can be very difficult and it may be necessary to reconsider the recognition model if the practical difficulties of measurement prove too great.

Question for the Boards

How should the lessee account for its obligations for the fixed rentals?

74. If, however, the Boards believe that the lessee has an obligation to pay variable rentals (View 1), the alternatives for initial and subsequent measurement would be the same as under Category I above.

Lessor's Asset

75. As with the analysis of Example D under Category II, at the start of the lease the lessor has the right to receive the fixed lease payments, which meet the definition of an asset. However, the additional rentals that might be received if the lessee exceeds the usage limit do not represent an asset since these are not under the control of the lessor and do not represent a liability for the lessee.

76. In addition, the lessor has an obligation representing the lessee's option to acquire additional usage.

Question for the Boards

Do you agree that at the beginning of the lease term, the lessor has an asset for the fixed payments receivable together with a written option representing the lessee's right to acquire additional usage rights?