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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: **24 July 2008, London**

Project: **Leases**

Subject: **Options to extend or terminate a lease (Agenda Paper 13B)**

Introduction

1. Lease contracts will often grant the lessee the right (but not the obligation) to extend the lease beyond the initial lease period (similarly, a lease contract may also grant the lessee the right to terminate a lease before the end of the lease period). This paper considers how to take options of this type into account in adapting the IAS 17 finance lease model to apply to all leases currently classified as operating leases. It concludes that options to terminate or extend a lease should not be recognised as separate assets. Instead, the staff recommends that recognition of the lessee's right of use asset and rental liability arising under the lease be based upon an assessment of the lease term that takes into account the likelihood of the options being exercised.

2. This paper goes on to consider the basis on which this assessment of the lease term should be made and whether guidance on the factors to be considered in determining the lease term is required.

3. The approach proposed in this paper is consistent with the treatment of leases classified as finance leases under IAS 17 and the overall approach to the lease accounting project described in the technical plan presented to the Boards in June. The staff notes that any decision to move away from the IAS 17 treatment of options will result in completion of the project being delayed beyond mid-2011.

Recognition and Measurement of Options

4. Lease contracts sometimes incorporate optional periods—that is, the lessee may have the right to use the leased item during the optional period but is not contractually required to do so. For example, a lessee may sign a five-year lease that incorporates an option to extend the lease for an additional three years. Under this lease, the lessee is contractually required to lease the item for five years but has the option to lease the item for an additional three years. An economically identical lease could also be structured as an eight-year lease with an option to terminate after five years.

Separate Recognition of Options

5. The staff has previously argued that a lease of this type gives rise to two assets—the right to use the leased item for a period of five years and an option to extend the lease (alternatively, the lease could be characterised as a right of use for eight years and an option to terminate). Papers presented to the Boards (May 2007) concluded that options to renew or terminate a lease meet the definition of an asset. However, the Boards were unable to reach a consensus on this issue.

6. Furthermore, Working Group members have advised that it will be very difficult to measure the fair value of these assets. This is because options of this type are not normally priced separately from the lease contract and there is no market for most lease contracts. Measurement is complicated by the fact that, unlike most financial options, the assets underlying options to extend or terminate a lease are often unique and the options may not be exercisable until a long way in the future (e.g., 20 years in some real estate leases). In addition, options that are seemingly

out of the money (for example, leases in which the rentals in the secondary period may be higher than market rentals for the same asset) may nevertheless be exercised by the lessees for entity-specific reasons. Because of the non-financial factors involved, standard options-pricing approaches and the assumptions underlying them may not be applicable.

7. In addition, a number of Board members have raised concerns about the accounting that might result if options to extend or terminate a lease are recognised separately from the right of use asset. For example, the asset and liability recognised by the lessee could be minimised if lease contracts were restructured as short-term leases with options to extend (the lessor's return could be protected by incorporating a penalty for failure to exercise the option to extend).

IAS 17 Approach to Options

8. Existing lease accounting standards IAS 17 and Statement 13 do not require the separate recognition and measurement of options to extend or terminate a lease. Instead, lessees are required to consider the existence of options and the likelihood of their exercise when determining the lease term.

9. The staff proposes a similar approach for the new standard. The lessee would determine the 'substantive' or 'effective' lease term, taking into account the options and the likelihood of their exercise. For example, a five-year lease with an option to extend for a further three years would be treated as a simple five-year lease if exercise of the options was considered unlikely and as a simple eight-year lease if exercise of the option was considered likely (the following section of the paper discusses what level of likelihood is necessary before the option exercise is assumed). Similarly, an eight-year lease with an option to terminate after five years would be treated as a simple five-year lease if exercise of the option was likely and as an eight-year lease if exercise of the termination option were unlikely. The right of use asset recognised, and the liability for rentals recognised, would be based on this substantive lease term.

10. Although the project could continue to explore ways of separately recognising and measuring options to extend or terminate a lease, the staff does not

recommend this approach as it is: (a) inconsistent with the overall approach to this project described in agenda paper 13A (FASB memo No. 16); and (b) would delay the project beyond mid-2011 . In addition, even if the Boards decided to explore alternative approaches to the treatment of options, the staff questions whether it would be possible to develop a technical solution that would address the measurement and structuring issues outlined above.

11. The staff believes that a significant improvement to lease accounting can still be achieved if the Boards decide to base the recognition and measurement of a lessee's assets and liabilities on an assessment of the term of the lease.

Question 1

The staff proposes that options to extend or terminate the lease should not be recognised separately from the right of use asset. Do the Boards agree?

Question 2

The staff proposes that the assets and liabilities recognised by the lessee should be based upon an assessment of the lease term. Do the Boards agree?

12. The rest of this paper examines how the lease term should be determined.

When Should an Optional Period be Included in the Lease Term?

13. The Boards need to decide on the probability threshold that will be applied in determining when an optional period should be included in the lease term.

Current Approach

14. IAS 17 requires a lessee to determine the term of a lease contract. This determination is made both for classification and measurement purposes. The lease term is defined in IAS 17 as:

> The non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at inception of the lease it is *reasonably certain* that the lessee will exercise the option. [Emphasis added.]

15. This means that periods covered by options to extend are included in the lease term if the exercise of the option is reasonably certain.

16. A non-cancellable lease is also defined in IAS 17:

> A non-cancellable lease is a lease that is cancellable only:
> (a) upon the occurrence of some remote contingency;
> (b) with the permission of the lessor;
> (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
> (d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is *reasonably certain.* [Emphasis added.]

17. This means that an option to terminate a lease is ignored if upon termination the lessee is required to make a payment that is large enough to make continuation of the lease reasonably certain. In practice, “payment” is interpreted more widely than simply a cash payment from the lessee to the lessor and would include consideration of other factors such as, for example, the existence of significant leasehold improvements that would be lost if the lease were terminated.

18. The requirements of Statement 13 are broadly similar to those of IAS 17. Options to extend are included in the lease term if their exercise is reasonably assured. Options to terminate are ignored if continuation of the lease is reasonably assured. Although Statement 13 uses the phrase “reasonably assured” and IAS 17 uses the term “reasonably certain”, in practice the two phrases are interpreted as meaning the same thing.

19. The Boards could decide to adopt the IAS 17 approach to determining the term of a lease. In general, this would mean that periods covered by options to extend would be included in the lease term if their exercise were judged reasonably certain. Similarly, options to terminate would be ignored in the assessment of lease term if continuation of the lease beyond the break clause were judged reasonably certain.

20. This approach deals well with many common lease types. For example, optional periods in which the lease rentals are significantly lower than expected market rate (bargain renewal options) are normally included in the lease term. Similarly,

leases that are only cancellable upon payment of a significant penalty are treated as non-cancellable.

21. This approach has a number of other advantages:
    - It is familiar to preparers. Consequently, the need for additional guidance should be minimised.
    - It is consistent with the approach currently used for finance leases. Consequently, the accounting for finance leases will be unchanged if the requirement to classify leases is removed. Conversely, if the requirement to classify leases is retained, any differences between operating leases and finance leases will be minimised.

22. However, the staff notes that there is little or no technical justification for basing the lease term upon whether an option is reasonably certain to be exercised (rather than some other probability threshold).

23. In addition, “reasonably certain” is a relatively high threshold to have to meet. This could lead to the lease term being understated when compared to, for example, a more likely than not lease term. Indeed, some constituents have expressed a concern that if this approach is adopted, leases will be restructured as short-term leases, incorporating options to extend that it is possible to argue are not reasonably certain to be exercised. This would help minimise the recognised asset and liability.

Alternative Approaches

24. The Boards could decide to use a different probability threshold to determine whether to include an optional period within the lease term. Possible probability thresholds are summarised in the table below (there may be more):

Threshold	Description	Comments
Virtually certain	Optional periods are included in the lease term only if it is virtually certain that the lessee's right to use the leased item in the optional period will be exercised.	Virtually certain is a very high threshold to meet. Very few leases would include options that are virtually certain to be exercised. Consequently, lease terms would be significantly shorter than is currently the case.
Reasonably certain	Optional periods are included in the lease term only if it is reasonably certain that the lessee's right to use the leased item in the optional period will be exercised.	See above.
Probable	Optional periods are included in the lease term if it is probable that the lessee's right to use the leased item in the optional period will be exercised.	The term "probable" appears to be interpreted differently in different contexts (e.g., the Framework and IAS 37). Consequently, additional guidance may be required if this term is chosen.
More likely than not	Optional periods are included in the lease term if it is more likely than not that the lessee's right to use the leased item in the optional period will be exercised.	Assets and liabilities recognised would be based upon the most likely lease term. However, it may be more difficult to determine whether exercise of an option is more likely than not than to determine whether exercise is reasonably certain.

25. The staff does not recommend that the Boards adopt any of these alternative approaches. The staff notes that there is no conceptually correct probability threshold that should be applied in determining the lease term. Each of the different approaches described above can be argued to be a reasonable way to draw the line between including an optional period in a lease term and excluding it. However, the application of the reasonably certain probability threshold is

familiar to lessees and is well understood. Any move away from this approach is likely to result in calls for additional guidance and could result in significant application issues. In addition, this approach deals well with many of the common lease contracts (leases with bargain renewal options, significant termination penalties etc…).

26. Another possible approach would be to base the measurement of the lessee's assets and liabilities upon the expected (probability weighted) lease term. This approach could result in a measurement of the lessee's assets and liabilities that approximates to fair value. However, the staff notes that this approach is complex and would require the exercise of significant judgement to determine the probabilities of the various lease terms. Consequently, the staff does not recommend this approach in this project.

Question 3

The staff recommends that assessment of the lease term be based upon whether it is reasonably certain that the right to use the leased item in an optional period will be exercised. Do the Boards agree?

Question 4

If the Boards disagree, which of the alternative approaches described above would the Boards prefer?

Factors to be Considered in Determining the Lease Term

Factors that Could be Considered

27. Factors that could affect the term of a lease can broadly be characterised as follows:

Category	Description	Examples
Contractual factors	Explicit contractual terms that could affect whether or not the lessee extends or terminates the lease.	• Level of rentals in any secondary period (bargain, discounted, market ,or fixed rate) • The existence and amount of any residual value guarantees • The existence and amount of any termination penalties • Costs associated with returning the leased item in a contractually specified condition or to a contractually specified location
Non-contractual financial factors	Financial consequences of a decision to extend or terminate the lease that are not explicitly stated in the contractual terms	• The existence of significant leasehold improvements that would be lost if the lease were terminated or not extended • Non-contractual relocation costs • Costs of lost production • Tax consequences • Costs associated with sourcing an alternative item
Business factors	Non-financial business factors that could affect the lease term	• Nature of the asset (Core vs. non-core, specialised vs. non-specialised, willingness to allow a competitor to use the leased property) • Industry practice
Lessee specific factors	Lessee-specific considerations	• Lessee intent • Past practice

28. IAS 17 provides very little guidance on factors that should be considered in determining the lease term. The definition of a non-cancellable lease clearly indicates that any requirement to pay a penalty on termination of the lease contract should be considered. However, no further guidance is provided.

29. Statement 13 provides more detailed guidance. In summary:

- Periods covered by bargain renewal options must be included in the lease term.
- Periods for which failure to renew the lease imposes a penalty in such an amount that renewal is reasonably assured are included in the lease term. Factors to consider in determining whether a penalty exists include, but are not limited to, the uniqueness of purpose or location of the property, the availability of comparable replacement property, the importance or significance of the property to the lessee's business, the existence of leasehold improvements, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement or to tolerate other parties using the property.

30. In practice under both standards, all of the factors listed in the table above are taken into account in determining the lease term with the exception of lessee intent and past practice, which generally are not considered.

31. The Boards could decide to adopt the approach used in the current standards or adopt an alternative approach.

32. For example, the Boards could decide to restrict the factors that should be considered in determining the lease term to contractual factors. This would be the simplest approach to apply but would result in a shortening of recognised lease terms. Consider the following example:

Example

An entity leases an office building for a period of 10 years and carries out significant leasehold improvements on the building. At the end of year 1 (and only at the end of year 1), the lessee has an option to terminate the lease without penalty.

33. In this example, it is highly unlikely that the lessee will terminate the lease after the end of the first year, as it will lose the benefit of the improvements carried out. However, the lease term would be assessed as one year if only contractual factors are considered.

34. An alternative approach would be for the Boards to require lessees to consider contractual factors and non-contractual financial factors. However, this approach would ignore the effect that the nature of the leased asset could have on the lease term. For example, a lessee that leases a core asset (for example, a production line) is much less likely to terminate the lease early than a lessee who leases a non-core asset (for example, the Finance Director's car). This approach would also represent a change to existing practice.

35. Finally, the Boards could decide to require the lessee to consider all relevant factors in determining the lease term (including lessee intent and past practice). Clearly, basing the lease term solely on the lessee's stated intention would be open to abuse. However, it might be reasonable to consider the lessee's intentions if they are supported by evidence (for example, budgets, plans, forecasts, prior actions and industry practice).

36. The staff recommends that any guidance on the factors to consider when determining the lease term should be consistent with current practice—that is, it should specify that all relevant factors except lessee intent and past practice should be taken into account in determining the lease term. The staff makes this recommendation for the following reasons:

- It is consistent with the approach currently used for finance leases (ensuring all leases are treated consistently and reducing the need to classify leases as operating or finance);
- The approach works well for leases currently classified as finance leases;
- Any change, in this area could result in significant implementation issues for lessees; and
- It is consistent with the overall approach to this project as described in agenda paper 13A (FASB memo No. 16).

37. Before asking the Boards to decide on the content of any guidance, the staff would like the Boards to consider whether guidance is actually required.

Should the New Standard Provide Guidance?

38. The staff notes that IAS 17 has been applied for a number of years without the need for additional guidance on how to determine the lease term. Consequently, the Boards could decide not to provide guidance in this area.

39. However, Statement 13 provides a list of factors to be considered in determining the lease term. Failure to provide at least some guidance could lead to application questions from those currently applying U.S. GAAP.

40. Whichever approach the Boards adopt, the staff proposes to include a question in the discussion paper seeking the views of constituents on whether additional guidance is required on how to determine the lease term.

Question 5

Should the leases standard provide guidance on the factors to be considered when determining the lease term?

Content of the Guidance

41. If the Boards conclude that guidance on the factors to be considered when determining the lease term should be provided, the content of that guidance must be determined.

42. The staff recommends that any guidance on the factors to consider when determining the lease term specify that all relevant factors except lessee intent and past practice should be taken into account in determining the lease term

Question 6

Do the Boards agree with the staff's recommendation that all factors are relevant except for lessee intent and past practice?