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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **24 July 2008, London**

Project: **Leases**

Subject: **Contingent rentals (Agenda Paper 13C)**

Introduction

1. In the Leasing section of the MoU discussion memo (Agenda Paper 3 presented at the April 2008 Joint Meeting) it was recommended that "the Boards should avoid reconsidering areas for which current lease accounting provides answers, even though those answers are imperfect. In particular we recommend that the Boards proceed using current definitions of what constitutes a lease and the treatment of contingent rentals." In addition, the June 2008 Technical Plan (including the timeline for project completion) is based on the assumption that the current accounting treatment for contingent rentals is retained. The purpose of this paper is to provide further information and analysis on contingent rentals and to ask the Boards whether they want to retain the current accounting treatment for contingent rentals (with enhanced disclosure requirements) in any new lease accounting standard.

2. In this paper the staff will:

- Provide an overview of the current accounting for contingent rentals under IAS 17, *Leases*, and FASB Statement No. 13, *Accounting for Leases.*
- Provide background on the different types of contingent rental arrangements.
- Summarize previous staff analysis and Board discussion of contingent rentals in the leasing project.
- Discuss the advantages and disadvantages of developing a new approach to contingent rentals as opposed to keeping IAS 17.

3. The staff notes that any decision to move away from the IAS 17 treatment of contingent rentals will have implications for the proposed timetable, and such a decision would be inconsistent with the staff's basic approach to adapt the finance lease model to operating leases. In previous discussions, the Boards have been unable to reach a consensus on this issue. Many of the issues that need to be addressed in developing a new approach to contingent rentals are similar to those that have previously been discussed by the IASB as part of their liabilities project and those that are being discussed as part of the joint conceptual framework project. Consequently, any attempt to develop a new approach to contingent rentals is likely to be time consuming resulting in the project extending beyond mid-2011.

4. For the purposes of this paper, contingent rentals are defined as lease payments that increase or decrease as a result of changes in factors occurring subsequent to the inception of the lease, other than the passage of time.[1] Examples of contingent rentals are rentals linked to an inflation index, rentals based on the sales the lessee achieves from the leased premises, and usage based rentals (for example, rentals based on the miles driven in a leased car).

Current Accounting

5. Under existing accounting, contingent lease payments have similar accounting under both U.S. GAAP and IFRS. Contingent lease payments are generally expensed in the

[1] This definition is consistent with the definition of contingent rentals in Statement 13 and IAS 17.

period incurred and excluded from the minimum lease payments that are used in both the determination of whether a lease qualifies as a capital (financing) or operating lease and the measurement of the initial lease obligation. In accordance with both Statement 13 and IAS 17, contingent rentals that depend on the future use of the leased asset are excluded from minimum lease payments; however, contingent rentals that are based on an existing index are included in minimum lease payments based upon the current level of the index. Any increases or decreases in lease payments that result from subsequent changes in the index are charged as expenses in the periods in which they are incurred.

6. An exception to expensing contingent lease payments as incurred is found in EITF Issue No. 98-9, "Accounting for Contingent Rent." Issue 98-9 reached the consensus that requires an entity to accrue contingent rental expense prior to the future achievement of a specified target (which, once met, requires the lessee to pay the contingent lease payments) if it is considered probable that the entity will reach the target. If it later becomes probable that the entity will no longer reach the target, the contingent rent should be reversed into income. Under IFRS, there is no such exception.

7. Lease contracts with payments that change in response to price changes may contain embedded derivatives as defined in both FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and IAS 39, *Financial Instruments: Recognition and Measurement*, 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. In accordance with both standards, the variable element would then be bifurcated from the lease contract and measured both initially and subsequently at fair value.

8. Both Statement 13 and IAS 17 require specific disclosures for contingent lease payments, including a general description of the basis on which contingent lease payments are determined and the separate identification of contingent lease payments incurred in the reporting period.

Background – Contingent Rentals

9. The staff has discussed contingent rentals with working group members, various leasing associations, and other individuals in practice. Based on those discussions, the staff understands that contingent rentals are less common in the equipment leasing industry but are often utilized in real estate leasing, especially in leases involving retail or office space. The three main categories of contingent rentals are discussed below (lease agreements can also contain a combination of all three types of contingent rents).

Category I – Lease payments with a variable factor based on price changes or an index

10. One of the most common types of contingent rental arrangements is an arrangement in which the rentals are adjusted in accordance with an underlying price, index, or other variable. In this type of lease, 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).

11. Lessees often enter into such lease terms to provide a 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. An inflation-linked rental also allows a lessor to hedge against price increases.

Category II – Lease payments with a variable factor based on the lessee's financial or operating performance from the leased item

12. Another type of contingent rental arrangement involves lease payments that are conditional on the lessee's financial or operating performance derived from the leased item. An example of this is a lease of retail property in which a fixed lease payment is called for monthly with a contingent lease payment based on a contractually determined percentage of the lessee's turnover or profitability at the location. Lessees will often agree to lower fixed rentals with a variable element that increases as their cash inflows increase as a means to provide protection against lower than

expected cash inflows from the leased property. 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 (a landlord may also do this to provide an incentive for tenants to open retail space in a new market). 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.

Category III – Lease payments with a variable factor based on the lessee's usage

13. A third type of contingent rental agreement includes lease payments that are conditional on the lessee's usage of the leased item. Examples include car leases in which the lease payment is fixed with an additional amount due if the lessee exceeds a contractually specified mileage and leases of copier equipment in which 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 residual value of the leased asset; the resale value of the leased asset 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. 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.

Previous Discussion of Contingent Rentals – Staff and Boards

Staff analysis

14. The staff's previous analysis of this issue attempted to identify the rights and obligations arising from lease contracts with contingent rental arrangements and analyze whether those rights and obligations meet the definitions of assets and liabilities in CON 6 and the IASB *Framework.* 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.

Category I – Lease payments with a variable factor based on price changes or an index

15. The staff concluded for Category I leases that 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.

Category II – Lease payments with a variable factor based on the lessee's financial or operating performance from the leased item

16. In the staff's previous analysis of this issue the staff discussed leases in which the lessor is able to enforce the use of the property by the lessee and leases in which the lessor is not able to enforce the use of the property by the lessee. For leases in which the lessor is able to enforce the use of the property by the lessee (i.e., a lease agreement that requires the lessee to operate a retail location on the property), the staff noted that the lessee had 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
    - Liability representing an unconditional stand-ready obligation to pay the additional variable rentals.

17. However, in a lease in which the lessor is not able to enforce the use of the physical asset by the lessee, the staff noted the conclusion was less clear. The lessee's obligation for the fixed rentals remains. However, as the lessee has no obligation to use the physical item, one could argue that there is no obligation to pay rentals based on sales that arise only if the item is used. Although there usually would be strong economic reasons why the lessee would wish to use the asset, there is no external party who can force the lessee to use the physical item. Some noted (for these types of leases) that the lessee still has an asset for the right to use the leased property regardless of whether the amount the lessee pays for that right is contingent on if the

lessee decides to use the asset or not (and that the asset value might serve as the most accurate measure of the corresponding obligation).

Category III – Lease payments with a variable factor based on the lessee's usage

18. As the staff noted in previous discussions, for Category III leases 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.

Board discussion

19. This issue was discussed at both the IASB and FASB Board meetings in October 2007. At those meetings, the Boards considered whether these types (Categories I–III above) of contingent rentals meet the definition of a liability and, if so, when the liability arises and how it should be measured. The Boards generally agreed that the lessee has a liability for both the fixed and variable components for rentals with a variable factor based on prices changes or an index (Category I). The Boards did not come to an agreement regarding contingent rentals based on the lessee's financial or operating performance from the leased item or the lessee's usage of the leased item; however, the meetings were informational and no overall decisions were reached on the topic of contingent rentals.

20. During the October 2007 meetings Board members discussed the following issues relating to Category II and III leases (but no definitive conclusions were reached):

- Whether the lessee truly has discretion to avoid the obligation to pay the contingent rentals (and whether or not that should determine if a liability is recorded related to the contingent rentals)
- Whether there should be symmetry between the asset and liability
- Whether there might be cases with a high percentage of contingent rent in which the fair value of the right to use asset provides a more relevant measure of the liability as opposed to the present value of the fixed rental payments
- Whether there is no right of use asset simply because the rentals are completely contingent
- If the lease contract is the unit of account, whether there is just a question of *measurement* of the total liability related to the lease and not *recognition* of the liability related to the lease.

Previous Discussion of Contingent Rentals – Working Group

21. The staff previously sent a questionnaire to working group members to obtain their views on several issues related to the right of use model, including the recognition and measurement of contingent rentals by the lessee. Those responses were summarized in a paper provided to the Joint Board Advisors in March 2008. Copies of the actual responses are available to Board members upon request.

22. All of the respondents agreed that the initial measurement of the liability should include both fixed and variable components of lease payments based on price changes or an index. The majority of working group members supported initial recognition of a liability by the lessee when variable payments are based on sales from the leased property or usage of the leased property.

23. The respondents who supported recognition of the variable and contingent features by the lessee at the inception of the lease noted that both the lessor and the lessee would take the variable factors into account in determining whether or not to enter into the lease transactions; accordingly, these respondents believed the accounting should

mirror this economic reality. Other respondents believed that the variable factors must be included to prevent structuring.

24. However, many of the working group members who supported recognition of the liability acknowledged there were numerous practical measurement issues, including how to access the probability of the contingent rentals occurring, how to discount the future cash flows, and how to address subsequent measurement. For example, several respondents noted the difficulty in estimating future sales over a long period, and one respondent noted the counterintuitive result that a gain would be recognized if the lessee revised expected sales downward. Another respondent noted additional complexity (and possibly a loss of objectivity) because many of the contingent payments would be affected by the lessee's own actions (such as, hitting a certain sales target or selling a certain number of units).

25. Other respondents believed the liability for contingent lease payments should not be recognized until the contingent events occur in the future, and several others had mixed views. One respondent noted that the answer for variable and contingent lease payments could depend on the leasing model selected (i.e., whether the initial obligation is recorded at historical cost or fair value).

Advantages and Disadvantages to Analyzing a New Approach for Contingent Rentals or Retaining the IAS 17 Approach

New Approach to Accounting for Contingent Rentals

26. Some believe that a new approach to accounting for contingent rentals is necessary because it is not clear whether the current model is conceptually sound. Those proponents believe that most (if not all) contingent rent payments should be recognized at the inception of a lease. Those proponents believe that although the amount of the future rental payments the lessee will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional and should be reflected in the lessee's financial statements at lease inception.

27. Proponents of a new approach also note that if the Boards decide to base the right of use asset (and the corresponding liability) on the substantive or effective lease term (and if that lease term includes *optional* renewal periods) then, in a certain sense, the Boards would have already decided to require a lessee to record a liability for rentals that they have the discretion to avoid.

28. A new approach to the accounting model for contingent rentals could potentially alleviate concerns that the current accounting model for contingent rentals would allow for both the right of use asset and the liability recognized to be minimized if the lease contract includes a significant element of contingent rentals. At a recent meeting of the U.S Investors Technical Advisory Committee (ITAC), certain ITAC representatives expressed significant concern with the current contingent rent guidance. Those ITAC representatives believed that lessors would restructure leases to minimize the recognized liability by including a significant amount of contingent rents if the Boards continue with the proposed approach.

Retaining the IAS 17 Approach for Accounting for Contingent Rentals

29. The IAS 17 approach is familiar to lessees (so implementation issues are likely to be minimized) and it can be quickly developed (if any modification is needed at all). This approach also acknowledges that the Boards and the G4+1 Special Report on Lease Accounting were unable to resolve this issue and it is likely that a further attempt to resolve the issue will delay the completion of the leasing project beyond mid-2011. In addition, any change to the contingent rental guidance will result in a change in practice for leases currently classified as finance leases if the Boards decide to remove the lease classification requirements. A change to the contingent rental guidance also would result in a change to the determination of minimum lease payments, which could raise additional questions regarding subsequent measurement of leases with contingent rentals (for example, how to account for changes in estimates related to contingent rentals that are included in minimum lease payments as a result of a probability assessment). If the Boards retain the lease classification requirements, but only change the contingent rental guidance for operating leases, there would be no conceptual basis for determining contingent rentals differently for

finance leases as opposed to operating leases. This would presumably result in confusion for both users and preparers of financial statements.

30. The staff acknowledges that both the right of use asset and the liability recognized can be minimized if the lease contract includes a significant element of contingent rentals. However, the staff believes that the ability of financial engineers to minimize the recognized asset and liability will be restricted by the lessor's willingness to take on the risks associated with contingent rentals.

31. The staff also notes that if a lessor structured a lease to include a significant element of contingent rent, this could have a negative effect on the lessor's accounting as well (by restricting the lessor's ability to recognize revenue).

32. If the Boards decide to retain the current IAS 17 approach to contingent rentals, the staff will suggest additional disclosures that will enable users to further understand any contingent rental arrangements and their effect on the lessee's financial statements. The staff has considered the following additional disclosures (both IAS 17 and Statement 13 currently require a general description of the basis on which contingent lease payments are determined and the separate identification of contingent lease payments incurred in the reporting period):

    - A description of the contingent rental provisions in a lease, including the expected timing of any resulting outflows of economic benefits
    - The amount of contingent rent expense recognized in previous periods
    - An estimate of the possible future amount of contingent rentals, or range of possible amounts, or, if an amount or range cannot be estimated, a statement that such an estimate cannot be made and the reasons why
    - The major assumptions made when estimating the possible future amount or range of possible amounts that the lessee will be required to pay.

Question 1 for Board Members

Do Board Members want to retain the IAS 17 approach for accounting for contingent rentals?

Question 2 for Board Members

If the Boards support retaining the current IAS 17 approach for accounting for contingent rentals, do the Boards want the staff to further develop the enhanced disclosure requirements for contingent rentals?

Question 3 for Board Members

If the Boards do not support retaining the current IAS 17 approach for accounting for contingent rentals, the staff would like Board members to indicate what additional analysis (beyond what was provided at the October 2007 Board meetings) the staff should perform on this issue in order for the Boards to reach a decision on this topic.