Project	**Leases**
Topic	**Contingent rentals and residual value guarantees**

Purpose of the paper

1. This paper is identical to AP 5E/50 that was distributed to the boards in November. It addresses recognition, measurement and reassessment of contingent rentals and residual value guarantees by the lessee only.

2. This paper is structured as follows:

   (a) Background information from the Leases discussion paper (DP).

   (b) For each of the areas discussed:

      (i) A summary of comment letter respondents' views on the proposed approach(es), including a summary of advantages and disadvantages quoted for each approach.

      (ii) An analysis of possible approaches.

      (iii) Staff recommendation.

3. In this paper, the staff recommend the following:

   (a) Recognise all contingent rentals (consistent with the DP).

   (b) Measure using the expected outcome technique, with clarification that not every possible scenario has to be taken into account (consistent with one of the views in the DP, with an expanded explanation).

      (i) Measure contingent rentals based on an index or rate using readily available forward rates or, if not available,

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rates at the inception of the lease (consistent with the FASB's view in the DP, with an expanded explanation).

(c) Reassess contingent rentals at each reporting date, and remeasure if there are new facts or circumstances indicating a change (consistent with the DP, with an expanded explanation).

(d) Reflect a change in the obligation as an adjustment to the right-of-use asset when the change reflects the lessee buying more or less of the right of use. All other changes are to be reflected through profit or loss (a mix of the approaches proposed in the DP).

(e) Recognise and measure residual value guarantees in line with contingent rentals (consistent with the DP).

Background

4. Contingent rentals can be divided into three main categories:

   (a) Contingent rentals based on price changes or an index. In this type of lease, rentals are adjusted for changes in market lease rates or other indices, such as market interest rates or the consumer price index.

   (b) Contingent rentals based on the lessee's performance derived from the leased item. An example is a lease of retail property under which the lessee pays rentals on the basis of an agreed percentage of sales made from that property.

   (c) Contingent rentals based on usage. For example, a car lease may require the lessee to pay additional rentals if the lessee exceeds a specified mileage.

5. Lease contracts sometimes include residual value guarantees. Under those guarantees, the lessee compensates the lessor if the value of the leased item at the end of the lease is below a specified amount.

6. The DP included the following tentative decisions on contingent rentals and residual value guarantees.

   (a) **Recognition** - The lessee's obligation to pay rentals should include the lessee's obligation to make payments under all contingent rental arrangements.

   (b) **Initial measurement** - The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a *probability-weighted estimate* of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the *most likely* rental payments. A lessee would determine the most likely amount by considering the range of possible outcomes. However, that measurement would not necessarily equal the probability-weighted sum of the possible outcomes. The FASB also tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. The IASB did not discuss this issue.

   (c) **Reassessment** - The obligation to pay rentals should be remeasured at each reporting date to reflect changes in estimated contingent rental payments. The IASB tentatively decided that changes in the obligation to pay rentals arising from remeasurement should be *recognised as an adjustment to the carrying amount of the right-of-use asset*. The FASB tentatively decided that changes in the obligation to pay rentals arising from remeasurement should be *recognised in profit or loss*.

   (d) **Residual value guarantees (RVGs)** – RVGs are recognised together with the obligation to pay rentals. Leases that include RVGs should be measured on the same basis as leases that include contingent rentals.

Recognition

Comment letter feedback received

7. More than half of the respondents, mostly from preparer and industry organisations, disagreed with the boards' decision that the lessee's obligation to pay rentals should include amounts payable under contingent rentals.

8. However, most other respondent groups (including users) supported recognising contingent rentals.

9. In addition, some respondents suggested an alternative approach:

> Contingent rentals vary significantly and warrant different accounting treatment based on their nature. Agree that unavoidable contingent payments should be capitalised (for example those that are based on changes in an index or rate). However, recognising avoidable contingent rentals (certain payments based on usage or performance factors) would contradict the definition of a liability. (CL #116)

10. The respondents' main arguments for and against the approaches presented in the DP are in the table below:

Advantages	Disadvantages
Recognise no contingent rentals	
• Simple to apply. Recognition and measurement would be based on the numbers included in contracts, with minimal judgement required. • Consistent with current practice in IFRS and familiar to preparers and users.	• Significant liabilities will be unrecognised, which has the following implications: (a) Lessees could have a right-of-use asset that would not be recognised at all or be understated, and thus not provide useful information to users. (b) Lessees could structure rentals as contingent to avoid recognising an obligation. (c) Limits comparability (eg if an entity owns an asset or has a lease with fixed rentals there would be assets and liabilities recognised. If an entity has a lease for the same asset with

Advantages	Disadvantages
	wholly contingent rentals there would be no assets and liabilities recognised.)
Recognise all contingent rentals	
• It is consistent with economic reality – there are no 'hidden' obligations and the right-of-use asset is not understated. • The liability exists at the contract inception; it is only the amount that is uncertain. • Comparability with owned assets and fixed rent leases (assets and liabilities are recognised regardless of whether the asset is owned, or leased with fixed or contingent rentals). • Limits structuring opportunities because all rentals would have to be recognised and measured.	• Respondents argue that there is no liability until the contingency happens (there is no past event). • Complex and costly to apply because a lot of judgement and assessment will be required to measure the obligation. • Recognising liabilities for contingencies that lessee can avoid may not provide useful information to users. • Recognising contingent rentals that lessee can avoid may be seen as inconsistent with IAS 37 and the liability definition.

Analysis

11. The staff identified three approaches to recognition of contingent rentals:

    (a) Do not recognise any contingent rentals, but provide additional disclosures.

    (b) Recognise contingent rentals where the obligation is unavoidable.

    (c) Recognise all contingent rentals, as proposed in the DP.

Do not recognise any contingent rentals, but provide additional disclosures

12. Proponents of this approach think that contingent rentals do not meet the definition of a liability or that contingent rentals cannot be measured reliably.

13. The staff think that contingent rentals are liabilities because the obligation to pay is unconditional, and only the amount that will be paid is uncertain. This is consistent with the boards' preliminary view in the DP.

14. Not recognising contingent rentals would have disadvantages as outlined in the table above and would also be inconsistent with the boards' tentative decisions on options within lease contracts, as well as with other standards (IAS 37, FASB ASC 450-formerly FAS 5). It would also be inconsistent with current US GAAP practice which recognises some contingent rentals (for example, lease payments that depend on an existing index or a rate are currently included in minimum lease payments).

Recognise contingent rentals where the obligation is unavoidable

15. Some respondents think that avoidable contingent rental payments should be excluded from the obligation to pay rentals. For example, a lessee will normally be able to control whether or not they use a leased item. Consequently, under this approach most usage-based contingent rentals would be excluded from the obligation to pay rentals. Those who support this approach argue that it is more consistent with the liability definition than the approach proposed in the DP. They also argue it is consistent with IAS 37.

16. Under this approach, both rentals contingent on indices and unavoidable performance-related contingent rentals (eg where the lessee is contractually required to keep the leased premises open to customers for a specified number of hours per day) would be recognised. Avoidable performance-related rentals would not be recognised (eg where there are no contract limitations, allowing lessees to avoid the obligation).

17. Some respondents suggested recognising obligations that can be avoided will not provide useful information to users. The staff think that not recognising an obligation at all because it can be avoided by lessee is not useful, because it does not reflect all rights and obligations under a contract. The avoidability is however taken into account in measurement. For example, let us compare two leases for a

retail shop, where rentals are contingent on turnover. One lease stipulates that the lessee must keep the premises open for a specified number of hours a day and for a specified number of days a week. The other lease has no such conditions, ie operation is fully within the control of the lessee. Measurement for the first lease would reflect the minimum hours of operation as a starting point, whereas measurement for the other lease would reflect the possibility that the shop can be closed for longer. If that possibility is remote, the two contracts are likely to have the same measurement and vice versa.

18. The staff see several additional disadvantages of this approach:

    (a) The dividing line can be difficult to draw, adding complexity to the standard.

    (b) It could create structuring opportunities allowing lessee to avoid recognising an obligation.

    (c) Limits comparability (similar contracts could end up on two sides of the dividing line, see the example in paragraph 17 above).

    (d) Inconsistent with the proposed approach to options, where the lessee controls the exercise of the option but still recognises an obligation to pay rentals in the optional period.

    (e) Inconsistent with IFRS 3 and FASB ASC 805 - formerly FAS 141R where contingencies within the entity's control arranged as a part of business combination are recognised.

Recognise all contingent rentals, as proposed in the DP

19. Proponents of this approach think that the obligation to pay rentals is unconditional and meets the definition of a liability. Only the amount that will be paid is uncertain.

20. This approach would ensure that the measurement of right of use reflects all rights received, even if payment for these rights is contingent. This aids comparability with other leased and owned assets.

21. This approach is also consistent with IFRS 3 and FASB ASC 805 - formerly FAS 141R, where contingencies within the entity's control arranged as a part of business combination are recognised.

22. Some respondents argued that this approach is inconsistent with IAS 37 which only recognises contingencies when an outflow of economic benefits is probable and it can be measured reliably. In addition, the current IAS 37 project is proposing only to recognise unavoidable obligations.

23. The staff recognise these differences but note that there are already differences in approach between IAS 37 and other standards (eg IFRS 3). We further think that introducing recognition criteria such as in IAS 37 will result in understatement of right-of-use assets obtained by lessees, undermine comparability, introduce structuring opportunities and increase complexity.

Recommendation

24. The staff continue to think that, on lease inception, the obligation to pay contingent rentals becomes unconditional and therefore all contingent rentals should be recognised on initial recognition. The proposed approach ensures all contingent rentals are measured and that the right-of-use asset is not understated. The staff will propose disclosures to inform users about uncertainties involved in that measurement.

25. The staff therefore recommend that the boards reconfirm their preliminary decision to recognise all contingent rentals.

Question 1
The staff recommend that all contingent rentals be recognised. Do the boards agree with this staff recommendation?

Recognise a liability for contingent rentals only if it can be measured reliably

26. Some respondents suggested that contingent rentals should be recognised only if the obligation can be measured reliably. This approach can be combined with

recognising all contingent rentals, or only those where the obligation is unavoidable.

27. While this approach is familiar to users and preparers, being consistent with many current standards (IAS 16, IAS 37, IAS 38, FASB ASC 905, 604, 740 etc), it does not reflect the direction in which the boards are going with current projects (eg work on the Framework or Financial Instruments Project).

28. Including reliability criteria would mean that contingent rentals whose measurement is not deemed reliable would not be recognised at all. The staff does not think that this will provide useful information, because it will mean some right-of-use assets will be understated or not recognised at all (as discussed in paragraph 23 above).

Question 2
The staff recommend that there is no reliability criteria for recognition of contingent rentals. Do the boards agree with this staff recommendation?

Initial measurement

29. The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a *probability-weighted estimate* of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the *most likely* rental payments.

Comment letter feedback received

30. More respondents supported measuring contingent rentals based on the most likely rental payment. The majority of preparers, industry and professional organisations supported the most likely rental payment approach. The majority of other groups (users, standard-setters, and accounting firms) supported measuring contingent rentals based on expected outcome.

31. The respondents' main arguments for and against the two approaches are in the table below:

Advantages	Disadvantages
Most likely approach	
• Can be simpler and easier to apply, more operational and cost-effective (especially for single leases). • Results obtained are possible outcomes, therefore more meaningful. • Arguably consistent with the lease term tentative decision. • Works well in symmetric unimodal (ie with single highest amount, eg normal) distributions. • Consistent with some of US GAAP	• In order to determine the highest probability the entity may need to assign probabilities to various possible scenarios, thus requiring a similar amount of work to the expected outcome approach. • Requires additional guidance where two or more outcomes share the highest probability. • Places too much emphasis on a single outcome, which can lead to significant adjustments. • Attempts to predict the liability to be paid in future, even though underlying agreement is to pay an uncertain amount • When distribution is skewed, it may provide misleading information to users. • Inconsistent with IAS 37, which requires most likely approach for measurement of single liabilities, but also requires it to be adjusted for asymmetric distribution of probabilities.
Expected value approach	
• Reflects the fact that the lessee entered into an agreement to pay rentals of uncertain amount. • Works well under both symmetric and asymmetric distribution. • Places less emphasis on a single outcome so may reduce volatility. • Consistent with approaches required in FASB ASC 820 – formerly FAS 157, IAS 36 and IAS 37.	• Difficult to determine probabilities of each possible outcome. • Results in an adjustment to reflect actual outcome. • Requires assessment of probabilities for values that have very low chance of occurring, making it more complex and costly. • Arguably inconsistent with the lease term tentative decision. • Arguably inconsistent with the IAS 37

• Consistent with measurement approach in some of the boards' ongoing projects.	approach for measuring a single liability.

Staff analysis

32. For background information on the boards' use of these two techniques when measuring liabilities please see the paper '*Liabilities, Uncertainties, and Expected Cash Flows*' presented during the joint Board meeting in October 2008.

33. The staff note that many respondents understood most likely and expected value approaches in their statistical textbook sense, as follows:

    (a) Most likely: the best chance of occurring.

    (b) Expected value: the sum of all possible values for a random variable, each value multiplied by its probability of occurrence.

34. The staff further note that these two techniques are often interpreted differently from the textbook definitions used above (including by some Board members). Instead:

    (a) Most likely is viewed as an approach that takes into account various probabilities and makes adjustments for the symmetry of distribution, which may be described as a best estimate.

    (b) Expected value is viewed as taking into account a reasonable number of scenarios, not as considering every possible scenario.

35. This implies that the two approaches are not as different as would appear from the analysis above. Instead, the issue is the wording used to describe the approach, which may be interpreted with a different meaning to what the boards intended. This may happen for various reasons, including cultural differences. This is also pointed out by some respondents, for example:

> "In practice, (we) don't think most likely payment vs probability-weighted should differ materially. In determining most likely, preparers would need to consider range of possible outcomes and likelihood." (CL #145)

36. The staff think that the boards' intentions are the same. That is, in measuring the obligation, preparers should look at a reasonable number of scenarios and take the probability distribution into account. The staff think that the expected value approach better reflects this intention and should therefore be used, with a clarification that a reasonable number of options (not every possible scenario) should be considered. For example, wording similar to what is in FASB ASC 820-10-55-18 (formerly SFAS 157) could be useful:

> In more realistic situations, there could be many possible outcomes. However, it is not always necessary to consider distributions of literally all possible cash flows using complex models and techniques to apply the expected present value technique. Rather, it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows.

37. The staff think that this approach would also address the concerns expressed in many of the comment letters received.

Recommendation

38. The staff recommend that expected outcome technique be used, with wording and an example that indicates that not every possible scenario has to be considered in measurement.

39. If the boards decide to use the most likely approach, the staff recommend that the boards clarify how it would apply when the distribution is skewed and in lease portfolio situations.

Question 3
The staff recommend that the expected outcome technique be used in measurement of contingent rentals, with the clarification that it does not mean considering every possible scenario. Do the boards agree with this staff recommendation?

Initial measurement of rentals contingent on an index or rate

40. The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the

lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. The IASB did not discuss this topic.

Comment letter feedback received

41. The majority of respondents supported this approach as a practical expedient.
42. There were a number of respondents who disagreed that initial measurement should be based on an index or rate existing at the inception of the lease. They argued that it is rules-based, inconsistent with both measurement approaches, and ignores the economic substance of the transaction. To alleviate these concerns, several respondents suggested that if the forward rate is readily available, it should be used for initial measurement.

Staff analysis

43. In principle, forecasting techniques should be used in the same way as with any contingent rentals. However, forecasting future index changes or a rate will require macroeconomic information that preparers may not have readily available. This approach could therefore be very costly and it is doubtful what benefits it would provide to users.
44. If, however, forward rates for an index or a price stipulated in the contract are readily available for the period of the lease term (eg from the Office for National Statistics or equivalent) using those will provide better information to users and will not incur additional costs for preparers.
45. Similarly, if rates or an index similar to those stipulated in the lease contract are readily available, the benefit of additional information to users will exceed the cost the preparers need to incur to adjust those rates.

Recommendation

46. Consequently, the staff recommend that the boards reconfirm the FASB's tentative decision, clarifying that forward rates should be used whenever readily available.

Question 4
The staff recommend that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using a forward rate. If a forward rate is unavailable, the index or rate at the inception of the lease can be used. Do the boards agree with this staff recommendation?

Reassessment

Reassessment of contingent rentals

Comment letter feedback received

47. Just over half of the respondents agreed with the boards' decision to remeasure the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Preparers were divided over reassessment, while the majority of all other respondent groups (including users) supported reassessment. .

48. The respondents' main arguments for and against the proposal in the DP are in the table below:

Arguments for reassessment	Arguments against reassessment
Provides more relevant information to users. Reflects current economic conditions. If not reassessed, information is outdated, irrelevant or misleading.	Burdensome, complex, excessive.
Consistent with lease term tentative decision.	The costs will outweigh the benefits.
Original measurement is an estimate, so it makes sense to reassess in the light of any new facts or circumstances.	
In line with IAS 37.	

49. A number of respondents who did not support reassessment stated they would support it only when: a) a triggering event occurs, and/or b) there has been a material change.

Staff analysis and recommendation

50. The staff think that requiring reassessment of the obligation for contingent rentals at each reporting date would provide useful information to users. However, if entities are required to remeasure the obligation even when there is no indication that there has been a significant change, the costs may exceed the benefits. Consequently, the staff recommend that the boards retain the requirement to reassess contingent rental payments but only where there has been a change in any facts or circumstances that would indicate that there is a material change in the obligation.

Question 5
The staff recommend requiring remeasurement of the obligation for contingent rentals at each reporting date when there has been a change in any facts or circumstances that would indicate that there is a material change in the obligation. Do the boards agree with this staff recommendation?

Accounting for change in obligation for contingent rentals

51. The boards had divergent views on this issue in the DP. The IASB tentatively decided that changes in the obligation to pay rentals arising from remeasurement should be recognised as an adjustment to the carrying amount of the right-of-use asset. The FASB tentatively decided that these changes should be recognised in profit or loss.

Comment letter feedback received

52. The majority of respondents supported reflecting changes in contingent rentals as an adjustment to the right-of-use asset rather than in profit or loss.

53. Some of the respondents stated one of the approaches as preferred, but qualified it by saying it was their preferred approach if they had to pick one out of two alternatives for all circumstances. They did not think that either of the approaches was appropriate in all circumstances. A number of respondents explicitly stated they would prefer a mix of those approaches, such as:

> "The theoretically correct treatment would probably adjust the asset or the profit and loss depending on the nature of the contingent rental" (CL #261)

54. The respondents' main arguments for and against the approaches presented in the DP are in the table below:

Advantages	Disadvantages
All changes in profit or loss	
• Change in obligation may have no impact on the value of the asset so P&L treatment is appropriate. • Consistent with treatment of changes in contingent liabilities in IAS 37 (except decommissioning liabilities). • Arguably easier and less complex.	• Carrying amount of the asset may not reflect the rights acquired. • Profit or loss will be affected by factors that are not related to performance in the current period, so potentially misleading. • Can appear counterintuitive (eg in performance-based contingent rentals, increase in the estimate of future performance leads to recognition of expense, and vice versa).
All changes as an adjustment to the right-of-use asset	
• Reflects the link between ROU asset and obligation to pay rentals. • Consistent with tentative lease term decision. • Similar to approaches in IFRIC 1 and FASB ASC 410 (formerly SFAS 143), where changes in asset retirement/decommissioning liabilities are reflected as an adjustment to the cost of the related asset.	• Asset's carrying amount changed when there has been no change in the benefits from the right-of-use asset, making it meaningless. Consequently, depreciation charge will not reflect consumption of economic benefits in the period. • Asset's value and depreciation charge in profit or loss is affected by timing of revisions in estimates (assuming prospective application of changes), limiting the usefulness of information provided.

Staff analysis

55. In addition to the two approaches proposed in the DP (reflect all changes in profit or loss or as an adjustment to the right-of-use asset), the staff considered a third option – to reflect the change in obligation based on the nature of the contingency. This is referred to as the hybrid approach and has two alternatives:

(a) Hybrid A: Only adjust the right-of-use asset for changes in contingent rentals if the lessee is buying more or less of the right of use. Other contingencies would be reflected in profit or loss. Under this approach, right-of-use assets would be accounted for on a historical cost basis.

(b) Hybrid B: Adjust the asset for all changes in contingencies that are related to the value (whether cost or fair value) of the right-of-use asset. Contingencies unrelated to the value of the right-of-use asset would be reflected in profit or loss. Under this approach, the right-of-use asset would be accounted for at historical cost with elements of fair value (but not full fair value, unless the revaluation option is chosen for IFRS preparers).

56. Under these hybrid approaches, contingency categories can be analysed as follows:

(a) Contingent rentals based on a rate or an index: changes in rates or indices can be seen as not being directly related to the value of the right-of-use asset. Although the index may be linked to the leased asset's market, there may still not be a high correlation with the value of the right-of-use asset. Consequently, changes in those contingencies would be reflected in profit or loss under both hybrid approaches.

(b) Contingent rentals based on usage: additional usage is equivalent to the lessee buying more of the right-of-use asset. Therefore, changes would be reflected as an adjustment to the right-of-use asset under both hybrid approaches.

(c) Contingent rentals based on performance: changes in performance-based contingent rentals do not reflect the lessee buying more of the right-of-use asset and would be reflected in profit or loss under the Hybrid A approach. There can be divergent views on whether a change in performance-based contingent rentals is related to the value of the right-of-use asset, ie how they should be reflected under the Hybrid B approach.

(i) For example, it is common for leases of airport shops to be based (contingent) on turnover. Some may view that an increase in turnover due to higher passenger throughput is unrelated to the value of the right-of-use asset. This is perhaps related to the value of an unrecognised intangible asset which is separate from the right-of-use asset.

In other scenarios the relationship can be more direct.

(ii) For example, an increase in the turnover rent for a car park next to a newly-built shopping area is a reflection of an increase in the value of the right-of-use for the car park.

Making a distinction between these two types would be complex and it can be argued that changes in performance-based rentals are always a reflection of the value of some asset arising from the contract. Consequently, under the Hybrid B approach, it would be more useful to reflect the change as an adjustment of the right-of-use asset.

57. The following table summarises how changes would be reflected for each contingency type for both hybrid approaches:

Approach/ contingency type	**Hybrid A**	**Hybrid B**
Index or rate	Profit or loss	Profit or loss
Usage	Right-of-use asset	Right-of-use asset
Performance	Profit or loss	Right-of-use asset

58. Each of the four identified approaches is discussed briefly below.

Reflect all changes in the obligation for contingent rentals through profit or loss

59. As noted by respondents, changes in the obligation for contingent rentals do not always reflect a change in the value or amount of the right-of-use acquired.

Consequently, in many situations it is appropriate to reflect changes in the obligation to pay rentals through profit or loss.

60. However, some changes in the obligation to pay rentals reflect a change in the value or amount of the right-of-use acquired making this approach inappropriate for all circumstances.

Reflect all changes in the obligation for contingent rentals as an adjustment to the right-of-use asset

61. Arguments opposite to those mentioned for the first approach apply, also making this approach inappropriate for all circumstances.

Reflect changes depending on the nature of contingency – Hybrid A

62. This approach has the following advantages:
    (a) It reflects the link between the historical cost of the right-of-use asset and the obligation to pay rentals.
    (b) The measurement basis for right-of-use assets is very clear, ie 'pure' historical cost, making it meaningful. It is also consistent with the cost-based approach selected for measurement of right-of-use assets.

63. However, several respondents think that reflecting changes in the obligation to pay contingent rentals through profit or loss is counter-intuitive (eg for performance-based contingent rentals an increase in the estimate of future performance leads to recognition of an expense and vice versa). They also think that it will create volatility in the profit or loss which is unrelated to the performance in the current period, which is potentially misleading.

64. The staff recognises the effect on the profit or loss. We note however that users treat remeasurements such as this one differently from other income and expenses. They recognise that profit or loss items arising as a result of remeasurement of an asset or a liability do not have the same level of persistence (ie are not likely to be repeated from one period to another in the way that cash or

accruals are), and as such they do not contribute as highly to the users' assessment of the quality of the entity's earnings.

65. The staff will propose disclosures to enable users to easily identify these remeasurements. In addition, the boards' project on Financial Statement Presentation is currently proposing to include an additional note that splits remeasurements from other items of income and expense. Consequently, the staff do not think that reflecting changes in contingent rentals in profit or loss will provide misleading information.

Reflect changes depending on the nature of contingency – Hybrid B

66. The advantage of this approach is that it reflects the link between the value of the right-of-use asset and the obligation to pay rentals.

67. This approach has the same disadvantages as Hybrid A, which are not repeated here. See paragraph 63 above.

68. In addition, this approach results in the measurement basis for the right-of-use asset being neither pure historical cost nor fair value but a mix. This is because it only reflects changes in value of the right-of-use asset that also caused the obligation to pay rentals to change. No other changes in value are recognised. It is therefore questionable whether this approach will provide useful information to users.

Recommendation

69. The staff recommend the Hybrid A approach based on the nature of the contingency, ie reflecting changes in the obligation for contingent rentals resulting from the lessee's acquiring more or less of the asset as an adjustment of the right-of-use asset. All other changes would be reflected in profit or loss. The staff think that this approach is the one most consistent with the proposed cost-based approach for the right-of-use asset, because it recognises changes in the original cost of the right-of-use asset with no other changes affecting it.

Question 6
The staff recommend that changes in obligation to pay contingent rentals resulting from the lessee buying more or less of the right-of-use should be recognised as an adjustment to the right-of-use asset. All other changes should be reflected in profit or loss. Do the boards agree with this staff recommendation?

Residual Value Guarantees

Recognition of residual value guarantees (RVGs)

Comment letter feedback received

70. Most respondents supported the boards' tentative decision to recognise RVGs together with the obligation to pay rentals. They commented that it is consistent with the decision not to adopt a components approach and that it reduces complexity. One respondent said:

> Requiring residual value guarantees to be separated from the lease contract and accounted for as derivates could result in different accounting for economically similar arrangements. Such differentiation would add unnecessary complexity to lessee accounting and could introduce opportunities for structuring lease arrangements to achieve desired financial statement presentation. (CL#139)

71. Some respondents said that RVGs should not be recognised at all. They argued that measurement would be difficult and any measurement would reduce the usefulness of financial statements, or that they should be expensed in profit or loss as incurred.

72. Some respondents disagreed with recognising RVGs together with the obligation to pay rentals and were in favour of a components approach. They said that RVGs are linked to the value of the underlying asset, not to the value of the right of use, and that they meet the definition of a derivative. They further argued that RVGs are not closely related to the host lease contract and should therefore be accounted for separately.

73. A number of respondents who disagreed with the boards' proposals for RVGs did so because they disagreed with proposals on options and contingent rentals, either because they preferred an executory contract approach, which would not recognise and measure these liabilities at lease inception, or a linked approach.

74. The respondents' main arguments for and against the proposal in the DP are summarised in the table below:

Advantages	Disadvantages
Separate recognition	
• Makes it clear what the lessee's exposure is to residual value risk. • Value can be seen as a reflection of the value of the underlying asset, not of the right-of-use, and separating it makes that clear.	• Inconsistent with the boards' decision not to adopt a components approach. • Often interlinked with other lease terms (eg options or rental payments). In these cases separate presentation may be misleading, especially if a different measurement basis is used. • Would increase complexity.
Recognise together with obligation to pay rentals	
• Consistent with the boards' decision not to adopt a components approach. • Better reflects the fact that RVGs are often linked with other lease terms (eg options to renew or purchase or even the level of rent – lower rent if an RVG is provided and vice versa). • Consistent with current practice (for finance/capital leases). • Would reduce complexity.	• Value can be seen as a reflection of the value of the underlying asset, not of the right of use, and putting them together may be misleading. • Does not provide information about the lessee's exposure to residual value risk.

Staff analysis and recommendation

75. RVGs meet the definition of a liability, consequently the staff think they should be recognised.

76. The staff think that RVGs should be recognised together with the obligation to pay rentals, because RVGs are often so interlinked with other lease terms that separate recognition would be misleading. Also, even though the value of RVGs is linked to the value of the underlying asset and not to the right-of-use these are likely to be closely related and so separate presentation would be further

misleading. Finally, this approach is consistent with the decision not to adopt a components approach. The staff will propose disclosures to inform the users of the extent of residual value risk exposure.

Question 7
The staff recommend that residual value guarantees be recognised together with the obligation to pay rentals. Do the boards agree with this staff recommendation?

Measurement of RVGs

Comment letter feedback received

77. The majority of respondents (from all respondent categories) supported the boards' tentative decision to account for RVGs in the same way as contingent rentals because contingent rentals and RVGs are similar types of transactions.

78. Those respondents who disagreed suggested that the full amount of the guarantee should be included because the lessee has no control over it. This would also reduce complexity.

Staff analysis and recommendation

79. Requiring measurement of RVGs based on the maximum amount payable is inconsistent with the boards' tentative decisions on options and contingent rentals. The staff also see no conceptual support for this approach.

80. No respondent explicitly suggested that RVGs should be measured at fair value. The staff note that, while this is an option, it would not work well with the measurement of other lease components, which is not at fair value. For example, RVGs and options can be mutually exclusive and having different recognition/measurement criteria might not be useful. It would also result in a confusing mixed-measurement basis for a single lease asset and liability which would not provide useful information to users.

81. Given the link between contingent rentals and RVGs, the staff see no reason for the boards to decide to choose a measurement approach different to the one chosen for contingent rentals.

82. Consequently, the staff recommend that the boards reconfirm their preliminary views, ie to account for RVGs in the same way as for contingent rentals.

83. The staff further note that, if the boards agree with the staff recommendation in Question 6, any changes in the obligation to pay rentals arising from a change in the amount payable under a RVG would be recognized in profit or loss. This is because a change in the amount payable under a residual value guarantee does not reflect the lessee buying more or less of the right-of-use asset.

Question 8

The staff recommend that residual value guarantees be measured in the same way as contingent rentals.

Do the boards agree with this staff recommendation?

Question 9

The staff recommend that changes in the obligation to pay rentals arising from a change in the amount payable under a RVG should be reflected through profit or loss.

Do the boards agree with this staff recommendation?