Project **Leases**

Topic **Lessor Accounting - Contingent Rentals**

Purpose of the paper

1. The leases discussion paper (DP), *Leases: Preliminary Views*, issued in March 2009, contained the boards' preliminary views of the accounting for contingent rentals for lessees. The purpose of this paper is to discuss the accounting for contingent rentals for lessors. It is identical to AP 5H/50 that was distributed to the boards in November. The accounting for residual value guarantees for lessors will be discussed at a future meeting.

2. This paper will discuss possible approaches to the accounting for contingent rentals for lessors, and will ask the board to reach a preliminary view on the accounting for contingent rentals for lessors.

3. The questions for consideration in this paper are, for the most part, the same as those in AP 4A/FASB Memo 50. Therefore, all of the arguments for and against all of the alternatives have not been repeated. Instead, the staff recommendations in this paper are similar to the staff recommendations in the lessee paper so as to achieve, to the extent possible, symmetry in the accounting by lessees and lessors. The rationale is that presumably the lessee's obligation to make rental payments should equal the lessor's right to receive rental payments. The staff note that the lessors will not have the same level of information as the lessee with regard to contingent rental arrangements; nevertheless, the staff recommend that the lessor estimate any contingent rental arrangements when measuring its lease receivable and performance obligation.

Background

4. Contingent rentals result in leases whose payments are variable rather than fixed. Lease contracts often contain payments that increase or decrease because of changes in factors occurring after the inception of the lease other than the passage of time. These are contingent rentals.

5. There are three main categories of contingent rentals:

   (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.

Recognition of contingent rentals

6. In the leases DP, the boards considered two approaches to the recognition of contingent rentals for lessees. Those approaches, updated for lessor consideration are:

   (a) follow existing lease accounting standards (generally recognise as an expense as incurred for lessees; recognize in income as accruable for lessors)

   (b) reflect the obligation to pay contingent rentals (for lessees) or the lease receivable (for lessors) in the measurement of the liability (for lessees) or in the measurement of the receivable (for lessors).

7. Under existing lease accounting standards for lessees, contingent rentals that are based on usage or the lessee's performance are generally excluded from the

calculation of minimum lease payments and are recognised as expenses in the period in which they are incurred. Contingent rentals that are based on an existing index are included in minimum lease payments on the basis of 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.

8. Under existing lease accounting standards for lessors, contingent rentals are not included in income until accruable. There is no distinction between different types of contingent rentals.

9. Supporters of the approach used in existing standards think that the lessor's right to receive contingent rental payments does not exist until the future event requiring the payment occurs (that is, the leased asset is used, a sale is made, or the level of the index changes). Consequently, they think that recognizing a receivable for contingent rentals before the contingency is resolved would overstate the revenues of the lessor. Instead of recognizing contingent rentals, there could be increased disclosures of contingent rental arrangements.

10. The boards' preliminary view for lessees in the leases DP is to include contingent rentals in the estimate of the expected lease payments. The argument for including those amounts for the lessor would be that the lessor has a right to the contingent payments; it is an unconditional right. The only uncertainty is in the measure of that right.

Staff Recommendation

11. The boards have tentatively concluded that the lessee should record assets and liabilities equal to the present value of its best estimate of the rentals that will actually be payable. From the lessor's perspective, the lessor has a receivable from the lessee of an uncertain amount. In principle, therefore, future rental variations should be taken into account when measuring the initial carrying values of the lease receivable and performance obligation.

12. Therefore, the staff recommends that the value of the lessor's receivable should reflect current contractual rentals as well as estimated contingent rentals. This

would also achieve symmetry in the accounting for contingent rentals between lessees and lessors.

13. The staff thinks that upon lease inception the lessor has an unconditional right to receive lease payments. The differences in the nature of the lease payments can be addressed through measurement.

14. It may be difficult for a lessor to estimate the contingent rentals, but the staff thinks that the leases with contingent rental arrangements are negotiated with some level of understanding as to where the payments may end up. Therefore, the best information for users of financial statements is to have an estimate of the expected lease payments reflected in the lessor's lease receivable and performance obligation.

Question 1
Do the boards agree with the staff recommendation that all contingent rentals should be recognized by the lessor?

Measurement of contingent rentals

15. In the DP, 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.

16. The staff thinks that it would be difficult for a lessor to determine the probability of each possible outcome of the contingent rental payments that it expects to receive from a lessee.

Staff recommendation

17. The staff recommends, consistent with its recommendation for lessees, that the lessor use an expected outcome technique to estimate the amount of rental payments that it will receive. However, that expected outcome technique will not have to consider every possible scenario.

Question 2
Do the boards agree with the staff recommendation that a lessor should use an expected outcome technique (without considering every possible scenario) to estimate the amount of rental payments that it will receive?

Reassessment of contingent rentals

18. The boards tentatively concluded in the leases DP that contingent rentals should be remeasured at each reporting date to reflect changes in estimated contingent rental payments.

19. Requiring remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rentals could impose a significant cost on preparers. In addition, requiring reassessment of the lease receivable would result in a more complex standard. However, requiring remeasurement of the expected rental payments is likely to provide users of financial statements with more relevant information because it reflects current conditions.

Staff recommendation

20. The staff thinks that requiring reassessment of the contingent rental payments would provide useful information. However, due to the costs involved, the staff recommends that contingent rental payments only be reassessed when there has been a change in any facts or circumstances that would indicate that there is a change to the lease receivable and performance obligation.

Question 3
Do the boards agree with the staff recommendation that a lessor should remeasure the lease receivable when there has been a change in any facts or circumstances that would indicate a material change in the measurement of the receivable and obligation?

Accounting for a change in the lease receivable

21. If the boards agree to require reassessment of the lease receivable for changes in estimated contingent rentals, the boards need to decide how to recognize the

resulting change in the estimated rental payments. Three possible approaches have been proposed by the staff:

(a) recognise any change in the receivable in profit or loss

(b) recognise any change in the receivable as an adjustment to the performance obligation

(c) adjust the performance obligation in circumstances where the change in contingency is requiring the lessor to allow additional usage of the leased item; otherwise recognize any changes in contingencies to profit or loss.

Staff recommendation

22. The staff recommends adjusting the performance obligation in circumstances where the change in contingency is requiring the lessor to allow additional usage of the leased item. For example, contingent rentals based on usage means that the lessor has to allow the lessee additional use of the leased item. In those circumstances, it would seem appropriate to increase the performance obligation of the lessor. The staff recommends that all other changes to estimates of contingent rentals be reflected in profit or loss. This recommendation is consistent with the recommendation for lessees in AP 3A/FASB Memorandum 50.

Question 4
Do the boards agree with the staff recommendation that a lessor should account for changes in the lease receivable for contingent rentals resulting from the lessor providing more of the use of the leased item should be adjusted to the performance obligation and all other changes in estimate should be reflected in profit or loss?