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Project **Leases**

Topic **Lessee accounting – Leases with options**

Purpose

1. Lease contracts often grant the lessee the right to:

   (a) extend the lease beyond the initial lease period; and

   (b) terminate the lease before the end of the lease period.

2. The purpose of this paper is to determine how to account for these types of lease under the proposed new accounting model for lessees. This paper does not address lessor accounting.

3. In this paper the staff recommend the following:

   (a) Uncertainty about the lease term should be dealt with through recognition (ie one of the possible lease terms is selected and the accounting is based on that term).

   (b) The recognised lease term should be the longest possible lease term that is more likely than not to occur.

   (c) In determining the lease term, the lessee should consider all relevant factors.

   (d) Options to renew a lease that are priced at market value at the date of renewal should be considered when determining the lease term.

   (e) The lease term should be reassessed at each reporting date.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

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(f) Changes to the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the right-of-use asset.

4. This paper is structured as follows:

   (a) a description of the approach to options proposed in the Leases discussion paper (DP);

   (b) a description of possible approaches to accounting for leases with options;

   (c) a discussion of the factors to consider when determining the lease term; and

   (d) a discussion of whether (and how) the lease term should be reassessed.

5. This paper does not deal with options to purchase the leased item. Leases that include options to purchase the leased item will be discussed at a future meeting.

The DP approach to options

6. The boards' preliminary views on how to account for leases with options were as follows:

   (a) Uncertainty about the lease term should be addressed through recognition (ie one of the possible lease terms is selected and the accounting is based on that lease term).

   (b) The assets and liabilities recognised by the lessee should be based upon the most likely lease term. This assessment should be based upon contractual, non-contractual and business factors

   (c) The lease term should be reassessed at each reporting date.

   (d) Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Possible approaches to options

7. The following sections summarise four main approaches to the treatment of options, and the advantages and disadvantages of each. The four approaches considered are:

   (a) the components approach;

   (b) the disclosure approach;

   (c) the measurement approach; and

   (d) the recognition approach.

8. To illustrate each of these approaches we will use the following example:

> Example 1
>
> A machine is leased for a period of 10 years (the primary period). The lease contract includes an option for the lessee to lease the machine for an additional five years (the secondary period).
>
> Annual rentals in both periods are CU100.

The components approach

Description of the approach

9. Under a components approach, the lessee would recognise and measure each of the rights and obligations in a lease separately. So, for the lease in example 1, the lessee would recognise:

   (a) a right to use the leased item (right-of-use asset) for 10 years;

   (b) an option to extend the lease; and

   (c) an obligation to pay rentals (this would include both the payment for the right-of-use asset and the option).

10. Possible approaches to initial and subsequent measurement of the option would need to be discussed and are summarised in the following table:

	Initial measurement	Subsequent measurement
Possible approaches	• Fair value • Intrinsic value • Cost	• Fair value • Intrinsic value • Carrying amount at initial measurement less impairment

Advantages and disadvantages of the approach

11. The following table summarises the advantages and disadvantages of the components approach:

Advantages	Disadvantages
• Consistent with the framework if the unit of account is considered to be the individual components of the lease contract • Arguably the most transparent approach because options are separately recognised, so their existence will be more apparent to users.	• May be difficult to reliably measure the options. There is usually no market for options of this type and they are not normally priced separately from the lease contract. Measurement is complicated by the fact that, unlike many financial options, the assets underlying options to extend or terminate a lease are often specialised, and may not be exercisable until a long way in the future (eg 20 years in some real estate leases) • Complex for preparers (many preparer respondents believe the costs would outweigh the benefits) • Ignores the interrelationship between the components of a lease. For example, a lease may include an option to extend, an option to purchase

Advantages	Disadvantages
	and a residual value guarantee; and payments under the residual value guarantee are made only if the lessee does not exercise one of its options. Recognising a liability in respect of a residual value guarantee may not provide useful information to users if the lessee is likely to exercise its purchase option or extend the lease. • Unless all the components are measured on the same basis (eg fair value) the recorded asset and liability can be minimized through structuring. • May not provide useful information, because out of the money options may be exercised, and in the money options could be allowed to lapse for entity-specific reasons.

12. In developing preliminary views for the discussion paper, the boards deliberated whether to require lessees to recognise and measure separately options to extend or terminate a lease. If the rights and obligations arising in a lease of this type are separated into components and analysed individually, it is possible to conclude that options to extend or terminate the lease meet the definition of an asset. Many board members stated that they think this components approach is the conceptually-correct approach.

13. However, following discussion with the leases working group, the boards concluded that a components approach would be difficult to apply and might not provide users with better information than other approaches. Consequently, the

boards tentatively decided not to adopt a components approach for the reasons summarised in the table above.

14. More than half of the respondents to the discussion paper who commented on this issue supported the boards' decision not to adopt a components approach to leases. Those respondents noted that the components approach would be complex and costly to apply. Only two users commented on this issue. One stated that they would have preferred to see options recognised separately and measured at fair value but accepted that this may be impractical. The other user agreed with the boards' decision not to adopt a components approach.

> We do not see these items as having a value separate from the lease. Although we are not preparers, we see the difficulties they might have in applying a components approach and the introduction of increased subjectivity in separately valuing each option.
>
> We wish to emphasise the importance of disclosures about the nature of options and similar arrangements and their potential to meaningfully alter the cash flows related to a lease. (CL #199)

Staff recommendation

15. The staff continue to think that a components approach to leases with options would be difficult to implement and might not provide any more useful information to users of financial statements than other approaches that are easier to apply. Consequently, we do not recommend the components approach.

The disclosure approach

Description of the approach

16. Under this approach, options would not be recognised separately. Instead, uncertainty about the lease term would be addressed through disclosures. The lessee would recognise an obligation to pay rentals for the *minimum* contractual term, and disclose the existence of any options. For the lease in example 1, the lessee would:

(a) recognise a right to use the leased item (right-of-use asset) for 10 years;

(b) an obligation to pay rentals for 10 years; and

(c) disclose the existence of the option to extend the lease.

Advantages and disadvantages of the approach

17. The following table summarises the advantages and disadvantages of this approach:

Advantages	**Disadvantages**
• Avoids many of the measurement problems of the other approaches • Simple to apply	• Options are neither recognised nor measured • Recorded asset and liability can be minimised through structuring • For lessees with a high volume of leases, the disclosures are likely to be lengthy, complex and difficult to understand.

18. Some preparer respondents to the discussion paper expressed support for a disclosure approach to leases with options. They stated that this approach would be easy for preparers to apply. They noted that the liability initially recognised under this approach reflects the lessee’s contractual obligation to make payments, whereas the boards’ proposed approach results in the recognition of a liability for payments that could potentially be avoided.

Staff recommendation

19. The staff do not think that a disclosure-based approach would result in an improvement to the existing accounting requirements for leases because:

(a) Leases could be structured to minimise the recognised liability.

(b) The disclosures for any entity with significant leasing activities would be lengthy and complex.

20. In addition the staff note that the boards' frameworks state that disclosures do not rectify a failure to recognise assets and liabilities that meet the boards' recognition criteria. Consequently, we do not recommend a disclosure approach.

The measurement approach

Description of the approach

21. Under this approach, options would not be recognised separately. Instead, uncertainty about the lease term would be dealt with in the measurement of the obligation to pay rentals. If there is an 80 per cent probability that the option to extend the lease in example 1 will be exercised, the lessee would recognise (ignoring the effects of discounting and assuming an expected outcome approach to measurement):

(a) a right to use the leased item (right-of-use asset) initially measured at CU1,400 (20% × CU100 × 10 years + 80% × CU100 × 15 years); and.

(b) an obligation to pay rentals initially measured at CU1,400 (20% × CU100 × 10 years + 80% × CU100 × 15 years).

Advantages and disadvantages of the approach

22. The following table summarises the advantages and disadvantages of this approach:

Advantages	**Disadvantages**
• Consistent with the *Framework* if the unit of account is considered to be a lease contract that gives rise to a single asset and liability • Existence of the option is reflected in both initial and subsequent measurement. • No need to differentiate between	• May be difficult to reliably measure the probability of exercise of an option • Boards will need to agree on the basis for measurement (best estimate vs. probability-weighted approach to measurement). • If a probability-weighted

Advantages	**Disadvantages**
options to renew and options to terminate • Takes account of entity-specific factors that might influence whether the option is exercised.	measurement of the obligation is used, the recognised liability may not reflect a possible outcome.

23. Before publication of the DP, the boards had discussed adopting a measurement approach to leases with options. However, the boards rejected this approach for the reasons listed in the table above.

24. Some respondents to the discussion paper expressed support for a measurement approach to options. However, most of those who commented stated that a measurement approach would add unnecessary complexity to the leases standard. They added that the boards' proposed approach (recognise the uncertainty through recognition) would provide more relevant information to users of financial statements than a probability-weighted measurement approach, because it would reflect only possible outcomes.

Staff recommendation

25. The staff also think that a measurement approach would be complex to apply and might not provide more useful information than other possible approaches (eg a recognition approach). Consequently, we do not recommend this approach.

The recognition approach

Description of the approach

26. Under this approach, options would not be recognised separately. Instead, uncertainty about the lease term is addressed through recognition – ie one of the possible lease terms is selected, and the accounting is based on that lease term. So, for the lease in example 1, the lessee would recognise:

(a) a right to use the leased item (right-of-use asset) for either 10 years or 15 years; and

(b) an obligation to pay rentals for either 10 years or 15 years.

27. In the discussion paper, the boards tentatively decided that the recognised asset and liability should be based upon the most likely lease term.

Advantages and disadvantages of the approach

28. The following table summarises the advantages and disadvantages of this approach:

Advantages	**Disadvantages**
• Avoids measurement reliability problems of components or measurement approach • Only possible outcomes are recognised and measured • May be simpler to apply than the components or measurement approach • No need to differentiate between options to renew and options to terminate • Takes account of entity-specific factors that might influence whether the option is exercised.	• Arguably inconsistent with the *Framework* • Option is ignored if exercise is not the most likely outcome • Fails to differentiate between a 10-year lease that is likely to be renewed for an additional 5 years and a non-cancellable 15-year lease • Difficult to apply to leases where the outcome is uncertain (eg probability of exercise is 50%) – could result in frequent remeasurements of the recognised asset and liability.

29. The boards tentatively decided to adopt this approach to options because it avoids many of the measurement problems associated with either the components approach or the measurement approach. The boards thought that this approach would be a pragmatic solution to the problem of leases with options that would nevertheless provide useful information to users.

30. Respondents to the boards' preliminary views held mixed views. Some agreed with the board that this is a practical solution to the problems associated with determining the lease term. They noted that this approach would be easier to apply than the alternative approaches considered by the boards.

31. Opponents of this approach stated that basing the obligation to pay rentals on the most likely lease term results in the recognition of a liability that does not meet the boards' definition of a liability. Some of those who opposed the recognition approach to options on these grounds suggested using the disclosure approach for options. As discussed above, very few supported either the components or measurement approach.

Staff recommendation

32. The staff acknowledge that the recognition approach to options results in the recognition of a liability that may include amounts that the lessee can avoid paying (ie payments during optional periods). However, as noted some respondents, if optional periods are excluded from the recognised assets and liabilities, the right-of-use asset may be understated.

33. The staff continue to think that the recognition approach is the only practical solution to the problem of leases with options. All other approaches considered either create significant structuring opportunities (the disclosure approach) or are difficult and complex to apply (the components and measurement approaches). Consequently, we recommend that the boards adopt a recognition approach to leases with options.

Question 1
The staff recommend that that uncertainty about the lease term should be dealt with through recognition (the recognition approach). Do the boards agree?

Recognition criteria

34. Many respondents to the discussion paper argued that determining the most likely lease term would be highly subjective.

35. Some respondents suggested alternative recognition criteria for determining the lease term, namely:

   (a) The contractual minimum lease term plus any optional periods that are reasonably certain to be exercised (the approach in the existing standards).

   (b) The contractual minimum lease term plus any optional periods, if the lease is priced to provide an incentive to exercise the right to use in the optional periods. Incentives could include: bargain renewals, residual value guarantees, and termination penalties.

   (c) The longest possible lease term that is more likely than not to occur (example 2 illustrates the difference between this and the most likely lease term).

Example 2

A lessee enters into a five-year lease of a machine. The lease includes an option to terminate the lease at the end of each year.

The probabilities of each of the lease terms are assessed as follows:

Term(x)	**Probability**	**Probability term is at least x years**
1 Year	35%	100%
2 Years	5%	65%
3 Years	5%	60%
4 Years	30%	55%
5 Years	25%	25%

The most likely lease term is 1 year (the term with the highest probability).

The single longest term that is more likely than not to occur is 4 years.

36. The following table summarises the advantages and disadvantages of these alternative recognition criteria compared to using the most likely lease term:

Recognition criteria	**Advantages**	**Disadvantages**
(a) Contractual minimum term + reasonably certain optional periods	• Remeasurements of the recognised asset and liability will be less frequent than under the most likely lease term approach • Familiar to users and preparers as it is similar to the approach in the existing standards	• Recorded asset and liability can be minimised through structuring (for example, in example 2 none of the optional periods would be considered reasonably certain) • May not provide most relevant information because it ignores options that are likely (but not reasonably certain) to be exercised
(b) Contractual minimum term + optional periods that are priced to give an incentive to renew	• Remeasurements of the recognised asset and liability will be less frequent than under the most likely lease term approach (may not be needed at all)	• May need to give detailed guidance on what constitutes an incentive • May not provide most relevant information as it ignores options that are likely to be exercised because of factors not included in the pricing (eg leasehold improvements, or the specialised nature of the asset)

Recognition criteria	**Advantages**	**Disadvantages**
(c) The longest possible lease term that is more likely than not to occur	• Works well for leases with multiple options	• Difficult to articulate relative to the other criteria

Staff recommendation

37. The staff think that the lease term should reflect the lessee's reasonable expectation[1] of what the actual term will be. We think that was the intention of the boards when they tentatively decided to use the most likely lease term as the recognition criteria. However, in statistics the phrase 'most likely' means the outcome that has the highest probability of occurring. As illustrated in example 2, this can result in a recognised lease term that does not reflect the lessee's reasonable expectation of the actual outcome when the lease includes multiple options. Consequently, we recommend that the recognised lease term should be the longest possible term that is more likely than not to occur. We would propose to include wording in the ED that clarifies that the intention of this approach is to establish the lessee's reasonable expectation of what the actual lease term will be.

Question 2
The staff recommend that the recognised lease term should be the longest possible term that is more likely than not to occur. Do the boards agree?

[1] We have not used the term 'best estimate' because it has a specific meaning in IAS 37.

Factors to consider when determining the lease term

38. Options to extend or terminate a lease are very different from some financial options (eg an option to buy or sell foreign currency or an option to buy or sell an equity instrument). For such financial options, the decision whether to exercise the option depends solely on the exercise price of the option, but whether a lessee exercises an option to extend or terminate a lease may also depend on additional factors. The following table summarises some of the factors that could affect the lease term:

Category	**Description**	**Examples**
Contractual factors	Explicit contractual terms that could affect whether 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) • Location of the asset • Industry practice

Lessee specific factors	Lessee specific considerations	• Lessee intentions • Past practice

39. For the purpose of the discussion paper, the boards decided that contractual, non-contractual and business factors should be considered in determining the lease term. However, the lessee's intentions and past practice would not be considered.

40. Some respondents to the discussion paper commented on this decision. They stated that all relevant facts should be considered in determining the lease term. They noted that the lessee intention and past practice could provide evidence to support the decision about lease term.

> [Respondent] considers that it is meaningless to require a leased asset to be recorded for a period beyond which the lessee has no intention of holding the asset. Accordingly, [respondent] believes that a combination of contractual, non-contractual, business, past practice and lessee intention factors should be assessed when determining the lease term, with the past practice and lessee intention factors being backed up by supporting evidence. (CL #34)

41. The staff agree with these respondents. Ignoring lessee intentions or past practice could result in the wrong lease term being recognised. Consequently, we recommend that in determining the lease term the lessee should consider all relevant factors.

Question 3
We recommend that in determining the lease term the lessee should consider all relevant factors. Do the boards agree?

Treatment of market rent options

42. Some lease contracts include an option to extend the lease at a market rent. Under these leases, the lessee has the right to extend the lease if they agree to pay the lessor the market rent for the asset at the date of exercise of the option.

43. Some constituents have argued that options of this type should be ignored when determining the lease term. They note that:

(a) options of this type are unlikely to have significant value to the lessee because the lessee could obtain a similar lease in the market.

(b) it can be difficult to assess whether an option to extend a lease at market rates will be exercised and, if it is exercised, what the market rent will be on the option exercise date. Ignoring options of this type would simplify the proposed accounting.

(c) the lessee is in a similar economic position to a lessee with no option to extend, because in most cases the lessee would be able to renew a lease at a market rent.

(d) while the option may be ignored when determining lease term, the cost of the option is incorporated into the initial measurement of the right-of-use asset and the obligation to pay rentals.

(e) in some countries, lessees are granted a statutory right to renew a lease at a market rent. From a theoretical point of view, there is no reason why statutory rights of this type should not be treated in the same way as contractual rights. Consequently, if market rate options are not ignored, lessees would potentially have to look beyond the contractual terms of the lease to determine the lease term.

44. However, the staff note that some leases that include a market rent option may be likely to be renewed. For example, if the lease is of a specialised property or if the lessee has undertaken significant leasehold improvements whose useful life extends beyond the lease term, the lessee would be likely to renew. Ignoring market rent options when it is likely that they will be exercised would lead to the recognition of assets and liabilities that do not reflect the lessee's reasonable expectation of the likely lease term. This is inconsistent with our proposed approach to options.

45. Consequently, the staff think that options to renew at a market rent should be considered when determining the lease term. We note that this would mean that statutory rights to renew a lease at market value would need to be considered when determining the lease term.

Question 4
The staff recommend that an option to renew at a market rent should be considered when determining the lease term. Do the boards agree?

Reassessment of lease term

46. In developing the DP, the boards discussed whether to require reassessment of the lease term. The boards noted that requiring the lessee to reassess the lease term at each reporting date is likely to provide users of financial statements with more relevant information. Lease terms, particularly in real estate leases, can be very long. Using a lease term that is based on assumptions made several years before could be misleading. Consequently, the boards tentatively decided to require reassessment of the lease term at each reporting date.

47. The majority of respondents who commented on this issue agreed with the boards' tentative decision to require reassessment. However, some respondents expressed concern about the potential costs of this requirement. They noted that in some situations a lessee could have several thousand leases that would (potentially) need to be reassessed on a quarterly basis.

> …reassessment at each reporting date would not be practical, especially where an entity has a large number of leases for small value items. We believe a reassessment should be triggered where there are obvious indicators of a significant change in the lease term. (CL #248)

48. The staff continue to think that requiring reassessment of the lease term at each reporting date would provide relevant information to users. Consequently, we recommend that the boards retain this requirement. However we think that the exposure draft should state that a detailed examination of every lease is not required unless there has been a change in facts of circumstances that would indicate that the lease term may need to be revised.

Question 5
The staff recommend that the lease term should be reassessed at each reporting date. However, the exposure draft should state that a detailed examination of every lease is not required unless there has been a change in facts of circumstances that would indicate that the lease term may need to be revised. Do the boards agree?

Accounting for the reassessment

49. Requiring the lessee to reassess the lease term at each reporting date will result in a change in the carrying amount of the obligation to pay rentals. The boards previously discussed three ways to account for a change in the obligation to pay rentals arising from a reassessment of the lease term:

    (a) recognise any change in the liability in profit or loss;

    (b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset; or

    (c) require the lessee to recalculate both the obligation to pay rentals and the right-of-use asset on the assumption that the lessee originally recognised a lease term equal to the reassessed term. The net difference between:

        (i) the carrying amounts of the asset and liability on the date of reassessment, and

        (ii) what the carrying amounts would have been had the lessee originally assessed the lease term as the reassessed term

        would result in adjustments to the asset, liability and profit or loss.

50. The boards tentatively decided to recognise changes in the obligation to pay rentals arising from a reassessment of the lease term as an adjustment to the carrying amount of the right-of-use asset.

51. The staff note that on exercising an option to extend a lease, the lessee acquires more rights to use the underlying leased item. Similarly, if a lessee chooses to terminate a lease, it acquires less of the rights to use the leased item. Consequently, the staff continue to think that reassessment of the lease term should result in a change in the carrying amount of the right-of-use asset. The staff do not support approach (c) above because we think that it will be difficult to apply.

Question 6
The staff think that changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset. Do the boards agree?