Project **Leases**

Topic **Lessor accounting – Options to extend or terminate a lease**

Purpose of the paper

1. Lease contracts often grant the lessee the right (but not the obligation) to:

    (a) extend the lease beyond the initial lease period

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

2. The purpose of this paper is to assist the boards in their deliberations on decisions on lessor accounting for options held by the lessee to extend or terminate a lease.

3. The paper summarizes possible approaches to lessor accounting for leases with options to extend or terminate the lease term and discusses the advantages and disadvantages of each approach. These approaches are compared to the boards' decisions on lessee accounting for leases with options to extend or terminate the lease term. For the purposes of this paper, the staff ignores options to purchase the underlying leased item. These options are linked to the issue of in-substance purchases/sales, which will be discussed separately.

4. The remainder of this paper is structured as follows:

    (a) Background providing a summary of the decisions made by the boards to date on lessor accounting and a summary of the approach to lessee accounting for leases with options adopted in the Leases Discussion Paper (DP), including a brief summary of respondents' views on the proposed approach

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(b) A description of the possible approaches to lessor accounting for leases with options, including the advantages and disadvantages of each of those approaches.

5. The staff recommends the following:

   (a) The approach for lessors to account for lease options should be symmetrical to the approach for lessees to account for lease options; that is, the lessor approach to lease options should be the longest lease term more likely than not to occur. Symmetry between the lessee and the lessor is considered important so that the obligation recognized by the lessee is similar to the right to receive rentals recognized by the lessor.

   (b) The lease term should be reassessed at each reporting date on the basis of any new facts or circumstances.

   (c) Any resulting change to the lease receivable should be recognized as an adjustment to the performance obligation.

      (i) However, in the period of reassessment some staff would charge to income any overstatement of previously recognized revenue resulting from a decrease in the lease term.

Background

6. The boards have previously decided that the lessor's right to lease payments constitutes an asset and should be recognised as a lease receivable. This decision was supported by almost all the respondents to the DP who commented on the issue. This paper assumes the lessor records a lease receivable upon inception of a lease.

7. The boards have previously made a tentative decision that a lessor would record a performance obligation at the inception of the lease. Also, the boards have tentatively decided that a lessor would not be permitted to recognize revenue at the inception of the lease.

Approach adopted in the Discussion Paper

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

   (a) Uncertainty about the lease term should be addressed through recognition (that is, 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.

   (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.

9. Respondents' views on the proposed approach to lessee accounting for options were mixed. Some viewed the proposed approach as a practical solution to the problems associated with determining the lease term. These respondents noted that the proposed approach is easier to apply than the alternative approaches considered by the boards. See Agenda Paper 5D/FASB Memo 49 for further detail regarding respondent views on lessee accounting for options.

10. As specific questions with regards to lessor accounting for term options were not posed in the DP, respondents did not express a view on the impact of the preliminary view on lease term as it related to the accounting by the lessor.

Possible approaches for lessor accounting for options

11. The following sections summarise four main approaches to the treatment of options, namely:

    (a) the components approach

    (b) the disclosure approach

    (c) the measurement approach

(d) the recognition approach.

12. To illustrate each of those approaches the staff will use the following example:

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

The components approach

13. Under the components approach, the lessor would recognise and measure each of the rights and obligations in a lease separately. For the lease in example 1, the lessor would recognise:

    (a) a receivable for 10 years, with a corresponding performance obligation

    (b) the value attributed to the lessee's option to extend the lease

14. The boards considered the components approach during deliberations on lessee accounting and rejected the approach due to its complexity. The staff notes that application of components approach to lessor accounting would be equally complex.

15. Moreover, there was limited support for the components approach amongst the comment letter respondents and members of the leases working group. The reason most often cited was the complexity of the approach, especially given the lack of the market for lease options and the interrelatedness of certain lease options.

The disclosure approach

16. Under the disclosure approach, options would not be recognised. Instead, uncertainty about the lease term would be addressed through disclosures. The lessor would recognise a receivable for the minimum contractual term and disclose the existence of any options. For the lease in example 1, the lessor would:

(a) recognise a receivable for 10 years, with a corresponding performance obligation

(b) disclose the existence of the lessee's option to extend the lease.

17. An argument for this approach is that it avoids including any periods covered by term options into the receivable and performance obligation. The inclusion of such periods would result in the recognition of revenue in subsequent periods, both through the accretion of interest on the receivable and the amortization of the performance obligation, although the option itself has yet to be exercised. The lessor has no contractual right to the cash flows associated with a receivable outside of those cash flows representing the contractual minimum lease payments; as such, some would argue that no revenue should be recognized for payments other than the contractual minimum lease payments.

18. This approach is closest to current lessor accounting rules for term extensions, which are only recorded when the lessee exercises its option to extend the lease. Also note that the disclosure approach is simple to apply because it does not require the subjectivity demanded by the measurement and recognition approaches.

19. An argument against this approach is that it does not record the impact of options on the face of the financial statements until they are exercised. Given that certain options may be priced such that their exercise is likely to occur, some would contend that the lease payments related to such optional periods should be included in the balances of the receivable and performance obligation.

20. This approach also could allow for structuring opportunities that may result in the lessor recording a lower performance obligation. For instance, a lessor may choose to structure a lease with a one-year minimum term followed by nine one-year extension options (with each option priced such that the lessee would be likely to exercise it), as opposed to a 10-year lease.

21. Further, a lessor with a high volume of leases subject to term options would likely disclose aggregated data that may not be useful to users of the financial statements.

The measurement approach

22. Under the measurement approach, options would not be recognised separately. Instead, uncertainty about the lease term would be addressed through the measurement of the lease receivable. For the lease in example 1 (ignoring the effects of discounting and assuming an expected outcome approach to measurement), the lessor would recognise a lease receivable initially measured at CU1400 (20% x CU100 x 10 years + 80% x CU100 x 15 years).

23. This approach will likely not result in a possible outcome because the various terms are probability weighted. Further, it would be difficult to reliably measure the probability of a lessee's exercise of an option. For these reasons, the boards did not advocate the measurement approach for lessees in the DP, nor did there appear to be considerable support from respondents and working group members. These disadvantages are consistent when evaluating the lessor's accounting for lease term options. As such, the staff does not recommend the measurement approach.

The recognition approach

24. Under the recognition approach, options would not be recognised separately. Instead, uncertainty about the lease term is addressed through recognition. That is, one of the possible lease terms is selected and the accounting is based on that lease term. For the lease in example 1, the lessor would recognise a receivable representing the lease payments for either 10 years or 15 years, and a corresponding performance obligation.

25. This approach is the boards' preliminary views in the DP for lessee accounting. The staff recommends a recognition approach for lessor accounting because it relates to lease term options as well.

26. The boards tentatively concluded in the DP that contractual, non-contractual, and business factors are considered in the lessee's determination of the lease term.

27. The boards preliminarily concluded in the DP that lessee intent and past experience—information that is available to the lessee but not to the lessor—

were not to be considered in the determination of the most likely lease term. This requirement would potentially enhance symmetry between lessee and lessor accounting. However, the information used by the lessor to consider the likelihood of a lessee's exercise of a termination or extension option is not guaranteed to be the same information as that used by the lessee. Moreover, even if the information were perfectly identical, such information could be interpreted differently by the lessor and the lessee.

28. Since the initial conclusion in the DP, the staff has recommended that lessee's intent and past experience should be used in making the lease term assessment. The staff now recommends that all relevant factors should be used in making the lease term assessment. The staff acknowledges that requiring a lessor and a lessee to consider all relevant factors when determining the lease term could result in differences, because the lessor may have different information or expectations than the lessee with regards to the lessee's intent and past experience.

29. In Agenda Paper 5D/FASB Memo 49, the staff recommends that the boards adopt the recognition approach to lessee accounting for options in which the lease term is determined as the single longest term that is more likely than not to occur. A symmetrical approach could be adopted for lessor accounting for options. Such an approach would be desirable because it would result in the lessor's initial measurement of its lease receivable and the lessee's initial measurement of its obligation to make lease payments to be theoretically identical.

30. Alternatively, the lease receivable recognized by the lessor could be based on either of the following:

    (a) the contractual minimum lease term plus any optional periods that meet a probability threshold; for example, lease options in which exercisability is:

        (i) virtually certain

        (ii) reasonably certain (the approach in current lease guidance)

(iii) probable

(iv) more likely than not.

(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 (this also is part of the approach in current lease guidance).

31. The staff does not recommend that the boards adopt any of the alternative recognition approaches in the previous paragraph. The staff notes that there is no conceptually correct probability threshold that should be applied in determining the lease term. Each of the alternative approaches described above can be argued to be a reasonable way to draw the line between including an optional period in a lease term and excluding it.

32. The staff also thinks that the components approach and measurement approach are difficult to apply. While the disclosure approach has some merit, the staff thinks the disclosure approach does not appropriately capture the impact of the probability that the lessee will exercise its lease term options.

Staff recommendation

33. Although the staff acknowledges that the recognition approach allows a lessor to record a receivable that includes payments for periods in which the lessee can avoid payment, the staff recommends an approach to lessor accounting for options that are symmetrical with lessee accounting – the recognition approach with the lease receivable based on the "longest term more likely than not to occur," so that the lessor's right to rental payments is more aligned with the lessee's obligation to make rental payments.

Question 1
The staff recommends that the lessor accounting for term options be symmetrical with lessee accounting for term options; that is, the lessor would recognize a lease receivable based on the "longest term more likely than not to occur." Do the boards agree with the staff recommendation?

Reassessment of lease term

34. In Agenda Paper 5D/FASB Memo 49, the staff recommends that the lease term should be reassessed by the lessee at each reporting date. The primary reasons cited also apply to lessor accounting for options, namely:

    (a) It is likely to provide users of financial statements with more relevant information.

    (b) Using lease terms initially established at initial recognition could be misleading.

35. Reassessment of the lease term could be costly to preparers; particularly in situations in which the lessor has several thousand leases with various renewal options.

36. However, reassessment of the lease term would alleviate the concern of some that the recognition approach overstates revenue by allowing revenue to be recognized that is associated with periods covered by options that have yet to be exercised. As soon as the lessor is aware of facts and circumstances that would indicate that those options will not be exercised, then the receivable and the performance obligation would be remeasured accordingly.

37. Some think it would be costly to require the lessor to reassess the lease term at each reporting date, especially considering that the lessor has access to less transparent information as compared to that of the lessee (because the lessee holds the option to terminate/extend, not the lessor).

Staff recommendation

38. The staff recommends reassessment at each reporting date if there has been a change in facts or circumstances.

Question 2
The staff recommends that the lessor be required to reassess the lease term 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 and circumstances that would indicate that the lease term may need to be revised.

Do the boards agree with the staff recommendation?

Accounting for the reassessment

39. Requiring the lessor to reassess the lease term at each reporting date will result in a change in the carrying value of the lease receivable. The staff notes the following ways to account for the changes in that balance:

    (a) recognize any change in the lease receivable in profit or loss

    (b) recognize any change in the lease receivable as an adjustment to the carrying value of the performance obligation (that is, any increase or decrease in the lease receivable will decrease or increase the performance obligation by the same amount).

    (c) require the lessor to recalculate both the lease receivable and the performance obligation on the assumption that the lessor originally recognized a lease term equal to the reassessed lease term, with the net difference going to profit and loss.

    (d) profits in approach (c) above should be deferred and amortized over the remaining lease term.

40. Note that in Agenda Paper 5D/FASB Memo 49, the staff recommends that lessees recognize changes in its 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. The staff also considered an approach for lessees that would require a cumulative adjustment to adjust both the right-of-use asset and obligation to pay rentals to what they would have been had the lessee recognized a lease term that was equal to the reassessed lease term. However, this approach was not recommended because it was deemed difficult to apply.

41. An approach that remeasures the lease receivable upon reassessment of the lease term and results in the corresponding adjustment to the performance obligation would be consistent with lessee accounting. That is, subsequent measurement of the lessee's obligation to pay rentals and the lessor's lease receivable would be

symmetrical, with neither the lessee nor lessor recording any impact to profit and loss (approach (b) above).

42. The staff notes that the lessor records revenue from the lease transaction rather than expense. As noted previously, one of the criticisms of the recognition approach is that measurement of the lease includes rental payments related to periods covered by unexercised term options. Revenue associated with renewal options could be recognized during the initial contractual lease term, for example in situations of escalating rents. In those situations, if the lease term were reduced upon reassessment, there is an argument that the revenue associated with renewal options that was initially recognized should be reversed or charged to earnings in that period.

43. Some staff members think that in those situations in which revenue has been overstated because of a reassessment of the lease term, that amount should be charged to earnings in the current period.

44. However, those staff members think this same approach would not be appropriate when the lease term is increased upon reassessment because it would result in a gain. Allowing the recognition of such gains upon reassessment may lead to abuse, especially given the subjectivity of the reassessment. If the lease term were increased, those staff members would increase the performance obligation.

Staff recommendation

45. The staff recommends that any change in the lease receivable resulting from a reassessment of the lease term should be recorded as an adjustment to the performance obligation (view (b) above).

46. In addition, some staff members recommend that if a change in the lease receivable resulting from a decrease in the lease term results in an overstatement of previously recognized revenue, then that revenue should be charged to earnings is the current period.

Question 3

The staff recommends that any change in the lease receivable resulting from a reassessment of the lease term should be recorded as an adjustment to the performance obligation.

In addition, some staff members recommend that if a change in the lease receivable resulting from a decrease in the lease term results in an overstatement of previously recognized revenue, then that revenue should be charged to earnings is the current period.

Which alternative do the boards support?