Project **Leases**

Topic **Lessor Accounting for Purchase Options**

Purpose of paper

1. The purpose of this paper is to discuss the accounting for purchase options by lessors (under the performance obligation approach to lessor accounting).

2. The staff will include an analysis of the accounting for purchase options by lessors under a derecognition approach to lessor accounting in a future memo.

3. The staff recommends that purchase options be accounted for by lessors the same way that lessors account for options to renew or terminate a lease. That is,

   (a) The accounting by lessors for purchase options would be symmetrical with the accounting by lessees for those options, noting that symmetry might not result in the same measurement of lease payments by the lessee and the lessor.

   (b) A lessor's receivable and performance obligation should be recognized based on the lease payments that would be received over the lease term. The recognized lease term would be the longest possible lease term that is more likely than not to occur.

   (c) The lease term would be reassessed at each reporting date. Detailed examination of every lease would not be required unless there is a change in facts or circumstances that would indicate that the lease term may need to be revised.

(d) Any change to the lease receivable resulting from a reassessment of the lease term would be recognized as an adjustment to the performance obligation.

(e) The lessor's discount rate would not be revised when there are subsequent changes in the expected lease term.

4. This paper is structured as follows:

(a) Background

(b) Staff Analysis and Recommendation.

Background

5. Purchase options give the lessee the option to purchase the leased item on or after a specified date. The exercise price of the option may be at a bargain price, at another fixed price, or at fair value.

6. The Discussion Paper, *Leases: Preliminary Views* (DP), was published without any preliminary views on a lessor's accounting for purchase options.

7. However, the boards have made a tentative decision on purchase options for lessees. The boards tentatively decided that purchase options can be viewed as the ultimate renewal option. Therefore, the boards tentatively decided that the accounting requirements for purchase options should be the same as for options to extend or terminate the lease. Therefore, for lessees, the boards tentatively decided that:

(a) Purchase options should not be recognized as separate assets.

(b) In recognizing the obligation to pay rentals, the lessee must decide whether it is likely that an option to purchase will be exercised. If the lessee decides that the option to purchase is likely to be exercised, the obligation to pay rentals will include the exercise price of the option.

(c) The assessment of the lease term will be based on the lessee's determination of the longest possible lease term that is more likely than not to occur.

(d) In deciding the lease term that is more likely than not to occur, the lessee will consider all relevant factors.

(e) Whether a purchase option will be exercised will be reassessed at each reporting date.

(f) Changes in the obligation to pay rentals arising from reassessing whether a purchase option will be exercised should result in a change in the carrying amount of the right-of-use asset.

8. For example, assume that a lease contract has a 10-year term and the lease contract permits the lessee to purchase the leased asset for a fixed price, to return the leased asset to the lessor, or to extend the lease for an additional five years at the end of the 10-year lease term. The lessee would determine at the start of the lease which of the three outcomes (purchase, return, or extend) is more likely than not to occur and would recognize an obligation to pay rentals that is consistent with that outcome. For example,

(a) If purchase is the outcome more likely than not to occur, the lessee would recognize an obligation to pay rentals equal to the present value of 10 years of rentals plus the present value of the exercise price of the purchase option. The right-of-use asset would be amortized over the useful life of the underlying asset.

(b) If returning the asset is the outcome more likely than not to occur, the lessee would recognize an obligation to pay rentals equal to the present value of 10 years of rentals.

(c) If renewal is the outcome more likely than not to occur, the lessee would recognize an obligation to pay rentals equal to the present value of 15 years of rentals.

9. A reassessment of which of the three outcomes is more likely than not to occur would be made at the end of each reporting period on the basis of any new facts or circumstances.

10. The staff note that the Boards have tentatively decided that a contract would be treated as a purchase or sale if at the end of the contract the contract transfers (a) control of the underlying asset or (b) all but a trivial amount of the risks and benefits associated with the underlying asset. Therefore, a contract with a bargain purchase option (if it is reasonably certain that the option will be exercised) would be treated as a sale rather than a lease. If it is determined at contract inception that the contract is a sale of the underlying asset because of a bargain purchase option, the contract would not be subsequently reassessed.

Staff Analysis and Recommendation

11. The Boards have tentatively decided that the lessor's accounting for options to extend or terminate a lease should be symmetrical with the lessee's accounting for those options. However, the Boards noted that the objective of symmetry may not result in the same measurement of lease payments by the lessee and the lessor.

12. The staff recommends that, because the proposed model currently views purchase options as the ultimate renewal option, purchase options be accounted for by lessors in the same way as lessors account for renewal or termination options.

Lease Receivable

13. For example, assume that a lease contract has a 10-year term and the lease contract permits the lessee to purchase the leased asset for a fixed price, to return the leased asset to the lessor, or to extend the lease for an additional five years at the end of the 10-year lease term. The lessor would determine at the start of the lease which of the three outcomes (purchase, return, or extend) is more likely

than not to occur and would recognize a lease receivable that is consistent with that outcome. For example,

(a) If purchase is the outcome more likely than not to occur, the lessor would recognize a lease receivable equal to the present value of 10 years of rentals plus the present value of the exercise price of the purchase option.

(b) If returning the asset is the outcome more likely than not to occur, the lessor would recognize a lease receivable equal to the present value of 10 years of rentals.

(c) If renewal is the outcome more likely than not to occur, the lessor would recognize a lease receivable equal to the present value of 15 years of rentals.

Performance Obligation

14. The amount of the lessor's performance obligation relating to the lease payments would be recognized to income over the lease term on a straight-line basis unless another consumption pattern of income recognition more accurately depicts the pattern of use of the underlying asset that the lessor is providing the lessee.

15. If a purchase option were the outcome more likely than not to occur, then the performance obligation remaining at the end of the lease term would represent the purchase price and, upon exercise of the purchase option, the lessor would recognize the sale of the underlying asset. Any difference between the purchase price and the carrying amount of the leased asset would be recognized as a gain or a loss.

16. The journal entries would be:

DR Cash

DR Performance Obligation

CR Lease Receivable

CR Leased Asset

CR Revenue

Staff Recommendation

17. The staff recommends that, because the proposed model currently views purchase options as the ultimate renewal option, purchase options be accounted for by lessors in the same way as lessors account for renewal or termination options.

Question 1
The staff recommends that purchase options be accounted for by lessors in the same way as lessors account for renewal or termination options. Do the Boards agree with the staff recommendation?