Project **Leases**

Topic **Accounting for Purchase Options**

Purpose

1. At the May 2010 joint meeting, the boards discussed how to apply the derecognition approach to lessor accounting for options to extend or terminate a lease as well as purchase options. During that discussion the boards asked the staff to reconsider the accounting for purchase options.
2. The purpose of this paper is to discuss the accounting for leases with purchase options for both lessees and lessors.
3. Some staff members think that purchase options should be accounted for consistently with the accounting for options to extend or terminate a lease.
4. However, other staff members recommend that purchase options should be accounted for only upon exercise.
5. This paper is structured as follows:
   (a) Background
   (b) Staff analysis
   (c) Staff recommendation.

Background

Options to extend/terminate

6. Lease contracts often grant the lessee the right, but not the obligation, to extend the lease beyond the initial lease period. Similarly, a lease contract also may grant the lessee the right to terminate a lease before the end of the lease period.

7. The Discussion Paper, *Leases: Preliminary Views*, (DP) included preliminary thoughts on the accounting for options to extend or terminate a lease for a lessee. The DP did not address the accounting for options to extend or terminate a lease for a lessor.

8. In developing preliminary views for the DP, the boards deliberated whether to require lessees to recognize and measure separately options to extend or terminate a lease. The boards thought that if the rights and obligations arising in a lease of that type are separated into components and analyzed individually, it would be possible to conclude that options to extend/terminate the lease meet the definition of an asset. Many board members have said that they think a components approach is the conceptually correct approach.

9. However, following discussions 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. Consequently, the boards have tentatively decided to adopt a single asset and liability approach to lease contracts, not a components approach.

10. More than half of the respondents to the DP 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. One user who commented on the issue stated that he would have preferred to see options recognized separately and measured at fair value, but accepted that his preference may be impractical. Another user agreed with the boards' decision not to adopt a components approach.

11. Under the boards' tentative decision to not adopt a components approach, uncertainty about the lessee's obligation to pay rentals and the lessor's right to

receive rentals would be addressed through recognition. That is, one of the possible lease terms would be selected and the accounting would be based on that lease term.

12. The boards tentatively decided that the recognized lease term should be the longest possible lease term that is more likely than not to occur.

13. In addition, the boards decided that the lease term should be reassessed at each reporting date if there has been a change in facts or circumstances that would indicate that the lease term may need to be revised.

Purchase options

14. Purchase options give the lessee the option to purchase the leased asset on or after a specified date. The exercise price of the option may be below, above, or at fair value.

15. The boards tentatively decided that leases with a bargain purchase option in which it is reasonably certain that the bargain purchase option would be exercised would be considered a sale of the underlying asset and, therefore, would not be within the scope of the proposed new leases guidance.

16. The boards tentatively decided that all other purchase options would be accounted for by lessors and lessees in the same way as lessors and lessees account for options to extend or terminate a lease. This includes the following:

    (a) Purchase options would not be accounted for as separate assets/liabilities.

    (b) A lease receivable/liability would include the exercise price of the purchase option if the purchase option is more likely than not to be exercised.

    (c) The exercise of the purchase option 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 purchase option would be exercised.

(d) For lessees, any change in the lease liability resulting from a reassessment of the exercise of a purchase option would be recognized as an adjustment to the right-of-use asset. The amortization of the right-of-use asset that includes a purchase option would be over the entire economic life of the leased asset.

(e) For lessors under a performance obligation approach, any change in the lease receivable resulting from a reassessment of the exercise of a purchase option would be recognized as an adjustment to the performance obligation.

(f) The lessor's performance obligation relating to rental payments would be recognized in income over the lease term in a manner that depicts the pattern of use of the underlying asset that the lessor is providing the lessee. The lessor's performance obligation relating to the purchase option would not be recognized in income until the purchase option is exercised.

17. At the May 2010 joint meeting, the boards did not reach a tentative conclusion on how to account for leases that include purchase options under a derecognition approach to lessor accounting.

Staff analysis

18. In this analysis, the staff has assumed that the approach for purchase options would continue to be the recognition approach discussed at the November 2010 joint board meeting. That is, uncertainty about the lessee's obligation to pay rentals and the lessor's right to receive rentals is addressed through recognition. The staff did not consider approaches for the accounting for purchase options under the components approach, the disclosure approach, or the measurement approach.

19. Therefore, the staff considered the following approaches for the accounting for purchase options for both lessees and lessors:

(a) Approach A: account for purchase options consistent with the accounting for options to extend or terminate a lease

(b) Approach B: account for purchase options only upon exercise.

Approach A—Account for purchase options consistent with the accounting for options to extend/terminate

20. Approach A views a purchase option as the ultimate renewal option. That is, Approach A views providing a purchase option as no different from providing renewals that extend over the entire economic life of the leased asset. Therefore, the accounting for a purchase option should be consistent with the accounting for options to extend/terminate.

21. Approach A, therefore, would account for purchase options in accordance with the criteria outlined in paragraph 16 of this memo for lessees and lessors under the performance obligation approach.

Lessees

22. In paragraph 16, the way a lessee would account for purchase options under Approach A is discussed. The board held discussions on the accounting for purchase options for lessees at the January 2010 joint board meeting.

23. Some staff members view purchase options as the ultimate renewal option. Providing a purchase option is no different from providing renewals that extend over the entire economic life of the leased item. Therefore, the accounting requirements for purchase options should be the same as for options to extend or terminate the lease.

24. Most respondents to the DP agreed that purchase options should be accounted for in the same way as options to extend or terminate the lease.

> Requiring purchase options to be accounted for separately from options to extend or terminate a lease introduces a distinction between economically similar arrangements which would add unnecessary complexity to lessee accounting and may provide opportunities for structuring arrangements to achieve desired accounting. (CL #139)

25. However, the staff notes the following disadvantages to Approach A for lessee accounting:

    (a) For those who disagree that a purchase option is the ultimate extension of a lease and view a purchase option as a purchase, it would include a possible purchase transaction in the measurement of the lessee's right-of-use asset and liability for its obligation to pay rentals.

    (b) It grosses up the right-of-use asset and liability for a lessee's obligation to pay rentals for the exercise price of the purchase option. However, the staff notes that this disadvantage applies equally to options to extend or terminate a lease. The lessee grosses up its right-of-use asset and liability for rentals expected to be paid during an optional period.

    (c) The purchase price included in the measurement of the lessee's right-of-use asset would be amortized over the lease term (which would be the economic life of the underlying asset). If the purchase option ends up not being exercised, the amortization of the right-of-use asset may not reflect the economics of the usage of the right-of-use asset.

Lessors

Performance Obligation Approach

26. In paragraph 16, the way that a lessor under the performance obligation approach to lessor accounting would account for purchase options under Approach A is discussed. The board held discussions on the accounting for purchase options for lessors at the January 2010 joint board meeting. Subsequently, the accounting for purchase options also was discussed at the April 2010 joint board meeting.

27. As stated in paragraph 23, some staff members view purchase options as the ultimate renewal option. Providing a purchase option is no different from providing renewals that extend over the entire economic life of the leased item. Therefore, the accounting requirements for purchase options should be the same as for options to extend or terminate the lease.

28. However, the staff notes the following disadvantages of Approach A for lessor accounting under a performance obligation approach:

    (a) For those who disagree that a purchase option is the ultimate extension of a lease and view a purchase option as a purchase of the underlying asset, it would include a possible purchase transaction in the measurement of the receivable and performance obligation.

    (b) Some staff members do not think it is appropriate for a lessor to make a determination on whether the lessee is likely to purchase the underlying asset until the purchase option is exercised.

    (c) It grosses up the receivable and performance obligation for the exercise price of the purchase option. However, the staff notes that this disadvantage applies equally to options to extend or terminate a lease. The lessor grosses up its receivable and performance obligation for rentals expected to be paid during an optional period.

Derecognition approach

29. Under a derecognition approach, Approach A for lessors would require the initial measurement of the lessor's residual asset including consideration of whether an option to purchase would likely be exercised; if so, the residual asset would most likely be measured at nil.

30. Revisions to the expected outcome would lead to a new derecognition/recognition event (consistent with the boards' tentative conclusion at the May 2010 joint meeting on AP 5D [FASB Memo 95]). That means that the lessor would derecognize/reinstate a portion of its residual asset. The amount of the underlying asset derecognized/reinstated would be based upon the relative fair value of what has been transferred (the receivable) and what has been retained (the residual asset). Revenue and cost of sales would be increased or decreased upon each reassessment.

31. The staff notes that an advantage to Approach A for a derecognition approach to lessor accounting would be that it is consistent with the accounting for options to extend or terminate a lease.

32. The staff notes the following disadvantages to Approach A for a derecognition approach to lessor accounting:

    (a) The underlying asset (and its residual value asset) would not appear on the books of the lessor if, at the beginning of the lease, it was determined that a purchase option is more likely than not to be exercised.

    (b) The approach grosses up the receivable. That is, the receivable (and any revenue) would be larger than if purchase options were only recognized when exercised.

    (c) Under the approach, revenue would be recognized (1) ahead of a purchase option being exercised and (2) based on purchase options that are more likely than not to be exercised. However, the staff notes that this disadvantage also applies to the approach to the accounting for options to extend or terminate a lease.

Approach B—Account for purchase options only upon exercise

33. Some board and staff members have expressed concerns about accounting for purchase options in the same way as options to extend/terminate a lease. Therefore, Approach B does not view purchase options as the ultimate renewal option. Instead, Approach B views purchase options as terminating the lease contract and purchasing the underlying asset.

34. Under Approach B, lessees and lessors would only recognize amounts payable/receivable based on the options to extend/terminate a lease, excluding purchase options. Purchase options would only be recorded upon exercise. Consequently, Approach B accounts for the lease under the proposed new leases guidance until the purchase option is exercised. At that time, the contract is no longer a lease, but a purchase/sale.

Lessees

35. Under Approach B, a lessee would only recognize a right-of-use asset and liability for its obligation to pay rentals for the contractual lease term that is more likely than not to occur, excluding purchase options.

36. The staff noted the following advantages of Approach B for lessees:

    (a) It is simpler to apply than Approach A. That is because Approach B does not include the subjectivity of determining if a lessee will exercise a purchase option.

    (b) It avoids including a purchase option that can potentially be avoided. Therefore, Approach B avoids grossing up the right-of-use asset and liability for the lessees obligation to pay rentals.

    (c) It avoids the need to "unwind" the accounting if it is later determined that the purchase option is not exercised.

37. The staff noted the following disadvantages of Approach B for lessees:

    (a) It avoids including a purchase option that the lessee may intend to exercise. Therefore, Approach B potentially understates the expected cash flows of the lease.

    (b) It is not consistent with the accounting for options to extend/terminate the lease.

Lessors

Performance Obligation Approach

38. Under Approach B, a lessor under the performance obligation approach to lessor accounting would only recognize a receivable and corresponding performance obligation for the contractual lease term more likely than not to occur, excluding purchase options.

39. The staff noted the following advantages of Approach B for lessors under the performance obligation approach:

(a) It avoids including any purchase options in the receivable and corresponding performance obligation. Therefore, it avoids grossing up those balances.

(b) It avoids the disadvantage of Approach A that requires the lessor to determine if the lessee will exercise the lessee's purchase option.

(c) It avoids the need to "unwind" the accounting if it is later determined that the purchase option is not exercised

40. The staff noted the following disadvantages of Approach B for lessors under the performance obligation approach:

(a) It does not consider the impact of purchase options on the face of the financial statements until they are exercised. Therefore, Approach B potentially understates the expected cash flows of the lease.

(b) It is not consistent with the accounting for options to extend/terminate the lease.

Derecognition Approach

41. Under Approach B, a lessor under the derecognition approach to lessor accounting would only recognize a receivable for the contractual lease term more likely than not to occur, excluding purchase options.

42. The staff notes that the advantages of Approach B for a lessor under the derecognition approach to lessor accounting are similar to the advantages of a lessor under a performance obligation approach discussed in paragraph 39. In addition, if revenue is recognized when a purchase option is considered to be more likely than not to be exercised and it is later determined that the purchase option will not be exercised, lessors will have to determine how to unwind the previously unrecognized sales revenue.

43. The disadvantages also are similar to those discussed in paragraph 40.

Lease contracts that include multiple options

44. There are concerns that, under Approach B, it would be difficult to account for lease contracts that include multiple options. For example, some lease contracts include both an option to extend and a purchase option.

45. For example, consider a 5 year lease that includes, at the end of the initial lease term, either an option to extend the lease for an additional 5 years or an option to purchase the underlying asset. Under Approach B:

    (a) If exercise of the option to extend the lease term is considered the most likely outcome, the lessee will recognize an obligation to pay 10 years of rentals and the lessor will recognize a receivable for 10 years of rentals.

    (b) If exercise of the purchase option is considered the most likely outcome, the lessee will recognize an obligation to pay 5 years of rentals and the lessor will recognize a receivable for 5 years of rentals. That would be the case even though the lessee would be expected to pay (and the lessor would receive) 5 years of rentals plus the exercise price of the option.

46. As a consequence, some staff members are concerned that Approach B would lead to the lessee understating its obligation to pay rentals (and the lessor understating its receivable). That may lead to structuring opportunities. For example, a lessee could continuously estimate that a purchase option is more likely than not to occur and, therefore, only recognize the minimum contractual liability. However, the staff notes that the requirement to reassess the most likely outcome at each reporting date should mitigate this concern to some extent.

Staff recommendation

47. The staff recommends that the accounting for purchase options for lessees and lessors be symmetrical.

48. However, some staff members think that the accounting for purchase options should be consistent with the accounting for options to extend/terminate a lease (Approach A).

49. Other staff members prefer Approach B because it avoids the gross-up of the receivable, the payable, the right-of-use asset, and the performance obligation for the exercise price of the purchase option. In addition, under the derecognition approach the recognition of revenue prior to a purchase price being exercised also is avoided.

Question 1
Should purchase options be accounted for the same as options to extend/terminate? OR Should purchase options be accounted for only when exercised?