



Project

Leases

Topic

**Accounting for Variable Lease Payments—Disguised
minimum lease payments**

This paper will also be discussed at the IASB/FASB joint meeting in the week commencing 11 April 2011

Objective

1. The purpose of this paper is to discuss the identification of lease payments that are in-substance fixed lease payments but are structured as variable lease payments in form (referred to in this memo as disguised minimum lease payments). This paper also discusses:
 - (a) how entities should determine if a lease payment represents a disguised minimum lease payment
 - (b) whether disguised minimum lease payments should be accounted for as non-variable lease payments.
2. This paper is organized as follows:
 - (a) Summary of staff recommendations
 - (b) Background
 - (c) Summary of feedback received
 - (d) Staff analysis.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB 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.

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Summary of staff recommendations

3. If the Boards reverse their decision and decide not to include an estimate of variable lease payments that meet a high probability threshold in the measurement of a lessee's liability to make lease payments (lessee's liability) and the lessor's right to receive lease payments (lessor's receivable), the staff recommends that the application guidance should be included in the leases standard to determine when lease arrangements contain disguised minimum lease payments. Those indicators would be consistent with the indicators proposed in paragraph 15 of this memo. Those indicators also would determine when the variable lease payments are based on contingencies or factors that are non-substantive (that is, the lease payments associated with the underlying sales, index, or performance in the lease arrangement will always be triggered) and, therefore, represents fixed lease payments.
4. The staff recommends that all disguised minimum lease payments should be accounted for as though they are non-variable lease payments.

Background

5. At the February 2011 joint Board meeting the Boards tentatively decided to require that the lessee's liability and the lessor's receivable include an estimate of disguised minimum lease payments.

Summary of feedback received

6. Topic 840 and IAS 17 currently do not include guidance on disguised minimum lease payments. However, the staff notes that, based on outreach performed and comment letters received, the concept of including disguised minimum lease payments in the measurement of the lease assets and lease liabilities is applied in practice.

With respect to contingent rents, ICSC realizes that, on occasion, leases are written with non-cancellable lease terms comprised entirely of contingent rents with no minimum payment. In these instances we agree that the lessee should follow the principle of estimating contingent rents due in the lease term as defined under

current GAAP and where the minimum contractual rents are below market. In current practice as applied by the major accounting firms, this situation is commonly called disguised minimum lease payments. (CL #489)

7. Suggestions from respondents on guidance to capture disguised minimum lease payments include the following:

To the extent that contingent rents comprise a substantial portion of lease payments in a particular lease arrangement and may be, in effect, disguised lease payments. We would support an attribution of fair market rent to be recognized. (CL #441)

We believe the current guidance is operational and the Boards should instead focus on addressing issues with the current definition such as disguised minimum lease payments - e.g. contingent rentals that are: i) completely unrelated to the leased asset; or ii) of immediate value to the Lessor; or iii) have level of uncertainty is not significant. (CL #244)

8. The staff has also performed various outreach activities since the Boards discussed variable lease payments at the February 2011 joint Board meeting.
9. The majority of entities that participated in that outreach (which included preparers, users, accounting firms, etc.) supported including disguised minimum lease payments in the measurement of the lessee's liability to make lease payments (lessee's liability) and the lessor's lease receivable (lessor's receivable).
10. Accounting firms that participated in the targeted outreach performed noted the importance of defining and providing examples of disguised minimum lease payments. Although they note that even though this concept is applied in practice, it is necessary to properly define those lease payments to ensure comparability between entities.
11. Working group feedback and feedback from private entities was consistent with that of the overall feedback received.

Staff analysis

12. The Boards decided to require that the lessee's liability and the lessor's receivable include an estimate of disguised minimum lease payments because they think that a liability and an asset exist at the date of commencement for all

variable lease payments and that only the measurement of those variable lease payments is uncertain. Therefore, the Boards were concerned that if they were to limit the payments included in the lessee's liability and the lessor's receivable to the fixed lease payments, a lease may be structured to contain only variable lease payments based on contingencies or factors that are non-substantive and/or unrelated to the economics of the lease. Consequently, the lessee's liability and the lessor's receivable would be understated even though the variable payments would, in substance, result in equivalent fixed payments being required under the lease.

13. The Boards also decided to require that an estimate of variable lease payments that meet a high threshold should be included in the measurement of the lessee's liability and the lessor's receivable (such as probable in the United States and reasonably assured outside of the United States). The staff thinks that unless the Boards reverse their tentative decision to include variable lease payments that meet a high threshold in the measurement of the lessee's liability and the lessor's receivable (see IASB Agenda Reference 1B/FASB Agenda Reference 157), it is not necessary to also include additional requirements for disguised minimum lease payments because those disguised minimum lease payments would meet a high threshold based on their "structured nature".
14. However, if the Boards reverse their decision and decide not to include variable lease payments that meet a high threshold in the measurement of the lessee's liability and the lessor's receivable, including an estimate of disguised minimum lease payments in the measurement of the lessee's liability and the lessor's receivable may mitigate concerns about entities structuring leases to include only (or a high proportion of) variable lease payments.
15. The staff thinks that if the Boards reverse their decision and decide not to include an estimate of variable lease payments that meet a high probability threshold in the measurement of the lessee's liability and the lessor's receivable, indicators for determining when the lease arrangement contains disguised minimum lease payments should be included in the guidance. The staff has identified the following indicators:

- (a) The lease payments associated with the underlying sales, index, or performance in the lease arrangement are based on a factor that is unrelated to the underlying asset; for example, lease payments for the right to use a piece of equipment are based on something other than the usage of that equipment.
- (b) The amount of the lease payments associated with the underlying sales, index, or performance in the lease arrangement is objectively measureable and, therefore, is determinable; that is, arrangements in which the variable lease payment has an insignificant level of uncertainty. For example, lease arrangements in which the lease payments are contingent on achieving a very low benchmark.
- (c) The lease payments associated with the underlying sales, index, or performance in the lease arrangement have immediate value to the lessor without considering future increases in the rate or index. That is, the fixed rental payments, if any, do not create a benefit to the lessor and the benefit to the lessor is a result of the variable lease payments.
- (d) The lease payments associated with the underlying sales, index, or performance are included in the lease arrangement to compensate for below-market fixed lease payments.
- (e) The lease payments associated with the underlying sales, index or performance in the lease arrangement are based on a minimum level of output or sales that are required by the lease arrangement; for example, if an entity requires lease payments to be made based on sales, but also requires a certain level of sales to continue to use the underlying asset.
- (f) All lease payments included in the lease arrangement are variable in nature and the arrangement does not include any fixed payments.

Staff recommendation

16. The staff thinks that the measurement of both an entity's non-variable lease payments as well as the measurement of an entity's disguised minimum lease

payments should be comparable to entities that do not include disguised minimum lease payments.

17. All staff members recommend that indicators in paragraph 15(a) through 15(e) of this memo be included in application guidance to determine when lease arrangements contain disguised minimum lease payments. Those indicators would determine when the variable lease payments are based on contingencies or factors that are non-substantive (for example, the lease payments associated with the underlying sales, index, or performance in the lease arrangement will always be triggered) and, therefore, represent fixed lease payments. Some staff members think that indicator in paragraph 15(f) should also be included because they think that if the entire arrangement is comprised of only variable lease payments, there must be a reasonable expectation that at least some portion is, in effect, fixed. However, other staff members think that just because there are no fixed payments included in the lease arrangement doesn't mean all, or some portion, of the variable payments are, by default, non-substantive. In addition, the staff thinks that clarifying the meaning of those payments would increase comparability and the informational value for users of financial statements.
18. The staff also recommends that all disguised minimum lease payments should be accounted for as though they are non-variable lease payments.

Questions – Disguised minimum lease payments

Question 1 – Do the Boards agree with the staff recommendation that indicators in paragraph 15(a) through 15(e) of this memo should be included in application guidance to determine when lease arrangements contain disguised minimum lease payments and, therefore, should be included in the measurement of the lessee's liability and the lessor's receivable?

Question 2 – Should indicator in paragraph 15(f) of this memo also be included in application guidance to determine when lease arrangements contain disguised minimum lease payments and, therefore, should be included in the measurement of the lessee's liability and the lessor's receivable?