

STAFF PAPER

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Introduction and background

1. Questions on how cancellable leases should be accounted for under the current lease proposals have frequently arisen in recent outreach meetings. This issue was also raised by a small number of respondents to the 2010 *Leases* exposure draft (ED). The staff think that this issue has been implicitly addressed by the boards' decisions to date regarding 'lease term' and 'short-term leases'. However, the staff think that it should be made clear how the proposals should be applied to cancellable leases. Consequently, the staff plan to include guidance for cancellable leases in the forthcoming *Leases* ED, based on the analysis in this paper. The staff are seeking approval by the boards of how the boards' tentative decisions should be applied to cancellable leases.
2. At the February 2011 joint meeting, the boards tentatively decided to define 'lease term' as 'the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease'.

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3. The boards also tentatively decided that options to extend the lease, and options to terminate the lease, should be treated similarly. For example, a three-year lease with an option to terminate the lease at the end of the second year should be accounted for similarly to a two-year lease with an option to extend the lease for a further year.
4. At the March 2011 joint meeting, the boards tentatively decided to define ‘short-term’ lease as ‘a lease that, at the date of commencement of the lease, has a maximum possible lease term including options to renew or extend, of twelve months or less’.
5. This paper addresses the accounting for a lease in which both the lessee and the lessor each have a right to cancel the lease at any point in the future without any termination penalty, subject to a short notice period (such as one month) (referred to in this paper as a ‘cancellable lease’). These leases may be called month-to-month, at-will, evergreen, perpetual or rolling leases. Because the boards have decided that options to terminate a lease, and options to extend a lease, should be accounted for on a similar basis, cancellable leases would also apply to contracts that include an option to extend the lease if this is agreed to by both parties. This paper does not consider leases that contain only lessee options to extend or terminate the contract, or leases that contain only lessor options to extend or terminate the contract, because the staff think that the accounting for these options is clear on the basis of the boards’ tentative decisions.
6. An example of a cancellable lease would be a contract that has a term of three years, for which both the lessee and the lessor have the right to cancel the contract with three months’ notice. In this example, either party is able to walk away after three months—neither the lessee nor the lessor is able to force the contract to continue after the end of the three-month notice period. Another example is a contract that runs from the date of signing until further notice, which both the lessee and the lessor have the right to cancel the contract with one month’s notice. A further example is a lease that has an initial term of one year, but that can be extended for another year if this is agreed to by both the lessee and the lessor before the end of the year.

Staff analysis

7. Any initial non-cancellable period or notice period meets the definition of a lease term, as referred to in paragraph 1 above. Consequently, the staff analysed how to apply the boards' decisions to any cancellable period, as described in paragraph 4 above.
8. The 2010 ED did not include a definition of 'option period' or 'contract', but the notion of enforceability is inherent in both. The staff intend to include a definition of a 'contract' in the 2012 *Leases* ED that is consistent with the definition of a contract in the 2011 *Revenue recognition* ED¹.
9. The definition of a contract implies that options to extend or terminate the lease that are included in the determination of lease term must be enforceable, ie the lessee must be able to force the extension of the lease term. Consequently, entities will need to determine whether the options to extend the lease in their lease contract are enforceable. Determining whether an option period is enforceable will be based on the facts and circumstances surrounding the transaction; for example, it will depend upon the exact terms of the contract and the legal jurisdiction in which the contract has been transacted.
10. If option periods are not enforceable, ie the lessee cannot force the extension of the lease term without agreement from the lessor, the lessee does not have the right to use the underlying asset beyond the non-cancellable period. Consequently, by definition, there is no contract beyond the initial non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term.
11. Consequently, the lease term for these types of leases would be the non-cancellable period together with any termination or notice period. Furthermore, entities would be able to apply short-term lease accounting to these leases if the non-cancellable period, together with the termination or notice period, is less than twelve months.

¹ See Appendix A.

12. The staff have included in Appendix B a few examples of these types of leases and the accounting that would result from applying the staff's interpretation of the boards' decisions to those leases.

Concerns raised about the staff interpretation

13. Some have raised concerns about the staff's interpretation of how the proposals should be applied to cancellable leases. This is because they fear that this interpretation will allow entities to add a clause in a lease contract stating that the lease can be cancelled at any point, knowing that in fact it will not be cancelled and, thus, be able to apply short-term lease accounting. The staff acknowledge this concern and are planning to ensure the proposals make reference to contracts being written or oral, and that constructive obligations can give rise to enforceable obligations, in order to minimise structuring opportunities².
14. The staff do not think that this interpretation will encourage entities to add such a clause. This is because it would not make economic sense for the lessor or lessee to always agree to such a clause, because it is likely the lessor would reflect the inclusion of such a clause when pricing the leases. For example, for a lessor, if the contract has been priced assuming that the lessee does not cancel the contract, including such a clause would put the lessor at risk of being exposed to a higher residual asset than had been anticipated when pricing the contract. Alternatively, if the lessor has priced the contract assuming that the lessee cancels the contract, the lessee is likely to have to pay higher rentals to compensate the lessor, which would not make sense if the lessee does not intend to cancel the contract.

Assess all possible options in the determination of a short-term lease

15. If board members remain concerned about the possibility of the staff's interpretation leading to structuring, one solution would be to provide guidance that an entity should assess all possible options to renew when determining

² See Appendix A.

whether a lease is short-term. That is, an entity should consider all options referred to in a lease contract when determining whether the lease is short-term even if the lessor has to agree to the option period or if there are other conditions attached such that the option period is not enforceable. The outcome of this interpretation would be that for cancellable leases with, for example, a one-month notice period, one month of lease payments would be recognised on the balance sheet because the maximum lease term could be more than 12 months when considering all options to renew. However, this outcome raises concerns as to whether the cost would outweigh the benefit.

Alter the definition of short-term leases

16. If all possible options were to be assessed in the determination of a short-term lease, some suggested that the definition of a short-term lease should be changed to be based on the lease term (using the current definition of lease term) having been determined to be twelve months or less, rather than on the term of the *contract* being twelve months or less. Take, for example, a lease that has an initial non-cancellable period of one year, followed by an option for the lessee to extend the lease by another year, and the lessee does not have a significant economic incentive to extend the lease. In that case, the lease term would be determined to be one year, and hence under this approach the lessee would be able to apply short-term lease accounting.
17. The staff do not recommend this approach because the boards decided on a contractual-based approach to defining short-term leases to ensure that this ‘short-term’ line would not be open to abuse. Given one of the main concerns raised with the staff interpretation is that it may be open to abuse, this alternative approach will not, therefore, address those concerns.

Assess all possible options in the determination of lease term

18. If all possible options were to be assessed in the determination of short-term leases, another suggestion was to interpret the boards’ decision on the determination of lease term to also include an assessment of all ‘possible’ options. For example, this would require entities to assess whether they had a significant

economic incentive to allow the lease to continue into a period to which both the lessee and lessor had to agree.

19. However, the staff are not recommending this approach because they are concerned that this interpretation would require the recognition of option periods that do not meet the definition of an asset. The right-of-use model is based on recognising and measuring the rights that the lessee controls and has had transferred to it by the lessor. The lessee has the right to control the use of the underlying asset for any non-cancellable period and controls any call options to extend the lease. The lessee does not, however, control options to extend the lease that have to be agreed upon with the lessor, or options that are not enforceable by the lessee.

Staff recommendation

20. Having considered and rejected the alternative ways of applying the boards' tentative decisions in regard to lease term and short-term leases to cancellable leases, the staff recommend that cancellable leases would meet the definition of short-term leases when the notice period, together with any initial non-cancellable period, is less than one year. The staff think that the boards should not change their previous tentative decisions on the definition of lease term or short-term leases within the context of cancellable leases. The staff think that applying the definition of short-term leases and lease term only to those options that are enforceable is consistent with the notion of a 'contract' that creates enforceable rights and obligations.

Questions for the boards

Do the Boards agree that cancellable leases would meet the definition of short-term leases when the notice period, together with any initial non-cancellable period, is less than one year?

Do the Boards agree that the definition of lease term and short-term leases should not be changed for cancellable leases?

Appendix A

This appendix contains an example of draft wording that will be included in the future *Leases* exposure draft.

Identifying a contract

- A1. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability is a matter of law. Contracts can be written, oral, or implied by an entity's other customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may also vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining when an agreement with another party creates enforceable rights and obligations for the entity.
- A2. An entity shall apply the requirements of this [draft] standard to a lease contract if all of the following criteria are met:
- (a) The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
 - (b) The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
 - (c) The entity can identify each party's rights regarding the underlying assets to be transferred.
 - (d) The entity can identify the payment terms for the underlying assets that are to be transferred.
- A3. A contract does not exist for the purpose of applying this [draft] standard if all parties to the contract have the unilateral enforceable right to terminate a wholly

unperformed contract without compensating the other party. A contract is wholly unperformed if both of the following criteria are met:

- (a) The entity has not yet transferred any underlying assets to the customer.
- (b) The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for a promised underlying asset.

Combination of contracts

A4. An entity shall combine two or more contracts entered into at or near the same time with the same party (or related parties) and account for the contracts as a single contract if one or more of the following criteria are met:

- (a) The contracts are negotiated as a package with a single commercial objective.
- (b) The amount of consideration to be paid in one contract depends on the price of the other contract.
- (c) The contracts are entered into at or near the same time.
- (d) The contracts are performed either concurrently or consecutively.

Appendix B

Terms of lease/circumstances	Staff analysis
<p>A lessee enters into a lease that has a three-month initial non-cancellable period. After three months the lease continues until future notice. Either the lessee or lessor can cancel the lease at any point after the initial three-month non-cancellable period with two months' notice.</p>	<p>The maximum term of the contract is five months (the three months' initial non-cancellable period together with the two months' notice period). The lessee and lessor can apply short-term lease accounting.</p>
<p>Lease of one year; the lessee can terminate the lease with one month's notice at any point in the year.</p>	<p>The lessee and lessor can elect to apply short-term lease accounting. If they do not elect to apply short-term lease accounting, the lease term would be the initial non-cancellable period of one month, plus any of the eleven one-month option periods, over which a lessee has a significant economic incentive to extend the lease.</p>
<p>Lease of four years; the lessee can serve the lessor notice on the first day of any month, after which the lease would then terminate on the last day of the month.</p>	<p>The lease has a maximum contractual term of four years and hence the lessee and lessor cannot apply short-term lease accounting. The lessee has 48 option periods and must assess whether it has a significant economic incentive not to terminate the lease in any of these option periods.</p>