IASB/FASB Joint Meeting
–week beginning 14 February 2011

IASB Agenda reference 5A

FASB Memo 129

Staff Paper

Project	**Leases**
Topic	**Accounting for Variable Lease Payments**

Objective

1. The purpose of this paper is to discuss the recognition and measurement of lease receivables and payables in leases with variable lease payments, such as, but not limited to, those arising from leases with contingent rentals and residual value guarantees, etc.

2. This paper does not discuss the remeasurement/reassessment of variable lease payments, which will be discussed in a future paper.

3. This paper is organized as follows:

   (a) Summary of staff recommendations

   (b) Summary of proposals in the leases Exposure Draft (ED)

   (c) Summary of feedback received from outreach activities and comment letters

   (d) Discussion of which variable lease payments should be included in the measurement of lease assets/liabilities

   (e) Discussion of the approaches for determining how variable lease payments should be incorporated into the measurement of the lessee's liability to make lease payments and the lessor's lease receivable

   (f) Discussion of a reliability threshold

   (g) Appendix A: Application of approaches (in a separate attachment).

Summary of staff recommendations

4. The majority of the staff recommends that variable lease payments should be included in the measurement of a lessee’s liability to make lease payments and a lessor’s lease receivable only if those variable lease payments depend on an index or a rate. Variable lease payments include any increases or decreases in amounts that would be required to be paid/received subsequent to the inception of the lease.

5. The minority of the staff recommends that all variable lease payments that are “probable” or “reasonably assured/certain” should be included in the measurement of a lessee’s liability to make lease payments and a lessor’s lease receivable.

6. Additionally, disclosures would be required for variable lease payments to provide users of financial statements with information on variable lease payments. That is, information on variable lease payments based on an index/rate as well as other variable lease payments such as, but not limited to, those based on usage and performance. Disclosures will be discussed in a future memo.

7. The staff recommends that the Boards require the initial measurement of the variable lease payments based on an index or rate to be based on a prevailing rate (or spot rate).

8. The staff also recommends that a reliability threshold should be included in the proposals for the measurement of variable lease payments for both lessees and lessors. In addition, the staff recommends that the reliability threshold should be consistent with the revenue recognition proposals, that is, that the variable lease payments should be “reasonably estimated.”

Summary of proposals in the leases ED

9. The leases ED identified that in some leases, the amount of each contractual lease payment is variable rather than fixed. That variability can arise because of features such as, but not limited to, residual value guarantees, penalties for failure

to renew, and contingent rentals. For example, contingent rentals could be based on one or more of the following:

(a) *Price changes or changes in an external rate or value of an index*. In this type of lease, the lease payments are adjusted for changes in market lease rates by linking the payments to changes in an external rate, such as LIBOR, or the value of an index, such as the consumer price index.

(b) *The lessee's performance derived from the underlying asset*. For example, a lease of retail property may specify that the lease payments are based on a specified percentage of sales made from that property.

(c) *The usage of the underlying asset*. For example, a car lease may require the lessee to make additional payments if the lessee exceeds a specified mileage.

Recognition

10. The ED proposes that at the date of commencement of a lease, a lessee should recognize a liability to make lease payments and a lessor should recognize a right to receive lease payments (lease receivable) in the statement of financial position. Payments arising under a lease include fixed payments as well as all variable payments. Variable lease payments include any increases or decreases in amounts that would be required to be paid/received subsequent to the inception of the lease.

Initial Measurement

11. The ED proposes that an entity should measure the liability to make lease payments and the lease receivable using an expected outcome technique. Expected outcome is the probability-weighted average of the cash flows for a reasonable number of possible outcomes.

12. In addition, the ED proposes that a lessor should include variable lease payments in the measurement of the lease receivable only if those payments can be reliably

measured. (There is no equivalent reliable measurement criterion proposed in the ED for lessees.)

Interaction with Other Projects

13. The revenue recognition ED states the following regarding variable consideration:

> An entity shall recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. The transaction price can be reasonably estimated only if both of the following conditions are met:
>
> a) The entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and
>
> b) The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.
>
> Factors that reduce the relevance of an entity's experience include the following:
>
> a) The consideration amount is highly susceptible to external factors (for example, volatility in the market, judgment of third parties, and risk of obsolescence of the promised good or service);
>
> b) The uncertainly about the amount of consideration is not expected to be resolved for a long time
>
> c) The entity's experience with similar types of contracts is limited; and
>
> d) The contract has a large number of possible consideration amounts.
>
> If the transaction price cannot be reasonably estimated, an entity shall not recognize revenue from satisfying a performance obligation. If circumstances change, the entity shall recognize revenue from satisfied performance obligations when the transaction price can be reasonably estimated.

Summary of feedback received from outreach activities and comment letters

Summary of User Feedback

14. Users had mixed views on the treatment of variable lease payments. Under current lease guidance, there is little information about variable lease payments. Therefore, users welcome better access to information about these payments, but have conflicting views on how best to provide it.

15. Users supported obtaining additional information relating to variable lease payments but were mixed in their views on whether amounts recognized in the financial statements should reflect:

    (a) only contractual fixed minimum lease payments (allowing users to apply their own judgment to estimate variable lease payments, based on disclosures);

    (b) in-substance contractual lease payments (similar to the alternative view expressed in the IASB ED); or

    (c) all payments under the lease arrangement, including variable payments as proposed in the leases ED (noting that management estimates could be adjusted by users to meet their specific needs based on information disclosed in the notes).

16. Some users think that estimates are a part of business and that including variable lease payments in the measurement of an entity's leased assets and liabilities, similar to other accounting estimates, provides the best possible information in the statement of financial position about that entity's assets and liabilities as long as users can understand the assumptions behind the estimates through appropriate disclosures. Those users argue that users place different weight on information that is included in the statement of financial position compared with information that is only disclosed.

> Exclusions of these amounts could result in significant understatement of the economic assets and liabilities under leases. Therefore, we believe measuring them initially is preferable to excluding them from the calculation of estimated lease payments

> and then recognizing the expense when incurred, as is generally the case under existing standards (CL #748)

17. Users also cited the difference in timeliness of information provided in the financial statements and in the notes. They observed that information presented in the financial statements is usually available earlier (typically in an earnings release) than information included in footnote disclosures.

18. Other users prefer to see only the minimum contractual fixed lease payments on the statement of financial position and additional, detailed information disclosed about variable lease payments in the footnotes, because of the uncertainly in estimating such amounts.

> Generally we prefer balance sheet assets and liabilities to be as "real" as possible otherwise they start to become less useful…
>
> On balance, we are nervous about requiring companies to estimate and capitalise contingent lease payments such as revenue-based payments. These contingent liabilities are really future operating expenses as the amount and timing will depend on how the business performs. From a fundamental standpoint, it is difficult to see why contingent lease payments should be capitalised when other contingent costs such as cost of goods, wages and so on are not. It would also be both onerous and subjective for preparers to estimate multi-year future contingent liabilities.
>
> As users, we also ask ourselves what we would do with this information. While it would be interesting to see more information about options and contingencies, we do not see that the utility of the balance sheet would be improved by including these very subjective items as concrete liabilities. We recognise that requiring lessees to capitalise only contractual liabilities may create opportunities for structuring but this is preferable to having a potentially meaningless (and also much larger) asset and liability. (CL #675)

19. Some users did not think that performance-based and usage-based contingencies should be considered in the measurement of the lease liability, but think that only index-based contingencies should be considered.

Comment Letter Feedback Received

20. Many respondents to the ED (which included preparers, users, industry organizations, etc.) expressed concerns relating to the proposals for including variable lease payments that depend on future performance or usage in the

measurement of a lessee's liability to make lease payments and the lessor's lease receivable. Those respondents commented that:

(a) performance-related payments are economically structured to provide a sharing of future risks between the lessee and lessor (for example, in the retail industry, leases for store space in a mall may involve a minimum lease payment plus a payment based on future sales to incentivize the performance of the mall owner (lessor)).

(b) a mismatch could arise between income and expenses. For example, if a retailer has lease payments that are contingent on sales, the lease payments are often viewed similarly to a commission and, therefore, should be recognized consistently with the underlying sales.

(c) contingent payments based on usage are akin to renewal options.

(d) recognition of revenue by lessors for these lease payments would be inconsistent with the revenue recognition ED.

21. Additionally, many respondents to the ED disagreed with the proposal to estimate variable lease payments using an expected outcome technique. These respondents commented that estimating variable lease payments would:

(a) be costly and challenging to reliably estimate; and

(b) create significant volatility in profit or loss.

22. Many respondents suggested alternative approaches such as:

(a) the approach proposed in the alternative view of the IASB ED, which advocates including only variable lease payments based on indices or rates and excluding variable lease payments that vary with usage or performance (noting that similar guidance in current U.S. GAAP works well in practice);

(b) including only those variable lease payments that are outside of an lessee's control and are therefore unavoidable; or

(c) changing the estimation approach from 'expected value' to an alternative estimation technique (ie, to be consistent with the threshold for recognizing options to renew or cancel leases).

23. In addition, some respondents questioned the interaction of the proposals for variable lease payments with current guidance on embedded derivatives.

> We do note, however, that some contingent rentals that are dependent upon rates or indices would clash with the embedded derivatives requirements of IAS 39:10-13 and IFRS 9:4.3. Currently, a contingent rental that is based on a rate or index that is not closely related to the host rental contract (for example, based on commodity prices (IAS 39:AG33(f) and IFRS 9:B4.3.8(f)) constitutes an embedded derivative that is required to be recognised separately at its fair value. (CL #378)

Private Company Consideration

24. The comment letter feedback received from private companies was consistent with that of the overall feedback from other comment letters summarized in paragraphs 20-23 of this memo. However, private companies noted that, with many accounting departments consisting of only a few members, the proposal may be even more burdensome than for a larger public company.

> We agree conceptually with the proposed treatment of contingent rental payments and payments from residual value guarantees for lessees. However, we believe it is likely lessees will encounter significant operationality issues in making some of the required estimates. For example, we believe lessees will struggle to estimate contingent rents that are based on future sales related to assets under long-term leases as the lease term will in all likelihood extend well beyond the normal budgeting and planning periods. We believe this to be an area in which the FASB should carefully weigh the costs to comply with the standard with the benefits received by users of the financial statements.(CL #66)

Revenue Recognition ED Comment Letter Feedback Received

25. The staff's comment letter summary for the revenue recognition ED noted that:

> As a general observation, respondents to the Revenue Recognition ED seemed to agree with limiting estimates of variable consideration to be included in the transaction price. However, respondents expressed mixed views on the boards' proposal to restrict variable consideration from the measurement of revenue to situations where the entity (or another entity) has relevant past experience with similar contracts. Some respondents commented

> that the boards' proposal would impose too high a hurdle in a situation where the entity (or other entities) has no experience but there is minimal variability in the transaction price and minimal uncertainty as to collectability. For example, this could arise with a new product or service. Those respondents argue that the criteria in paragraph 38 of the Revenue Recognition Exposure Draft creates a rule that constrains and potentially negates that principle that variable consideration is included in the transaction price only if it can be reasonably estimated.
>
> Other respondents to the Revenue Recognition ED (including, for example, respondents from the media and entertainment industries) were concerned that the board's proposals would allow revenue to be recognized prior to the amount of variable consideration becoming certain. They were concerned that the boards' proposals would require entities to "true-up' their estimate of the transaction price on an ongoing basis. They suggested that estimates of transaction price should be subject to a probability threshold that is higher than a 'reasonable estimate'.

26. Particularly relevant to the leases project were the comments made on royalty-type arrangements, that is, contracts in which the amount of consideration depends on actions taken by the customer. The comment letter summary noted:

> Some respondents commented that an estimate of the transaction price should not include amounts of consideration where the variability is within the control of the customer. This may occur with some arrangements in which the entity receives a royalty based on the level of sales made by a customer. Those respondents hold that view even though the entity may be able to use historical data to reasonably estimate of the royalty revenue it will receive. Those respondents argue that the estimation of the transaction price should distinguish between variability of consideration that is within the control of the customer and variability that is outside the customer's control.

27. In general, respondents have been supportive of consistency between the leases and revenue recognition guidance.

Working Group Feedback Received

28. Feedback received from the working group was consistent with that of the overall feedback from other comment letters summarized in paragraphs 20-23 of this memo. Specifically, they supported simplification to the approach proposed in the ED for the inclusion of variable lease payments in the measurement of lease assets/liabilities.

Discussion of which variable lease payments should be included in the measurement of lease assets/liabilities

29. The staff is presenting the following approaches for determining which variable lease payments should be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable:

    (a) Include an estimate of all variable lease payments, as proposed in the ED.

    (b) Include an estimate of all variable lease payments that are "probable" or "reasonably assured/certain."

    (c) Include an estimate only of variable lease payments that depend on an index or a rate.

    (d) Include an estimate only of variable lease payments that are outside of a lessee's control and are, therefore, unavoidable.

Approach A: Include an estimate of all variable lease payments

30. Under Approach A, the proposed guidance in the leases ED for the recognition of variable lease payments would be retained (see paragraph 10 above). That is, the liability to make lease payments and the right to receive lease payments should include an estimate of all variable lease payments which include any increases or decreases in amounts that would be required to be paid/received subsequent to the inception of the lease.

31. Those who support Approach A think the measurement of the right to receive lease payments and the liability to make lease payments should reflect all expected cash flows, even though a portion of those cash flows may be uncertain. For example, a lease could specify zero fixed lease payments and high variable lease payments. Regardless of the composition of fixed versus vriable lease payments, the lessee has received a right-of-use asset and has an obligation to make lease payments.

32. Those who do not support Approach A do not think the lessee's measurement of the liability to make lease payments and the lessor's measurement of the lease receivable should reflect amounts that an entity has the ability to avoid.

33. The advantages and disadvantages of Approach A are summarized in the following table:

Advantages	**Disadvantages**
• May give a more faithful depiction of the rights obtained by the lessee and obligations incurred. • Reflects management's best estimate of the cash inflows/outflows from the entire lease arrangement.	• Would include estimates of variable lease payments that may be highly subjective. • May be difficult and complex to apply. The inclusion of optional terms may make it more difficult to project lease payments that are based on performance or usage.

34. The staff note that Approach A is inconsistent with the staff recommendation for lease term and options to extend or renew (IASB Agenda Reference 5B/FASB Memo 130).

35. An example of Approach A is included in Appendix A (as a separate attachment).

Approach B: Include an estimate of all variable lease payments that are "probable" or "reasonably assured/certain"

36. Under Approach B, all variable lease payments that are "probable" or "reasonably assured/certain" should be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable. Approach B is the same as Approach A, except for the increased recognition threshold.

37. Those who support Approach B agree with the general views discussed in paragraphs 30-34 above, but think that creating a higher threshold for recognition would result in estimates that are less subjective and, thus, more useful and comparable. That is because Approach B would exclude those variable lease payments that have a lower probability of occurring and which, therefore, might exclude estimates that may be more subjective and difficult to estimate.

38. The advantages and disadvantages of Approach B are summarized in the following table:

Advantages	Disadvantages
• May give a more faithful depiction of the rights received by the lessor and the obligations incurred by the lessee as compared to Approach A because it may be more reflective of actual cash flows. • Because measurement is less subjective than under Approach A, both the balance sheet and profit/loss statement could result in the presentation of more reliable estimates as compared with Approach A. • May be simpler to apply than Approach A.	• Would include estimates of variable lease payments that may be highly subjective. • As compared to Approach A, this approach could result in a liability that is less reflective of the lessee's contractual obligations to make payments. • May be difficult and complex to apply. The inclusion of optional terms may make it more difficult to project lease payments that are based on performance or usage.

39. The staff note that Approach B is inconsistent with the staff recommendation for lease term and options to extend or renew (IASB Agenda Reference 5B/FASB Memo 130). However, the staff think that Approach B is arguably more consistent with the staff recommendation for lease term and options than Approach A.

40. Approach B is substantially similar to Approach A (see example in Appendix A).

Approach C: Include an estimate only of variable lease payments that depend on an index or a rate

41. Under Approach C, the lessee's liability to make lease payments and the lessor's lease receivable would include variable lease payments only if those variable lease payments depend on an index or a rate. Lease payments that depend on a factor directly related to the future use of the lease property, such as machine hours of use or sales volume during the lease term, would be excluded from the measurement of the lessee's liability to make lease payments and the lessor's

lease receivable and would be reflected in profit and loss only in the period in which the uncertainty is resolved, for example, when the machine hours are used or a sale is made.

42. Approach C would be similar to current lease guidance in Topic 840 that states:

> Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. (Example 6 [see paragraph 840-10-55-38] illustrates this guidance.) However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable. (Example 7 [see paragraph 840-10-55-39] illustrates this guidance.)

43. Approach C would also be similar to the alternative view in the IASB ED. The alternative view proposes including contingent rentals in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable if those rentals are contingent on an index or rate. The alternative view disagrees with including contingent rentals that vary according to asset usage or performance.

44. Although those who support Approach C acknowledge that one reason for the ED's proposed approach is to avoid structuring opportunities, they do not think that this concern should outweigh the provision of relevant information and the consideration of cost/benefit concerns with the ED's approach. Those supporters consider that it is possible (a) to avoid structuring opportunities by establishing principles for identifying where variable lease payments lack economic substance and represent disguised minimum rental payments and (b) to highlight such payments through appropriate disclosure. Constituents have suggested a principle in which variable lease payments are included when variable lease payments are meant to compensate for below market committed rentals, such that the lease payments included would be consistent with the right-of-use asset that has been conveyed to the lessee.

45. The advantages and disadvantages of Approach C are summarized in the following table:

Advantages	**Disadvantages**
• May avoid problems relating to the accuracy or precision of measurement that may exist in Approach A and Approach B. • More consistent accounting between the lessor and lessee in cases in which the lessor would otherwise be unable to estimate variable lease payments reliably. • May be simpler to apply than Approach A and Approach B because it is more consistent with current guidance, reducing costs to organizations. • May better reflect the fact that variable lease payments based on usage or performance provide lessees with flexibility and reduce their business risk.	• May understate the depiction of the lessee's obligation and the lessor's receivable because it could exclude cash flows that are highly likely or for which the lessee has little realistic possibility of avoiding (if variable lease payments are viewed as a measurement issue rather than a recognition issue). • Could create structuring opportunities, or at least would require the establishment of additional principles to identify situations in which the variable lease payments lack economic substance and represent disguised minimum lease payments.

46. The staff note that Approach C is more consistent than Approach A and Approach B with the staff recommendation for lease term and options to extend or renew (IASB Agenda Reference 5B/FASB Memo 130).

47. An example of Approach C is included in Appendix A (in a separate attachment).

Approach D: Include an estimate only of variable lease payments that are outside of the control of a lessee and are, therefore, unavoidable

48. Under Approach D, entities would be required to recognize variable lease payments that are outside of a lessee's control and are, therefore, unavoidable. For example, usage-based variable payments would be excluded from variable lease payments because the variable lease payments are within the control of the lessee.

We agree that many (but not all) contingent rentals and residual value guarantees should be included in the measurement of assets

> and liabilities arising from a lease. However, we believe that only those contingent payments that are not within the control of the lessee should be included in the calculation of lease payments. Contingent payments that are within the control of the lessee should not be included in the lease payments. This is consistent with the treatment of contingent interest payments on debt instruments accounted for in accordance with IAS 32, Financial instruments: Presentation . (CL #63)

49. Approach D has characteristics similar to the current guidance in IAS 32 which states:

> A financial instrument may require the entity to deliver cash or another financial asset, or otherwise settle it in such a way that is would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless…

50. Difficulties arise when considering performance-based variable lease payments such as payments that are dependent on the turnover of a retail store. Some would argue that performance-based variable lease payments are within control of the lessee. That is, for example, the lessee can control whether or not they open their store and generate additional turnover. However, some would argue that performance based variable payments are not within the lessee's control and are in the control of others, for example, customers.

51. The advantages and disadvantages of Approach D are summarized in the following table:

Advantages	**Disadvantages**
• May avoid problems relating to the accuracy or precision of measurement that may exist in Approach A and Approach B. • May be simpler to apply than	• Could result in incomparability between organizations that view performance-based variable payments as either avoidable or unavoidable.

Advantages	Disadvantages
Approach A and Approach B because it is more consistent with current guidance than those approaches, reducing costs to organizations. • More principles based than Approach C, which may reduce the risk of structuring opportunities.	• May be practically difficult to apply. For example, estimating variable payments based on performance may be costly and unreliable (as noted in preparer workshops held).

52. The staff note that Approach D is more consistent than Approach A and Approach B with the staff recommendation for lease term and options to extend or renew (IASB Agenda Reference 5B/FASB Memo 130).

53. Approach D is substantially similar to Approach C (see example in Appendix A) if variable lease payments dependent upon performance are determined to be within the control of the lessee. However, some variable lease payments other than those based on index or rate may be considered outside of the control of the lessee and consequently would be recognised as a variable lease payment.

Staff Recommendation

54. The majority of the staff recommends that variable lease payments should be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable only if that payment depends on an index or a rate (Approach C). Variable lease payments include any increases or decreases in amounts that would be required to be paid/received subsequent to the inception of the lease.

55. The majority of the staff thinks that the benefits of Approach C would outweigh the costs of implementing it and that the approach addresses the concerns of feedback received throughout outreach activities and the comment letter process. The staff thinks that Approach C appropriately captures residual value guarantees and term option penalties (or obligations to retire the leased asset), which is consistent with the definition of *minimum lease payments* in Topic 840 and IAS 17.

56. In addition, the staff notes that, the results of Approach C may be similar to the results of Approach D. Although the staff think that Approach D may provide more of a principles-based solution, the staff think that Approach D may be difficult to apply because of the judgment in determining what is, and what is not, within the control of the lessee. The staff think that Approach C is a practical and less costly approach to the inclusion of variable lease payments.

57. The minority of staff members recommend that all variable lease payments that are "probable" or "reasonably assured/certain" should be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable (Approach B).

58. The staff members who recommend Approach B think that the approach appropriately addresses the operationality and reliability concerns expressed by preparers while still providing users of financial statements with useful information in the financial statements to assess amounts, timing, and uncertainty of cash flows.

59. Additionally, disclosures would be required for variable lease payments to provide users of financial statements with information on variable lease payments (ie, information on variable lease payments based on an index/rate as well as other variable lease payments such as, but not limited to, those based on usage and performance. Disclosures will be discussed in a future memo.

Question 1 - Recognition
Question 1 – Which approach should be used for determining which variable lease payments should be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable?

Discussion of the approaches for determining how variable lease payments should be incorporated into the measurement of the lessee's liability to make lease payments and the lessor's lease receivable

60. If the Boards choose either Approach A or Approach B in Question 1, they will also need to determine how variable lease payments should be incorporated into

the measurement of the lessee's lease payable and lessor's lease receivable (ie, whether the Boards will retain the expected value approach [described as the probability-weighted estimate approach] proposed in the leases ED or require some other method for measuring uncertain cash flows). However, the Boards plan to discuss a cross cutting issues paper on measuring uncertain cash flows at the February 2011 joint Board meeting (IASB Agenda Reference 2A/FASB Memo 1A). The staff thinks that it is important for the Boards to discuss that paper before decisions are reached on the leases project.

61. However, apart from that issue, the Boards also need to consider how variable lease payments that depend on an index or rate should be measured.

Rates to be used in the measurement of variable lease payments based on an index or rate

Summary of Proposals

62. The ED states that when determining the present value of lease payments payable, variable lease payments that depend on an index or rate should be determined using readily available forward rates or indices. If forward rates or indices are not readily available, then prevailing rates or indices should be used.

63. Furthermore, the basis for conclusions states the following:

> In principle, forecasting techniques should be used to determine the effect of contingencies based on changes in an index or rate. However, forecasting contingencies on the basis of changes in an index or rate requires macroeconomic information that entities may not have readily available. In the boards' view, the usefulness of the additional information obtained using such a forecast would not justify the costs of obtaining it. However, if forward rates or the prices stipulated in the contract are readily available for the period of the lease term (for example, from a government department or public service agency), using such forecasts would limit costs to adjusting the available rates or indices while providing better information to users of financial statements.

Feedback received

64. Only a few comment letter respondents commented specifically on the measurement of variable lease payments that depend on an index or rate. Some

respondents think that using and estimate of future rates will be very difficult to estimate and increases the complexity of the guidance.

> We believe that if contingent rentals depend on an index or rate, then the lessee should determine the expected lease payments using the spot rate on the measurement date. We believe it would be very difficult to estimate (and verify) the index or rate that will exist in the future, and we believe the use of forward rates or indices adds unnecessary complexity as there is significant debate regarding whether and when forward rates or indices are 'readily available' and some preparers will be less likely to have access to such rates than others. (CL #692)
>
> Contingent rents based on an interest rate index like LIBOR-based floating leases, in which the rent has a portion based on the prevailing LIBOR plus a spread, should not be subject to estimating future payments based on estimated forward rates. This is an unnecessary complication. The amounts capitalized using the spot rate method of calculation or the forward rates method of calculation would be the same. It is virtually assured that there will be changes in actual spot rates and estimates of the forward rates throughout the lease term. Additionally, the forward rates in a normal or steep yield curve environment will create an effective incremental borrowing rate that is likely to be artificially high. This will create more imputed interest expense than the likely actual amounts in the early portion of the lease term, exacerbating the front ending of lease costs. (CL #14)

65. Respondents also noted inconsistency with the measurement of variable rate loans in Topic 310and IAS 39 which state:

> If a loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that loan's contractually required payments receivable shall be calculated based on the factor as it changes over the life of the loan. Projections of future changes in the factor shall not be made for purposes of determining the effective interest rate or estimating cash flows expected to be collected. (310-30-35-14)
>
> For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability. (IAS 39 AG7)

66. Some commented that it also was difficult to determine what rates were "readily available" and whether or not "readily available" is consistent with the proposals in the revenue recognition ED that states that the transaction price needs to be "reasonably estimated."

Staff Analysis

67. The staff is presenting the following approaches for determining how variable lease payments should be incorporated into the measurement of the lessee's liability to make lease payments and the lessor's lease receivable if the Boards choose either Approach C or Approach D in Question 1:

    (a) Retain the guidance proposed in the ED. That is, variable lease payments that depend on an index or rate should initially be measured using readily available forward rates or indices. If forward rates or indices are not readily available, then prevailing rates or indices should be used.

    (b) Require measurement of variable lease payments that depend on an index or rate to be initially measured using the index or rate existing at the inception of the lease. That is, based on a prevailing rate (or spot rate).

68. The staff has analyzed the advantages and disadvantages for the two approaches that determine how variable lease payments should be incorporated into the measurement of the lessee's liability to make lease payments and the lessor's lease receivable if the Boards choose either Approach C or Approach D in Question 1 in the table below:

ED Approach	
Advantages	**Disadvantages**
• May provide better information if forward rates and indices are available but does not require an entity to make complex estimates if that information is not readily available.	• May result in incomparability between organizations. • Difficult to judge what is "readily available" and may be inconsistent with revenue recognition proposals. • Using forward rates may be misleading, for example creating an artificially high effective rate of interest during the start of the lease term when contingent payments are measured based upon an increasing interest curve. • May be difficult to determine forward rates for long-term lease arrangements that may be required if an entity thinks it meets the definition of "readily available".

Require use of index/rate at inception of lease	
Advantages	**Disadvantages**
• May be simpler to apply because it may be difficult to forecast future index changes or rates and to determine whether forward rates are "readily available".	• May result in accounting mismatches in profit and loss that do not reflect economic mismatches. For example, the spot rate may be significantly different from the forward rate.

69. The staff notes that in the leases Discussion Paper (DP) the FASB had tentatively decided that if variable lease payments depend on changes in an index or rate, the initial measurement of the lease asset or liability should be using the index or rate existing at the inception of the lease. However, there were some concerns from respondents to the DP that if forward rates were readily available, those rates

would provide better information to users without incurring additional costs. The Boards, therefore, decided to clarify in the ED that, if readily available, forward rates could be used.

Staff Recommendation

70. The staff recommends that the Boards require that the initial measurement of the variable lease payments that depend on an index or rate to be based on a prevailing rate (or spot rate). Based on comments received, the staff thinks that this (to use a prevailing rate [or spot rate]) is a practical and preferable approach to the ED proposal because it is difficult to determine what is "readily available" and may create incomparability between entities.

Question 2 – Measurement
Question 2 – Do the Boards agree that, if the Boards tentatively decide on Approach C or Approach D in Question 1, that the Boards require the measurement of the variable lease payments to be based on a prevailing rate (or spot rate)? If not, which approach do you prefer?

Discussion of a reliability threshold

71. The ED proposes that a lessor include variable payments in the lease receivable only if the variable lease payments could be measured reliably. That is similar to the proposals in the revenue recognition ED (paragraph 13). However, there is no equivalent 'reliable measurement' criterion for lessees.

Feedback Received

72. Respondents to the leases ED questioned whether a reliability threshold (similar to that included for lessors) also should be applied by lessees, which is consistent with other guidance in U.S. GAAP and IFRS.

> Furthermore, we agree with the proposal that lessors should include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments only if they can be measured reliably. Because their amounts and timing would depend on the lessees' behaviours, lessors may have difficulty in predicting the amounts and timing and the outcome resulting from estimation may

> vary significantly among lessors. Accordingly, we believe it is inappropriate to include such estimates in the lessors' lease assets when they cannot be measured reliably.
>
> However, we believe that such recognition criterion regarding measurement reliability should be provided not only for lessors but also for lessees. Some contracts that include contingent rentals are affected by various factors including the economic environment, long-term business plans, and the degree of physical and economic obsolescence of properties, and we think it could be difficult for both lessors and lessees to reasonably estimate the amount and timing of contingent rentals based on these factors. (CL #351)

Staff Analysis

73. Based on feedback received, the staff is presenting the following approaches:

    (a) Retain guidance proposed in ED, that is, include a reliability threshold for lessors only.

    (b) Retain guidance proposed in the ED, that is, include a reliability threshold for lessors. However, also include a reliability threshold for lessees.

    (c) Do not include a reliability threshold for lessors or lessees.

74. The Boards tentatively decided that lessors should only recognize variable lease payments if those variable lease payments are "measured reliably" because, at that point in revenue recognition project, it would have created consistency between the projects. However, as discussed in paragraph 13, the revenue recognition proposals now include a "reasonably estimated" threshold and the staff thinks it is important that the projects are consistent with one another and the terminology be updated to reflect "reasonably estimated" rather than "measured reliably".

75. The staff thinks that it is possible for lessees (not only lessors) to have difficulties in reliably measuring variable lease payments. However, the staff notes that the difficulty of measuring variable lease payments may be reduced if the Boards do not retain the guidance proposed in the ED, difficulties may still exist. Therefore, the staff thinks it is important to include a reliability threshold for both lessors and lessees so that information and estimates provided to users are helpful and as accurate as possible.

Staff Recommendation

76. The staff recommends that a reliability threshold should be included in the proposals for the measurement of variable lease payments for both lessees and lessors. The staff also recommends that the reliability threshold should be consistent with the revenue recognition proposals, that is, that the variable lease payments should be "reasonably estimated".

Question 3 – Reliability Threshold
Question 3 – Do the Boards agree that a reliability threshold should be included for the measurement of variable lease payments for both lessees and lessors and that the reliability threshold should be consistent with revenue recognition? That is, variable lease payments should be "reasonably estimated". If not, which approach do you prefer?