Project **Leases**

Topic **Accounting for options to extend or terminate a lease**

Objective

1. The purpose of this paper is to discuss the accounting for options to extend or terminate a lease; that is, initially assessing and then subsequently reassessing the lease term.

2. This paper is structured as follows:

   (a) Summary of the proposals in the Leases Exposure Draft (ED)

   (b) Summary of feedback including comment letters and other outreach

   (c) Analysis of alternative approaches to initial measurement

   (d) Subsequent measurement

   (e) Symmetry between lessee and lessor accounting

   (f) Appendix A – Alternatives previously considered and rejected by the boards

   (g) Appendix B – Suggested definition of lease term

3. In this paper, the staff recommend:

   (a) The lease term is initially determined as the lease term that is reasonably certain to occur. In assessing whether the exercise of an option to extend a lease is reasonably certain, an entity would consider

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only factors that create an economic incentive for the lessee to extend the lease.

(b) A lessee and lessor are required to reassess the lease term for changes in the indicators applied in determining the initial lease term.

(c) The lessee and lessor account for the lease term using the same definition at both initial and subsequent measurement.

4. The staff expect to discuss the following related topics in a follow-up memorandum:

(a) Accounting for purchase options

(b) Presentation impact of changes from a reassessment of lease term

(c) Disclosures regarding options to extend or terminate a lease.

Summary of the Proposals in the Leases Exposure Draft (ED)

5. Lease contracts often grant the lessee the right to either (a) extend the lease beyond the initial lease period or (b) terminate the lease before the end of the lease period.

6. The ED proposed that an entity should account for options to extend or terminate a lease by defining the lease term as the longest possible term that is more likely than not to occur (see paragraphs B16-B20 of the ED). This definition of lease term applies to both the lessee and the lessor and requires an ongoing reassessment of the lease term after the date of lease commencement.

7. However, the ED acknowledged that the lessee and the lessor may have different information on the likelihood of term options being exercised and, therefore, may reach different conclusions about the recognized lease term for the same contract. The ED proposed that an entity should consider all relevant factors in determining the lease term, including contractual and non-contractual factors, business factors, and lessee-specific factors (for example, past practice and intention).

8. In the Basis for Conclusions in the ED, the boards stated that:

> The proposed approach to lease term options is a practical solution to the problems associated with the accounting for leases with options. If optional periods are not included in the lease term, the right-of-use asset or the liability to make lease payments may not result in a faithful depiction of the entity's assets and liabilities associated with the lease.

9. In addition, under the proposed approach, options would not be recognized separately. Instead, uncertainty about the lease term would be addressed through recognition, that is, one of the possible lease terms is selected, and the accounting is based on that lease term. Consider the following example:

> A machine is leased for a period of 10 years (the primary period). The lease contract includes an option for the lessee to lease the machine for an additional five years (the secondary/optional period).
>
> Annual lease payments in the initial 10 year period are CU100 and the optional five year period are at market at the option date.

10. In the example above, when applying the proposals in the ED, the lessee would recognize both a right to use the machine (right-of-use asset) for either 10 years or 15 years and a liability to make lease payments for either 10 years or 15 years. A lessor would recognize a right to receive lease payments for either 10 years or 15 years and either record a performance obligation or derecognize a portion of the underlying asset.

11. This approach results in only contractually possible outcomes being recognized, compared to a weighted-average and components approach which were discussed in the ED.

12. Appendix A includes a table summarizing the advantages and disadvantages of the weighted-average and components approach that were previously rejected by the boards.

13. The staff note that the weighted-average approach received limited support in either outreach activities or in the comment letter feedback.

14. However, the components approach did receive some support, specifically from some auditors and some accounting standard setters. As noted in Appendix A, they recognized they supported the conceptual strength of this approach and thought that this outweighed the costs of applying this approach to some, or all, options to extend or terminate a lease.

Summary of Feedback Including Comment Letters and Other Outreach

Support for the proposals

15. Many respondents agreed with the boards that options to extend and terminate leases affect the economics of lease contracts and supported a consistent approach for applying the lease term definition to both lessees and lessors.

Concerns relating to the proposals

16. Almost all preparer and auditor respondents disagreed with the definition of the lease term as the longest possible term that is more likely than not to occur.

17. The majority of respondents expressed concerns relating to including options to extend and terminate leases in the lease term. These respondents argued that:

    (a) Including cash flows expected to arise from the exercise of options in the measurement of the lessee's payable and lessor's receivable could result in an overstatement of the payable or receivable on the balance sheet.

    (b) For lessors, the receivable for lease payments will only arise as a result of a future action taken by another party (that is, they are outside of the lessors' control).

    (c) Counter-intuitive outcomes arise with the lessee reporting a higher liability and the lessor a higher receivable in situations where the lessee has the benefit of optionality. Recognition of assets and liabilities when the lease payments in option periods are based on fair market

value is inappropriate because the option has zero or nominal value in those cases.

18. Many respondents, especially preparers and auditors, expressed concerns with, and demonstrated in workshops, the cost of complying with the proposals. They commented that determining lease term as defined in the ED would:

    (a) Be time consuming because the current functionality of IT accounting systems and nature of the estimation required would lead to a manually-intensive process with inputs to the estimation process required from many senior organization members.

    (b) Lead to unreliable estimates at the contract level. For example, the retail industry noted that within a portfolio, some retails stores are likely to under-perform and, consequently, the leases will not be renewed. Other stores will perform strongly and will likely lead to leases being renewed. However, significant challenges exist in identifying which individual stores are likely to under-perform and over-perform, and consequently which individual store options will be exercised.

    (c) Decrease comparability due to the difficulty of estimations (for example, in assessing lease terms associated with rigs in the energy industry, factors such as drilling success, the quality of associated service, commodity prices and weather will all affect renewal assessments).

    (d) Place a challenging burden on lessors to estimate the behavior of lessees.

    (e) Create significant estimation uncertainty when a lease term goes beyond the period of an entity's business plan.

    (f) Add additional complexity because the assessment of lease term would likely be a decentralized process, involving inputs from a range of

business units and departments, rather than being performed centrally at the corporate accounting level.

19. Many respondents acknowledged the boards' concerns relating to the structuring risks associated with options to extend and terminate leases. However, these respondents discouraged the boards from defining lease terms purely to avoid structuring arguing that:

    (a) As noted in the Alternative View, options provide flexibility to react to changing business circumstances and thereby reduce risk

    (b) A 5-year lease with an option for a further 5 years should not be accounted for as a 10-year lease if the option is expected to be exercised because the economics are different between the two lease contracts

    (c) Option flexibility would be reflected in contractual minimum lease payments (for example, a lessor would demand a premium if the lessee wanted to structure a lease contract in a way that reduces the lease term).

20. Many respondents and workshop participants questioned the practical application of the proposals, questioning how the lease term would be determined in situations in which a lease contract includes:

    (a) Month-to-month extension terms/open-ended/'pay-as-you-go' contracts (for example, construction equipment such as scaffolding)

    (b) A right of first refusal, or statutory right for the lessee to extend at the end of the lease term (for example, tenancy agreements in some European countries)

    (c) 'Evergreen' statutory or implicit extension terms (for example, in some Asian jurisdictions, tenants have an infinite right to extend that may be outside of statute or the terms of the contract)

    (d) Terms permitting termination by either the lessee and/or the lessor

21. A few respondents also noted that because financial statements are generally prepared on a going concern basis, it could be argued that assumptions for lease terms should be broader than just focusing on extensions included in lease contracts. For example, an entity that has corporate headquarters, and will need those headquarters for an infinite period of time, is in an economically similar situation regardless of whether it has:

    (a) A 50 year lease at market rates, with no extension or termination options

    (b) A 30 year lease at market rates, with a 20 year extension option at market rates

    (c) A 20 year lease at market rates, with no extension option, but will relocate to a similar office at the end of the current lease term and continue to pay a market rate.

22. In all three situations, the entity will need to commit similar future cash flows to obtain the right to use a corporate office headquarters. These respondents encouraged the boards to consider whether the objective of the lease term definition is to focus on:

    (a) Contractual future lease cash flows

    (b) Estimating all future lease cash flows

    (c) In-substance contractual future lease cash flows.

Private company feedback

23. Private companies expressed considerable concern with regards to the cost of adopting the provisions of the ED. Consistent with public companies, their primary concerns with regards to cost related to the additional cost of systems and personnel that would be required to determine the lease term at lease inception and to reassess the lease term if facts or circumstances indicate that there would be a significant change in the lessee’s liability to make lease payments or in the lessor’s right to receive lease payments.

User feedback

24. Users had mixed views on the treatment of options to extend or terminate leases. They have not had significant information in the past about term options, unlike the information that the proposed model would provide. They welcome better access to this information, but disagree on how best to provide it.

25. Some users think that estimates are an inherent part of business and that reflecting the estimated expected lease term in the measurement of the lease assets and liabilities, similar to other accounting estimates, provides the best possible information on the statement of financial position, as long as users can understand the assumptions that were made about these features (that is, via disclosure). They argue that statement of financial position presentation and footnote disclosure have different weights and that footnotes are not audited as robustly.

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

27. Other users would prefer to see only the minimum contractual lease term on the statement of financial position and see additional, detailed information disclosed about options to extend or terminate in the footnotes, because of the uncertainly in estimating such amounts. Some industry-focused users (for example, retail) are particularly uncomfortable with including optional lease terms in the statement of financial position, because they think that options to extend are negotiated to provide the lessee with flexibility and do not represent obligations of the lessee.

28. Some users think that economic compulsion should be reflected in the recognition of renewal terms. Those users did not think that an expectation of renewal without some economic incentive to do so (for example, the existence of significant leasehold improvements) is enough.

Suggested approaches

29. As an alternative to the proposals in the ED, many preparer and auditor respondents supported either:

    (a) Increasing the threshold for taking into account options to extend or terminate from 'longest possible term that is more likely than not to occur' to either:

        (i) 'Reasonably assured' (a term used in current US GAAP) or 'reasonably certain' (current IFRS), with respondents noting that current practice generally works well; or

        (ii) 'Virtually certain' (which would be close to just including contractual minimum lease payments, similar to the disclosure approach rejected by the boards in paragraph BC120 (b) of the ED); or

    (b) The Alternative View (an approach rejected by the boards in paragraph BC120 (d) of the ED) to reflect options to extend and terminate leases in the measurement of lease assets and liabilities only when the lease contract includes incentives for the lessee or lessor to exercise the options. This might be the case if there is/are:

        (i) Customization and specialized nature of the underlying asset;

        (ii) Reduced payments due in option periods;

        (iii) Significant leasehold improvements; and/or

        (iv) Penalties payable on termination of the lease.

30. If the boards were to pursue one of the alternative approaches above to defining the lease term, a number of respondents were supportive of providing additional disclosure, by type of contract, of optional periods and minimum lease payments in those periods.

31. A few respondents (especially preparers) also suggested that if the boards were to proceed with the lease term definition in the ED, then entities should be permitted to assess the longest possible term that is more likely than not to occur on a

portfolio of homogeneous leases, rather than on an individual lease contract basis. However, although this may be acceptable, auditors and preparers expressed significant concerns regarding whether a portfolio approach would be auditable (for example, determining the basis of identifying 'homogenous' leases because of the unique nature of separate lease arrangements).

Analysis of Alternative Approaches to Initial Measurement

32. The boards previously considered alternatives to the approach proposed in the ED, which were rejected. Two of the rejected approaches – the components approach and probability-weighted measurement approach – are summarized in Appendix A. The disclosure approach, which would require the lease term to be established at the contractual minimum lease term, was also rejected by the boards. The staff do not think that the feedback received on the ED indicates that the boards should re-consider these three approaches.

33. In addition, there was some support from constituents, including some users, for a "virtually certain" threshold, supplemented with disclosures. However, the staff have rejected this approach for many of the reasons identified by the boards in paragraph BC120(b) of the ED, observing that it is similar to the contractual minimum lease term. Specifically, although this approach would be simple to apply, it would provide less useful information to users of financial statements because the measurements of the asset and liability would ignore the existence of most of the options in a lease and thus potentially misrepresent the assets and liabilities arising from a lease.

34. However, the staff have considered the feedback received from proponents of the previously rejected approaches in developing the alternative approaches discussed below.

Alternative approaches to initial measurement

35. Instead, based upon the feedback received from interested parties, the staff propose the following alternative approaches to the accounting for lease term options:

    (a) **Approach A**: Account for the longest term more likely than not to occur as proposed in the ED. (The basis supporting this approach and the concerns with this approach have been discussed above.)

    (b) **Approach B:** Account for the contractual minimum lease term plus any optional periods that are reasonably certain to be exercised. At inception, indicators that optional periods are reasonably certain and therefore should be included in the lease term include, but are not limited to, any contractual terms that provide an incentive to exercise the options. In addition, other indicators should also be considered in the assessment of lease term, including past business practices, common industry practice, and management intent.

    (c) **Approach C**: Account for the contractual minimum lease term plus any optional periods that are reasonably certain to be exercised. Approach C would be limited to factors that provide an economic incentive to extend the lease. Those factors include indicators in the Alternative View expressed in the IASB's ED. Refer to Appendix B for the suggested definition of lease term under Approach C.

36. For reference, the staff have included the current definitions of lease term below.

    (a) IFRS: The definition of lease term under IAS 17 is as follows:

        the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is **reasonably certain** that the lessee will exercise the option.

    (b) US GAAP: The US GAAP definition of lease term is more detailed but has the same basic principle as IFRS. US GAAP defines lease term as:

(i) the fixed noncancelable lease term plus all of the following (except the lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable)"

a) All periods, if any, covered by bargain renewal options.
b) All periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be **reasonably assured.**
c) All periods, if any, covered by ordinary renewal options during which any of the following conditions exist:
   (a) A guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect.
   (b) A loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding.
d) All periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable.
e) All periods, if any, representing renewals or extensions of the lease at the lessor's option.

Analysis of approaches

37. Consider the following example:

(a) Two lessees have 5-year leases with level monthly payments, and an option to extend the lease at fair market price for an additional 2 years.

(b) At lease inception, management of Lessee X intends to be at the location for 7 years and concludes it is reasonably certain that it will be. Lessee Y does not intend to be at the location for 7 years and concludes that it is not reasonably certain that it will be. There is no specific economic incentive for either Lessee X or Lessee Y to exercise the extension options.

38. Under Approaches A and B it is likely that Lessee X would conclude that the lease term is 7 years and Lessee Y would conclude that the lease term is 5 years. At inception, Lessee X concludes that the lease term is 7 years because management concludes based on its intent and past practice that it is reasonably

certain that the extension option will be exercised. Lessee Y, on the other hand, can only conclude that it has a 5 year lease term. Despite the two lessees being in economically similar (although not identical) situations, their recognized lease obligations would differ significantly.

39. Under Approach C, only the initial 5 years would be included in the lease obligation of both Lessee X and Lessee Y because it is not reasonably certain that the extension option will be exercised because there are no specific economic incentives for Lessee X and Lessee Y to exercise the options. However, under Approach C, Lessee X and Lessee Y are unable to look to management intent, past practices and common industry practice and both Lessee X and Lessee Y must both record a lease obligation reflecting a 5 year lease term.

Staff recommendation

40. A majority of the staff recommend Approach C. Under Approach C, the indicators in the Alternative View expressed in the IASB ED would be used to supplement the current IFRS and US GAAP guidance to determine the reasonably certain lease term at inception. Paragraph AV2 of the ED specifically notes that the following constitute incentives to extend:

    (a) penalties payable on cancellation

    (b) reduced rentals in the optional period

    (c) instances where costs of customization or installation make renewal likely.

41. Factors such as past practice and management intent would not influence the determination of a reasonably certain lease term at inception. The staff think this approach is more objective because it does not depend on the assessment of future business conditions or management intent, which could easily be altered by external economic circumstances.

42. Further, Approach C is still arguably consistent with the overall approach in the ED in that it is a ‘whole lease’ approach but includes only some optional periods. However, Approach C is responsive to concerns that:

    (a) It may be misleading to include amounts in the lessee’s liability that the lessee has genuine flexibility to avoid, because there is no economic incentive to renew

    (b) The approach in the ED is very subjective and complex.

43. The staff recommendation is consistent with a considerable amount of constituent feedback that that was supportive of the Alternative View:

> Consistent with the existing approach under IAS17 Leases we suggest that an option to extend the lease should only be recognised when it is considered ‘reasonably certain’ that the lease will be extended, for example if the lease contains commercially advantageous terms for the extension period. The Board’s proposals include narrative disclosures about optional lease periods. We believe that accounting for the minimum lease term or the full term only where the option is reasonably certain to be exercised in conjunction with such disclosures will provide more useful information for the users of the financial statements. We agree with many of the arguments set out in the alternative view. (CL#683)

44. Approach C would also address the concerns that other approaches would result in higher costs and less consistent, less reliable, more volatile financial reporting. This approach could thus be more useful to users of financial statements:

> The estimation of lease terms many years into the future is highly subjective and uncertain and will lead to a lack of comparability and undue complexity. One of the reasons given for the treatment is to minimise structuring (paragraph BC 123). However, introducing arbitrary rules that are not based on sound principles is not an answer to this. (CL #122)

45. Other staff think Approach B is more appropriate because including all factors that may affect the potential lease term, such as past practice and management intent, would more closely reflect the expected future cash flows associated with the lease and, thus, be more responsive to the needs of users of the financial

statements. Approach B also would reduce subjectivity and complexity and therefore address those concerns expressed by constituents.

Question 1
Which approach should be used for determining the term of the lease?

Subsequent Measurement

46. The ED proposes that lessees and lessors should adjust the lease liability/asset after initial recognition if facts or circumstances indicate that there would be a significant change in the lessee's liability to make lease payments or in the lessor's right to receive lease payments. When such indications exist, the lessee and lessor are required to reassess the length of the lease term.

47. The ED states in paragraph BC132 that requiring the lessee and lessor to reassess the lease term at each reporting date is meant to provide users of financial statements with more relevant information. However, many preparer and auditor constituents:

    (a) Argued that because reassessment is overly complex and burdensome, the costs of reassessment are greater than the benefits

    (b) Recommended that the reassessment should be required only when specified 'triggering events' occur.

48. The staff notes that the different thresholds evaluated to establish the lease term at lease inception affect the frequency of reassessment. For instance, including periods under extension options in the lease term only when they are reasonably certain would reduce the frequency of reassessment compared with the approach proposed in the ED, thereby making the approach less burdensome and costly.

Alternative approaches to subsequent measurement

49. The staff have identified two approaches to subsequent measurement relating to the lease term:

(a) **Approach 1**: Reassess the lease term as proposed in the ED. That is, reassessment should be performed on a basis consistent with the initial determination of lease term.

(b) **Approach 2:** Reassessment should not be performed. The lease term is determined only at inception and when the lease contract is modified.

Analysis of approaches

50. Consider the following example:

    (a) A lessee has a 10-year lease with level monthly payments, and an option to extend the lease at market prices for an additional 5 years.

    (b) At lease inception, management is not reasonably certain that it will exercise the renewal option and determines the lease term is 10 years.

    (c) At the end of Year 6, management has budgeted that it will continue to lease the location for the optional period because management plans material leasehold improvements in the coming years.

    (d) At the end of Year 7, management begins substantive renegotiations with the lessor regarding the intent to exercise the renewal option.

    (e) At the end of Year 8, leasehold improvements are undertaken and completed at the direction of the lessee.

    (f) At the end of Year 9, the lessee exercises the 5 year renewal option.

51. In applying Approach 1, management would increase the lease term up to 15 years at one of the following dates:

    (a) At the end of Year 6, due to management's intent based on its budget forecast;

    (b) At the end of Year 7, due to substantive renegotiations with the lessor indicating management intent; or

    (c) At the end of Year 8, due to the installation of leasehold improvements.

52. Under Approach 1, the factors considered for reassessment would be different depending on what the boards decide on Question 1 above. The factors considered in reassessment would be consistent with those considered in the initial determination of the lease term.

53. Under Approach 2, management would not update the lease term until the option is exercised at the end of Year 9.

Staff recommendation

54. The staff support Approach 1, requiring a reassessment of the lease term on a basis consistent with the initial determination of lease term.

55. The staff think that requiring reassessment of the lease term provides useful information to users because the lease term is determined on a consistent basis over the duration of the lease contract.

56. The staff acknowledge concerns raised by constituents in responding to the ED about the cost of reassessment. However, the staff think that these reassessment costs would be lower if the approach recommended by the staff in this paper is applied rather than the ED because:

    (a) If Approach B or Approach C are applied, the threshold for recognizing options to extend or terminate a lease is increased.

    (b) If Approach C is applied, the requirement to reassess the lease term would not apply to all leases at each reporting period. Instead, the requirement to reassess would be limited to lease contracts where incentives to exercise options to extend or terminate a lease exist.

Question 2
Do the boards agree with the staff recommendation that reassessment should be required on a basis consistent with the initial determination of the lease term?

Symmetry Between Lessee and Lessor Accounting

57. The ED does not make a distinction between a lessee and a lessor in the way term options are accounted for. However, because the lessee and the lessor may have different information on whether the lessee will extend or terminate the lease, the lessee and the lessor may not determine the same lease term.

58. The staff have highlighted the following reasons that support differences in the accounting for options to extend or terminate a lease between a lessee and a lessor:

    (a) The information known to the two parties of the lease will be asymmetrical.

    (b) The lessee is usually the party that holds the option and exercise of the option is usually within the control of the lessee, but outside of the control of the lessor.

    (c) For a lessor applying the derecognition approach, reassessment of the lease term results in the recognizing revenue and/or reversals of revenue based on a subjective determination by the lessor. Because there is an impact on revenue resulting from a reassessment, the recognition principle for a lessor applying the derecognition approach may need to be more restrictive.

59. The staff have highlighted the following reasons that do not support differences in the accounting for options to extend or terminate a lease between a lessee and a lessor:

    (a) Less complex to apply and understand, which may be helpful to users of financial statements.

    (b) Easier to account for subleases and related party leases.

Staff recommendation

60. The majority of the staff recommend Approach C in Question 1. Under Approach C, the accounting for the lease term requires both parties to assess the lease term based on the lease contract and the leased asset, rather than business and other factors. In other words, there would usually be symmetrical information available to both parties. Because both parties are assessing the same contract at the same time (lease inception) to determine the lease term, it is more likely that the lessee and lessor would determine the same lease term. The staff concludes that it is appropriate to have a consistent definition of lease term between the lessee and the lessor and think that this avoids creating additional complexity.

Question 3
Do the boards agree with the staff recommendation that the definition of lease term be consistent between the lessee and the lessor?

APPENDIX A

Alternatives Previously Considered and Rejected by the Boards

A1. The boards have previously considered and rejected the following approaches:

(a) The components approach

(b) The probability-weighted measurement approach.

A2. The following example is used to illustrate those two alternative approaches:

> **EXAMPLE 1**
>
> A machine is leased for a period of 10 years (the primary period). The lease contract includes an option for the lessee to lease the machine for an additional five years (the secondary/optional period).
>
> Annual lease payments in both periods are CU100.

The Components Approach

A3. Most constituents agreed with the views expressed by the boards in paragraph BC120(a) of the ED that, although having some conceptual merit, accounting separately for extension and other options embedded in a lease contract would be overly complex and burdensome. However, a small minority of key constituents, specifically some standard setters and accounting firms, continue to support a components approach with intrinsic cost measurement.

A4. Under this approach, the lessee would recognize and measure each of the rights and obligations in a lease separately. So, for the lease in example 1, the lessee would separately recognize the following:

(a) A right to use the machine (right-of-use asset) for 10 years

(b) An option to extend the lease

(c) A liability to make lease payments (this would include both the payment for the right-of-use asset and the option).

A5. Constituents that support this approach argue that this approach is most consistent with the Conceptual Frameworks and the most transparent with regards to the economics of the lease terms. The majority of staff agree with these arguments.

A6. However, the staff do not recommend this approach given the level of complexity involved with measurement and the extent of interaction of the option component of the lease with other terms of the lease. Further, the staff expect that many of the options that have material intrinsic value (that is, bargain renewal options) would be captured as part of the lease term as defined in the staff recommendation. Paragraph BC120(a) of the ED explains the boards' reasons for rejecting this approach.

The probability-weighted measurement approach

A7. Under this approach, options would not be recognized separately. Instead, uncertainty about the lease term would be dealt with in the measurement of the liability to make lease payments.

A8. Under Example 1, if there is an 80 percent probability that the option to extend the lease will be exercised, the lessee would recognize the following (ignoring the effects of discounting and assuming an expected outcome approach to measurement):

(a) A right to use the machine (right-of-use asset) initially measured at CU1,400 (20% × CU100 × 10 years + 80% × CU100 × 15 years)

(b) A liability to make lease payments initially measured at CU1,400 (20% × CU100 × 10 years + 80% × CU100 × 15 years).

A9. This approach is seen by some as more consistent with the *Conceptual Framework* than the proposals in the ED. Also, because it is a probability-weighted approach, this could provide users more useful or accurate expectations of future cash flows when applied to a large portfolio of similar leases.

A10. However, the staff acknowledge that this approach could result in a measurement approach that is both burdensome and costly. Moreover, the boards have previously concluded that a probability-weighted approach is not appropriate to determine whether an asset or liability exists. Thus, the boards did not propose to adopt this approach for determining the lease term because it might be difficult to measure reliably the probability of exercise of an option, and to avoid an entity recognizing a lease term that does not reflect a possible outcome, which some find counter-intuitive. BC120(c) of the ED explains the boards' reasons for rejecting this approach.

APPENDIX B

Suggested Definition of Lease Term

B1. The ED defines the lease term as follows:

> The longest possible term that is more likely than not to occur.

B2. The staff suggest changing the definition as follows:

> The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is **reasonably certain** that the option will be exercised.
>
> The lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable.
>
> The following are indicators that the exercise of an option to extend a lease is reasonably certain:
>
> (i) The existence of bargain renewal options.
>
> (ii) When failure to renew the lease imposes an economic penalty on the lessee in such amount that a renewal appears likely**.** Economic penalties include:
>
> (a) A penalty payable upon cancellation of a lease.
>
> (b) High costs of customization or installation of the underlying asset.
>
> (iii) There is a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect.
>
> (iv) There is a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding.
>
> (v) Ordinary renewal options preceding the date as of which a bargain purchase option is exercisable.