



Staff Paper

Project

Leases

Topic

Other Lease Payment Considerations

Objective

1. IASB Agenda Paper (AP) 5A/FASB Memo (Memo) 129 discusses the recognition and measurement of a lessee's liability to make lease payments and a lessor's lease receivable in leases with variable lease payments.
2. The purpose of this paper is to discuss the recognition and measurement of a lessee's liability to make lease payments and a lessor's lease receivable for other lease payment considerations that were not discussed in the memo on variable lease payments (AP 5A/Memo 129).
3. Some of the topics in this paper may or may not be relevant depending on the decisions that the Boards reach in AP 5A/Memo 129.
4. This paper is organized as follows:
 - (a) Summary of Staff Recommendations
 - (b) Disguised Minimum Lease Payments
 - (c) Lease Arrangements with Significant Variable Consideration
 - (d) Residual Value Guarantees
 - (e) Third Party Residual Value Guarantees
 - (f) Term Option Penalties.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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Summary of Staff Recommendations

5. In this paper, the staff recommends that the Boards do the following:
- (a) Clarify that disguised minimum lease payments should be considered in the estimate of the present value of lease payments at the date of inception of the lease.
 - (b) Require an estimate of lease payments for arrangements where the variable consideration is significant in relation to the entire consideration to be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable. However, some staff members recommend that (a) if the variable consideration is significant in relation to the entire consideration in the contract and (b) these variable payments are not determined to be disguised minimum lease payments, appropriate disclosure should be made.
 - (c) Clarify that residual value guarantees (RVGs) (that are not from an unrelated third party) should be included in the measurement of a lessee's liability to make lease payments and the lessor's lease receivable, similar to current guidance. The full amount of the RVG would be included in this measurement.
 - (d) Confirm their tentative decision reflected in the leases Exposure Draft (ED), that is, the lessee's liability to make lease payments and the lessor's lease receivable should not include an estimate of amounts payable under RVGs provided by an unrelated third party.
 - (e) Require the accounting for term option penalties to be consistent with the decisions in AP 5B/Memo 130, discussing lease term. That is, if there are term option penalties for non-renewal and the renewal period is not included in the lease term, then those term option penalties should be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable.

Disguised Minimum Lease Payments

Feedback Received

6. Some respondents are concerned that if the Boards were to limit the payments included in the lessee's liability to make lease payments and the lessor's lease receivable, a lease may be structured to contain variable lease payments that lack economic substance and that are, in effect, disguised minimum lease payments.

The proposals should include qualitative considerations to include base rentals that have been "disguised" as contingent rent ("anti-avoidance measure") using management's best estimate rather than a probability weighted scenario analysis. (CL #421)

Estimated contingent rents that are disguised minimum lease payments should be capitalized, as in the example of a retail real estate lease where the entire rent the lessee is obligated to pay during the base lease term is contingent based on a percentage of sales calculation. This is the driver for the proposed rule of capitalizing all contingent rents, that is, the fear that many leases would be structured with entirely contingent rents. Entirely contingent rents are extremely rare in my experience. I have only heard of their existence (again rare) in the retail real estate leasing industry. Third-party equipment lessors would never write an entirely contingent rent lease as it would create intolerable residual risk. Rather than writing a rule capitalizing all contingent rents, I suggest using a principle of only capitalizing base term contingent rents that are disguised minimum lease rents. That is how current GAAP is applied in practice in the United States (CL #14)

Staff Analysis

7. The staff considered requiring an estimate of disguised minimum lease payments in the measurement of lease assets/liabilities. The staff thinks that estimates made for disguised minimum lease payments may have similar disadvantages to the measurement of variable lease payments based on usage or performance, as discussed in AP 5A/Memo 129. That is, estimates made for disguised minimum lease payments may be subjective. However, an advantage of including an estimate of those lease payments in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable is that it may mitigate

concerns about entities structuring lease to include only (or a high proportion of) variable lease payments when the variable lease payment has no substance.

8. In such cases, requiring an estimate of disguised minimum lease payments to be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable would, therefore, provide better information of the expected cash flows of an organization for users of financial statements.
9. The staff also considered requiring only disclosure on disguised minimum lease payments because the information would still be available to users of the financial statements. A suggestion of those disclosures from an organization may be:

Example of Accor: rating agencies and investors are today pleased with the information published in the Notes of our financial statements. Accor is used to present, for its Hotel Division:

- its entire future minimum rental commitments for each of the 15 future periods (and not by category of periods).
- Its rental expenses for the period broken down by type of rents (fixed rents with and without purchase options, contingent rents, contingent rents with minimum guarantees...) and types of brands of leased hotels.
- The number of contracts.
- The rental expenses by segment.
- A main description of its significant lease contracts. (CL #662).

10. However, the staff thinks that disclosures are not an appropriate substitute for the recognition of disguised minimum lease payments on the face of the financial statements. If organizations are able to provide information on disguised minimum lease payments in disclosure, that information should also be available and reliable enough for the financial statements.

Staff Recommendation

11. The staff does not think it is appropriate to ignore disguised minimum lease payments in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable. The staff recommends that the Boards clarify that disguised minimum lease payments should be considered in the estimate of the present value of lease payments at the date of inception of the lease.

12. To achieve this clarification, the staff thinks it is appropriate to include the notion of disguised minimum lease payments in the definition of lease payments.

Question 1 – Disguised Minimum Lease Payments

Question 1 – Do the Boards agree that it is appropriate for disguised minimum lease payments to be considered in the estimate of the present value of lease payments at the date of inception of the lease? If not, which approach do you prefer?

Lease Arrangements with Significant Variable Consideration

Feedback Received

13. Those who commented on lease arrangements with significant variable consideration were sympathetic to the possibility of structuring if variable lease payments were not included.

Consequently, Ahold believes there is some merit to including contingent rentals in the right-of-use asset and lease liability when there is certainty in the amount and where the contingent rental is significant in relation to the entire rental. (CL #315)

We understand the Boards' concern that lessees may structure lease payments as contingent rents to avoid recognizing a liability, however at lease inception, the terms and conditions of each lease agreement should be carefully reviewed to make sure that assets and liabilities reflect the true economics of the transaction. Contingent payments that become unconditional during the term of the lease should be subsequently considered for adjustment. (CL #135)

14. Users had mixed views about the appropriate accounting for leases with 100 per cent variable lease payments (for example, based on sales). Some users prefer to estimate those amounts because they are concerned about the potential for management bias in making the estimates. Others think that management has the best information about future variable lease payments (for example, those linked to sales) and would like those amounts to be included in the statement of financial position, as long as users can understand how the amounts are calculated when looking at the notes.
15. Through outreach activities, the staff was able to note examples of lease arrangements with significant variable consideration including some hotel and outlet mall arrangements. Interested parties with those arrangements explained that the arrangements were structured in a way to reflect the operational flexibility of the lessee, rather than a desired financial reporting outcome.
16. However, the feedback also suggests that it is rare for an arrangement to include only variable consideration.

There are very few instances in which a lessor would accept the possibility of receiving no rent at all, or an amount significantly below what they could get from another tenant. (CL #13)

Staff Analysis

17. The staff thinks that an entity may need to consider whether a contract that has a high proportion of variable consideration relative to the overall consideration is an indicator that the contract should not be accounted for as a lease but, instead, should represent a service contract. The definition of a lease is discussed in AP 5C/Memo 131.
18. However, should the Boards not require all variable payments to be included in the measurement of lease receivables and payables (Approaches A and B in AP 5A/Memo 129), the staff thinks that, to minimize the risk of structuring, it is important that appropriate disclosures are provided for arrangements in which the variable consideration is significant in relation to the entire payment.

Staff Recommendation

19. The majority of the staff recommends that, in arrangements where the variable consideration is significant in relation to the entire consideration in the contract, an estimate of lease payments should be made at the inception of the lease and included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable. This is because they think that these are always disguised minimum lease payments, which should be recognized in accordance with the staff recommendation in paragraphs 11-12 above.
20. However, although it has been acknowledged that disclosure is not a substitute for recognition, some staff thinks that some users of financial statements would accept disclosure versus recognition of significant variable consideration so that they are able to perform their own analysis of variable consideration. Therefore, some staff members recommend that (a) if the variable consideration is significant in relation to the entire consideration in the contract, and (b) these variable payments are not determined to be disguised minimum lease payments, appropriate disclosures should be presented. Specific disclosure requirements will be discussed in a future memo.

Question 2 – Arrangements with Significant Variable Consideration

Question 2 – Do the Boards think that, if the variable consideration is significant in relation to the entire consideration in the contract, that consideration should be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable? Or, do the Boards think appropriate disclosure should be presented for that consideration?

Residual Value Guarantees

Summary of Proposals

21. Consistent with the proposals for variable lease payments, the leases ED proposes that the present value of lease payments should include an estimate of amounts payable under RVGs (that are not from an unrelated third party).

Feedback Received

22. Some respondents noted that RVGs should be included in the measurement of lease assets and liabilities even if other variable payments are excluded.
23. However, the majority of respondents did not note any objections to treating RVGs consistently with other variable payments.

Staff Analysis

24. The staff thinks that under the majority staff recommendation in AP 5A/ Memo 129, the accounting treatment for RVGs is unclear.
25. Therefore, the staff thinks it is important to clarify whether RVGs are included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable.
26. Current guidance in Topic 840 (and similar guidance in IAS 17) states that minimum lease payments include:
 - b) Any guarantee by the lessee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the lease property. When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the guarantee to be include in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up.

27. The staff notes that increases in the amount payable under a RVG arise from a decrease in the value of the underlying asset. Accordingly, some might view adding such an increase to the carrying amount of the right-of-use asset and lease receivable as counterintuitive.
28. However, the staff views a RVG equivalent to a contingent payment at the end of the lease term. The Boards considered the view that entities should account for RVGs separately because they are linked to the value of the underlying asset and may meet the definition of a derivative. Those with this view think that such guarantees should not affect the amount of the right-of-use asset or the right to receive lease payments. However, the staff thinks that RVGs (that are not from an unrelated third party) are often so interlinked with other lease terms that it could be misleading to recognize those guarantees separately.

Staff Recommendation

29. Based on feedback received from constituents and the above analysis, the staff thinks that it is important to clarify that RVGs (that are not from an unrelated third party) should be included in the measurement of a lessee's liability to make lease payments and the lessor's lease receivable, similar to current guidance. The full amount of the RVG would be included in that measurement.

Question 3 – RVGs

Question 3 – Do the Boards agree with the staff recommendation that RVGs should be included in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable? If not, which approach do you prefer?

Third Party Residual Value Guarantees

Summary of Proposals

30. The ED proposes that the present value of lease payments should not include an estimate of amounts payable under RVGs that are provided by an unrelated third party. That is because RVGs that are provided by an unrelated third party are not lease payments and are outside of the lease contract.

Feedback Received

31. Very few respondents specifically commented on RVGs provided by an unrelated third party.
32. One respondent noted that RVGs provided by an unrelated third party should be included in the measurement of lease assets and liabilities.

The AASB thinks that lessors/lessees should include receipts/payments to be made under RVGs in the estimation of lease receipts/payments, that are either present in the lease contract, or to be made by a related party...Lessors should also include payments to be made under RVGs by unrelated parties in their estimation of total lease receipts. From an accounting perspective, to lessors it is irrelevant if RVGs payments come from lessees or other entities. The AASB is concerned that if RVGs are not included in the lessor's lease receivable there is scope for abuse. (CL #121)

33. Additionally, another respondent noted the possible consequences of not including unrelated third party RVGs:

The current accounting standard requires a lessor to include residual value guarantees by an unrelated third party. If a lessor does not include the residual value guarantees by an unrelated third party, the lessor would understate its revenues over the lease term. In addition, there would be some distortions for periodic loss or profit, because a lessor recognizes loss or profit on sale at the point of selling the underlying asset, in spite that the minimum amount of the estimated selling price is clarified in advance. (CL #289)

Staff Analysis

34. The staff notes that current guidance in Topic 840 (which is consistent with IAS 17) states that minimum lease payments for a lessor should include the following:

[Any guarantee of the residual value]...by a third party unrelated to either the lessee or the lessor, provided the third party is capable of discharging the obligations that may arise from the guarantee.

35. The staff notes that some RVGs provided by unrelated third parties are included in minimum lease payments in current guidance because the value of the underlying asset is an important factor in classifying a lease. That is, it is a factor to determine whether a lease arrangement should be accounted for as an operating lease or a capital/finance lease. However, under the proposed right-of-use model, the value guaranteed on the underlying asset is not, in itself, relevant to the accounting for a lease arrangement when the guarantee is from a third party.
36. Therefore, the staff thinks that any payment under a RVG provided by an unrelated third party should not be accounted for as part of the lease arrangement because it solely affects the value of the underlying lease asset and is not an arrangement between the lessee and the lessor. Rather, RVGs provided by unrelated third parties should be accounted for as other guarantees.

Staff Recommendation

37. The staff recommends that the Boards confirm their tentative decision reflected in the leases ED, that is, the lessee's liability to make lease payments and the lessor's lease receivable should not include an estimate of amounts payable under RVGs provided by an unrelated third party. RVGs provided by an unrelated third party are not lease payments.
38. However, the staff thinks it is important to clarify the conceptual basis for that decisions in the basis for conclusions, that is, unrelated third party RVGs are not part of the lease contract between the lessee and the lessor and should be accounted for in accordance with other existing guidance on guarantees (Topic 460/IAS 37).

Question 4 – Third Party RVGs

Question 4 – Do the Boards agree that lease payments should not include an estimate of amounts payable under RVGs provided by an unrelated third party? If not, which approach do you prefer?

Term Option Penalties

Summary of Proposals

39. Consistent with the proposals for variable lease payments, the leases ED proposes that the present value of lease payments should include an estimate of expected payments to the lessor under term option penalties.

Feedback Received

40. Very few respondents commented on term option penalties specifically.
41. Of those who responded specifically to the proposals on term option penalties, a number of them requested clarification of the term “*term option penalty*”.

The phrase 'term option penalties' is not one that we see in practice, but we assume the boards' are referring to payments that a lessee would be required to make if the lease is terminated prior to the end of the fixed, contractual term or payments for failure to renew a lease. That should be clarified, however, as the term is unfamiliar to some readers. (CL #692)

42. Some of those respondents also did not agree with including an estimate of term option penalties in the measurement of a lessee's liability to make lease payments and a lessor's lease receivable.

If term option penalties refer to penalties that the lessee would have to pay if it terminates the lease early or fails to extend the lease into a secondary period, we do not agree with the ED proposal that expected payments under term option penalties should be included in the measurement of assets and liabilities arising from a lease. Similar to our comments under question 8, we believe that term option penalties arise from a future decision of the lessee. Hence, they do not meet the definition of liabilities/assets as defined in the Framework from the lessee's/lessor's perspective. (CL #142)

Staff Analysis

43. The staff thinks that under the majority staff recommendation in AP 5A/ Memo 129, the accounting treatment for term option penalties is unclear.

44. The staff thinks that the inclusion of term option penalties is dependent on the decisions made on the accounting for options to extend or terminate a lease (AP 5B/Memo 130). A comment letter respondent noted:

Assessing whether or not a lease will be terminated is part of assessing the lease term. Thus, if a lessee concludes that it is more likely than not that they will terminate the lease early, a term option penalty should be included at its full amount in the lease liability (the measurement of the lease liability would not include probabilities that the lessee would or would not early terminate the lease—it is assumed that the lease will be early terminated and that the term option penalty will be paid). (CL #692)

45. For example, an entity may have a lease arrangement with a five year term with an option to renew for an additional five years. Also, within that arrangement is a term option penalty of \$10,000 if the entity does not renew for the additional five years.
46. The staff recommendation in AP 5B/Memo 130 is that the lease term should initially be 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, the majority of the staff recommends an entity would consider only factors that create an economic incentive for the lessee to extend the lease. Therefore, if the entity in the example in paragraph 45 above thinks it is reasonably certain that the lease will be for the additional five years, the term option penalty should not be included in the measurement of the lessee's lease liability to make lease payments and the lessor's lease receivable. However, if the entity does not think it is reasonably certain that the lease will be renewed, the \$10,000 term option penalty should be included in the lessee's liability to make lease payments and the lessor's lease receivable.

Staff Recommendation

47. The staff thinks that that the inclusion of term option penalties should be consistent with the accounting for options to extend or terminate a lease (AP 5B/Memo 130). Therefore, the staff recommends that term option penalties follow the guidance reached based on the decisions in AP5B/130, discussing lease term (the majority staff recommendation is if it is reasonably certain that the

lessee will not extend the lease). That is, if there are term option penalties for non-renewal and the renewal period is not included in the lease term, then those term option penalties should be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable.

Question 5 – Term Option Penalties

Question 5 – Do the Boards agree that term option penalties should be included in the measurement of the lessee's liability to make lease payments and the lessor's lease receivable if it is reasonably certain that the lessee will not extend the lease? If not, which approach do you prefer?