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 and assessing and reassessing the lease term. 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.

2. This paper is organized as follows:

   (a) Summary of the proposals in the Exposure Draft on leases

   (b) Alternative approaches to consider

   (c) Subsequent measurement

   (d) Symmetry between lessee and lessor accounting

   (e) Appendix A - Alternatives previously considered and rejected by the Boards.

Summary of the proposals in the Exposure Draft on leases

3. The Exposure Draft proposes that an entity should account for options to extend or terminate a lease by assuming the longest possible lease term that is more likely than not to occur (see paragraphs B16-B20). That applies to both the lessor

and the lessee and for both initial and subsequent measurement. However, the lessee and the lessor may have different information on the likelihood of a term option being exercised and, therefore, may reach different decisions about what the recognized lease term should be. The Exposure Draft (ED) proposes that an entity should consider all relevant factors when that entity determines the lease term, including contractual and non-contractual factors, business factors, and lessee-specific factors (e.g., past practice and intention).

4. The Boards think that using the most likely lease term 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 lease liability may not result in a faithful depiction of the entity's assets and liabilities associated with the lease.

5. Under the approach in the ED, options would not be recognized separately. Instead, uncertainty about the lease term would be addressed through recognition – i.e., one of the possible lease terms is selected, and the accounting is based on that lease term. Take, for instance, 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 period).
>
> Annual rentals in both periods are CU100.

6. So, for the lease in example above, the lessee would recognize both of the following:

   (a) A right to use the underlying asset (right-of-use asset) for either 10 years or 15 years

   (b) A liability to make lease payments for either 10 years or 15 years.

Advantages and disadvantages of the recognition approach

7. The following table summarizes the advantages and disadvantages of this approach:

8.

Advantages	**Disadvantages**
• Avoids problems relating to the accuracy or precision of measurement that may exist in other alternatives included in the Appendix A of this memo, specifically the components and measurement approaches • Only contractually possible outcomes are recognized and measured • May be simpler to apply than the components or measurement approach discussed in Appendix A • No need to differentiate between options to renew and options to terminate • Takes account of entity-specific factors that might influence whether the option is exercised.	• Highly subjective and dependent on management intent, which could result in a lack of comparability across entities with similar lease contracts • Option is ignored if exercise is not the most likely outcome • Fails to differentiate between a 10-year lease that is likely to be renewed for an additional 5 years and a non-cancellable 15-year lease • Difficult to apply to leases in which the outcome is uncertain (e.g., probability of exercise is 50 percent) – could result in frequent remeasurements of the recognized asset and liability • May result in frequent reassessments; resulting in volatility in the balance sheet and profit/loss statement, which might not be useful to users of the financial statements.

Alternative approaches to consider

9. The Boards previously considered alternative approaches other than the recognition approach, which were ultimately rejected. The rejected approaches are summarized in Appendix A. In performing its outreach, the staff has noted some level of support for the components approach described in the appendix; under the components approach, the value of the lessee’s option to extend or

terminate a lease would be recognized and measured separately from the lessee's right-of-use asset.

10. Regarding the recognition approach described in the ED, constituents have expressed concerns that determining the longest lease term more likely than not to occur would be highly subjective and complex. Another criticism is that by 'grossing up' the option and including it in the measurement of the asset and liability, the resulting lease liability may not be a faithful depiction of the lessee's obligation because it includes amounts that the lessee is not obliged to pay to the lessor. Those constituents have suggested the following alternative approaches for determining the lease term:

    (a) Account for only the contractual minimum lease term, but supplement with additional disclosures regarding the existence of any optional periods.

    (b) Account for the contractual minimum lease term plus any optional periods that are 'reasonably certain' to be exercised (the approach in existing guidance under both U.S. GAAP and IFRS).

    (c) Account for the contractual minimum lease term plus any optional periods if the lease provides the lessee an incentive to exercise the right to use in the optional periods. Incentives could include bargain renewals, residual value guarantees, and termination penalties. This view is the Alternative View expressed in the IASB's ED on leases.

11. The following table summarizes the advantages and disadvantages of these alternative recognition criteria compared to using the longest lease term more likely than not to occur:

Recognition criteria	**Advantages**	**Disadvantages**
(a) Contractual minimum term + disclosure of optional periods	• Avoids the subjectivity and volatility of the other approaches • Simple to apply • Provides users with information to calculate an expected lease term using their own approach.	• Options are neither recognized nor measured • Recognized assets and liabilities can be understated through structuring • For lessees with a high volume of leases, the disclosures are likely to be lengthy, complex, and difficult to understand.
(b) Contractual minimum term + reasonably certain optional periods	• Remeasurements of the recognized asset and liability will be less frequent than under the more likely than not lease term approach. As a consequence, this alternative would mitigate the impact on earnings due to a reassessment, which would occur under the derecognition approach to lessor accounting. • Familiar to users and preparers as it is similar to the approach in the existing standards.	• Recognized assets and liabilities can be understated through structuring • May not provide most relevant information because it ignores options that are likely (but not reasonably certain) to be exercised.
(c) Contractual minimum term + optional periods that give the lessee an incentive to renew	• Remeasurements of the recognized asset and liability will be less frequent than under the more likely than not lease term approach. As a consequence, this alternative would mitigate	• May need to give detailed guidance on what constitutes an incentive.

Recognition criteria	Advantages	Disadvantages
	the impact on earnings due to a reassessment, which would occur under the derecognition approach to lessor accounting. • Subsequent measurement may not be necessary if the assessment of the lease term is to be performed based on facts and circumstances that exist at lease inception • Acknowledges that options provide the lessee with flexibility; that is, a lessee is not required to exercise the option and, thus, should not record any liabilities associated with optional periods.	

Question 1

Does the working group support the proposals in the Boards' Exposure Draft to account for the lease term as the longest lease term more likely than not to occur? If not, why not and what alternative method of accounting for lease term options should be required?

Subsequent measurement

12. 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 obligation to make lease payments or in the lessor's right to receive lease payments.

13. The Boards discussed whether to require reassessment of the lease term. The Boards noted that requiring the lessee to reassess the lease term at each reporting date is likely to provide users of financial statements with more relevant information. Lease terms, particularly in real estate leases, can be very long. Using a lease term that is based on assumptions made several years before could be misleading. However, many have argued that, because reassessment is overly complex and burdensome, the costs of reassessment are greater than the benefits derived.

14. In the summary of the advantages and disadvantages of the various recognition thresholds presented above, the staff noted that the different thresholds also have an impact on the decision to require subsequent reassessment of the lease term. For instance, requiring only the contractual minimum lease term to be recognized would eliminate the need to require reassessment.

Question 2
Does the working group support the Boards' Exposure Draft proposal on the subsequent measurement of the lessee's obligation to make lease payments and the lessor's right to receive lease payments due to reassessment of the lease term? If not, why not and what alternative method of subsequent measurement should be required?

Symmetry between lessee and lessor accounting

15. 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 "more likely than not" lease term.

16. The staff has previously highlighted the following reasons that might support the idea that there should be a difference in the principles underlying how the lessee and the lessor account for lease term options:

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

(b) The lessee is the party that holds the option and exercise of the option is 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 recording of 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.

Question 3
Does the working group support the Boards' Exposure Draft proposal that the principles underlying the accounting for lease term options should be symmetrical between the lessee and lessor? If not, why not and what alternative method of accounting should be required?

Appendix A – Alternatives previously considered and rejected by the Boards

1. The Boards have previously considered and rejected the following approaches:

   (a) The components approach

   (b) The measurement approach.

2. 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 period).
>
> Annual rentals in both periods are CU100.

The components approach

Description of the approach

3. Under a components 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 leased item (right-of-use asset) for 10 years

   (b) An option to extend the lease

   (c) An obligation to pay rentals (this would include both the payment for the right-of-use asset and the option).

4. Possible approaches to initial and subsequent measurement of the option would need to be discussed and are summarized in the following table:

	Initial measurement	**Subsequent measurement**
Possible approaches	• Fair value • Intrinsic value • Cost.	• Fair value • Intrinsic value • Carrying amount at initial measurement less impairment.

Advantages and disadvantages of the approach

5. The following table summarizes the advantages and disadvantages of the components approach:

Advantages	**Disadvantages**
• Consistent with the *Conceptual Framework* if the unit of account is considered to be the individual component of the lease contract • Arguably the most transparent approach because options are separately recognized, so their existence will be more apparent to users.	• May be difficult to precisely measure the value of the options. There is usually no market for options of this type and they are not normally priced separately from the lease contract. Measurement is complicated by the fact that, unlike many financial options, the assets underlying options to extend or terminate a lease are often specialized, and may not be exercisable until a long time in the future (e.g., 20 years in some real estate leases). • Complex for preparers (many preparer respondents and some users believe the costs would outweigh the benefits). • Ignores the interrelationship between the components of a lease. For example, a lease may include an option to extend, an option to purchase, and a residual value guarantee; and payments under the residual value guarantee are made only if the lessee does

Advantages	**Disadvantages**
	not exercise one of its options. Recognizing a liability associated to the residual value guarantee may not provide useful information to users if the lessee is likely to exercise its purchase option or extend the lease. • May not provide useful information because out of the money options are accounted as if they are exercised, and in the money options could be allowed to lapse for entity-specific reasons. For instance, if the lessee is leasing highly specialized equipment, there may be an economic compulsion for the lessee to renew. Similarly, if the lessee has an exit strategy regarding the leased asset, the lessee may not exercise the renewal option even if the option is in the money.

The measurement approach

Description of the approach

6. Under this approach, options would not be recognized separately. Instead, uncertainty about the lease term would be dealt with in the measurement of the obligation to pay rentals.

7. 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 leased item (right-of-use asset) initially measured at CU1,400 (20% × CU100 × 10 years + 80% × CU100 × 15 years)

(b) An obligation to pay rentals initially measured at CU1,400 (20% × CU100 × 10 years + 80% × CU100 × 15 years).

Advantages and disadvantages of the approach

8. The following table summarizes the advantages and disadvantages of this approach:

Advantages	**Disadvantages**
• Consistent with the *Conceptual Framework* if the unit of account is considered to be a lease contract that gives rise to a single asset and liability • Existence of the option is reflected in both initial and subsequent measurement • No need to differentiate between options to renew and options to terminate • Takes account of entity-specific factors that might influence whether the option is exercised • In a large portfolio of homogenous leases, the aggregate amount measured may better reflect the actual cash flows than that recognized under the ED approach.	• May be difficult to reliably measure the probability of exercise of an option • Boards will need to agree on the basis for measurement (best estimate vs. probability-weighted approach to measurement). • If a probability-weighted approach to measurement of the obligation is used, the recognized liability will likely reflect payments for an expected lease term that is not contractually possible.