Project	**Leases**
Topic	**Accounting for variable lease payments**

Objective

1. The purpose of this paper is to discuss the accounting for the recognition and measurement of variable lease receivables/payables, for example, those arising from leases with contingent rentals and residual value guarantees.

2. This paper is organized as follows:

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

    (b) Alternatives

    (c) Questions for working group members

    (d) Appendix A: Application of approaches.

Summary of proposals in the Exposure Draft

3. In some leases, the amount of each contractual lease payment is variable rather than fixed. That variability can arise because of features, such as contingent rentals, based on 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

4. The ED proposes that at the date of commencement of a lease, a lessee/lessor should recognize a liability to make lease payments/right to receive lease payments in the statement of financial position. Payments arising under a lease include fixed payments as well as variable payments. Variable payments include, but not limited to, contingent rentals as well as any amounts payable/receivable to the lessor/from the lessee under residual value guarantees and term option penalties.

Initial measurement

5. The ED proposes that an entity should measure the right to receive lease payments/liabilities to make lease payments using an expected outcome technique. Expected outcome is the probability-weighted average of the cash flows for a reasonable number of possible outcomes. 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.

Subsequent measurement

6. The ED proposes that an entity should reassess the expected lease payments if any new facts or circumstances indicate that there has been a significant change to the expected lease payments.

7. A lessee and lessor should distinguish changes in variable lease payments that relate to current or prior periods from those that relate to future periods. Changes

in variable lease payments relating to current or prior periods would impact the profit/loss statement.

Alternatives

Recognition/Measurement

8. The staff has considered the following approaches to the recognition and measurement of variable receivables/payables:

    (a) Retain guidance proposed in the ED.

    (b) Retain guidance proposed in the ED, except increase the threshold for recognition to a higher threshold, such as "probable" or "reasonably assured/certain."

    (c) Recognize and measure variable receivables/payables similar to current lease guidance in Codification Topic 840, Leases, and IAS 17, *Leases*, or similar to the alternative view expressed in the IASB's ED. That is, an entity would be required to recognize and measure variable receivables/payables only if the contingent rental depends on an index or a rate; otherwise, the contingency should be recorded in profit/loss in the periods in which the contingency is resolved. Additionally, disclosure of contingent rental arrangements would be required.

Approach A: Retain guidance proposed in the ED.

9. Under Approach A, the guidance in the proposed ED for the recognition and measurement of variable payments/receivables would be retained (see paragraphs 4-7 above).

10. Those that support Approach A view variable lease payments as a measurement issue as opposed to a recognition issue. They 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 variable. For example, a lease could specify zero fixed lease payments and high contingent rentals. The right to receive lease payments and the liability to make

lease payments for such a lease would be zero if contingent rentals were not included in the measurement of those rights and obligations. Clearly, however, despite such payment terms, the lessee has received a right-of-use asset.

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

Advantages	**Disadvantages**
• Arguably gives a more faithful depiction of the rights received by the lessor and the obligations incurred by the lessee • Reflects management's best estimate of the cash inflows/outflows from the entire lease arrangement.	• Because the lessor's receivable and the lessee's payable could include amounts that the lessee has the discretion to avoid, the lessor does not have an unconditional right to all of the payments included in the measurement of the receivable and the lessee does not have an unconditional obligation for all of the amounts in its payable. • Difficult and complex to apply, especially if reassessment every period is required and the accounting for lease term options remains as stated in the ED. The inclusion of optional terms may make it more difficult to project lease payments that are based on performance or usage.

12. An example of Approach A is included in Appendix A.

Approach B: Retain guidance proposed in the ED. However, increase the threshold for recognition.

13. Under Approach B, the guidance in the ED for the recognition and measurement of variable payments/receivables would be retained (see paragraphs 4-7). However, recognition of those amounts would be subject to a recognition threshold, such as recognizing variable payments/receivables only if they are "probable" or "reasonable assured/certain".

14. Those that support Approach B agree with the general views discussed in paragraphs 4-7 but think that creating a higher threshold for recognition would be less subjective and, thus, more useful and comparable.

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

Advantages	**Disadvantages**
• Arguably gives a more faithful depiction of the rights received by the lessor and the obligations incurred by the lessee. • As measurement is less subjective than under Approach A, both the balance sheet and profit/loss statement would be less volatile as compared to under Approach A. • Simpler to apply than Approach A because reassessment may not occur as frequently unless there are significant changes to those estimates made at lease inception. That is, the estimates at lease inception already capture those lease payments that are "reasonably assured".	• Because the lessor's receivable and the lessee's payable could include amounts that the lessee has the discretion to avoid, the lessor does not have an unconditional right to all of the payments included in the measurement of the receivable and the lessee does not have an unconditional obligation for all of the amounts in its payable. • As compared to Approach A, this approach could result in a liability that is less reflective of the lessee's cash outflow expectations. • Difficult and complex to apply, especially if reassessment every period is required and the accounting for lease term options remains as stated in the ED. The inclusion of optional terms may make it more difficult to project lease payments that are based on performance or usage.

16. Approach B is substantially similar to Approach A, for which an example is provided in Appendix A.

Approach C: Recognize and measure variable receivables/payables only if the contingent rental depends on an index or a rate; otherwise, the contingency should be recorded in profit/loss in the periods in which the contingency is resolved.

17. Under Approach C, the recognition and measurement of variable receivables/payables would be similar to current lease guidance in Topic 840 and IAS 17 and in the Alternative View expressed in the ED. In general, 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, are contingent rentals and would be excluded from lease payments. That is, an entity would include variable lease payments in the determination of income as accruable; in other words, the variable lease payment affects profit or loss only in the period in which the contingency is resolved. However, lease payments that depend on an existing index or rate, such as the consumer price index or prime interest rate, would be included in lease payments based on the index or rate at the inception of the lease; that is, the variability resulting from future change in the index or rate are being excluded from measurement. Approach C also would require disclosure of contingent rental arrangements.

18. Some think that lease payments that an entity has no contractual or constructive obligation to pay/receive do not meet the definition of a liability/asset. The ED proposes that the liability definition has been satisfied – the lessee has been conveyed a right-of-use asset and has incurred a corresponding liability at inception of the lease – and that the inclusion of contingent rentals is simply a question of measurement of those assets and liabilities.

19. Although those that support Approach C acknowledge that one reason for the proposed approach in the ED is to avoid structuring opportunities, they do not think that this concern should outweigh the provision of relevant information. Those supporters consider that it is possible (a) to avoid structuring opportunities by establishing principles for identifying where contingent rental arrangements lack economic substance and represent disguised minimum rental payments and (b) to do this through appropriate disclosure. Constituents have suggested a principle whereby lease payments are included when such 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.

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

Advantages	**Disadvantages**
• The lessor's receivable and lessee's payable would include only amounts for which the lessor/lessee have unconditional rights/obligations • Avoids problems relating to the accuracy or precision of measurement that may exist in other alternatives discussed • More consistent accounting between the lessor and lessee in cases in which the lessor would otherwise be unable to estimate variable lease payments reliably • Simpler to apply than the other alternatives discussed.	• Arguably understates the lesseee's liability and lessor's receivable because it could exclude cash flows that are highly likely or for which the lessee has little realistic possibility of avoiding • Creates structuring opportunities, or at least would require the establishment of additional principles to identify situations in which the contingent rental arrangement lacks economic substance and represents disguised minimum lease payments.

21. An example of Approach C is included in Appendix A.

Remeasurement of lease receivables/payables

22. If the initial measurements of the lease receivables and payables reflect some estimate of variable lease payments, the Boards must decide whether to require those estimates to be updated subsequently. The staff has considered the following alternatives to the reassessment of variable receivables/payables:

(a) Retain guidance proposed in the ED.

(b) Do not require remeasurement of the assets/liabilities arising from variable payments/receivables. Any differences between the actual and expected cash flows would be recognized in profit and loss in the period in which the differences occur.

Approach A: Retain guidance proposed in the ED.

23. Under Approach A, the guidance in the proposed ED for the reassessment of variable payments/receivables would be retained (see paragraphs 6 and 7 above).

24. Some think that the reassessment of the expected lease payments would provide more relevant information to users of financial statement because it would reflect current economic conditions. However, the Boards concluded that the benefits of reassessment would outweigh the cost of performing the reassessment only if there is an indication that there is a significant change in the lease payments.

Approach B: Do not require remeasurement of the assets/liabilities arising from variable payments/receivables.

25. Under Approach B, entities would not be required to remeasure the assets/liabilities arising from the reassessment of variable payments/receivables. Those that support Approach B think that this approach would significantly reduce the costs of reassessment while still providing useful information. This approach would be most appropriate if the Boards were to require a measurement of variable lease payments that is other than the measurement described in the ED. Under the alternative methods described as Approach B and Approach C in the previous section above, the variable lease payments determined at inception may not change significantly. Thus, the benefits of reassessment would not justify the costs that an entity would incur.

26. For performance and usage based variable lease payments, Approach B is not appropriate under the ED method of measuring variable lease payments. Recording a best estimate of the variable lease payments at inception and then subsequently not updating that estimate would provide information that is not meaningful to users of financial statements.

27. For lease payments that vary based on an index or rate, regardless of the measurement approach used, reassessment often results in only small changes to the balance sheet and profit/loss statement. Moreover, because the index or rate

will almost always vary from that which was estimated in the most recent reassessment, there will always be a difference between actual and expected lease payments (the difference under any of the measurement approaches above would be recorded in the profit/loss statement). Because this is true regardless of whether or not reassessment is required, constituents argue that the costs of reassessment would outweigh the benefits.

Questions for working group members

Question 1
Question 1 – If estimates of variable lease payments are included in the recognized assets and liabilities, how should the asset/liability be measured? Do you agree with the proposed expected outcome technique? If not, what other approach would you prefer (for example, most likely estimate)?

Question 2
Question 2 – If estimates of variable lease payments are included in the recognized assets and liabilities, should the asset/liability be reassessed? If so, how often? If reassessed, how do you think the reassessment should be accounted for?

Question 3
Question 3 – Should there be different accounting treatment for different types of variable lease payments (rate/index, performance, usage)?

Question 4
Question 4 – Do you think that lessor and lessee accounting should be symmetrical? For example, is it appropriate to require a lessor to estimate a lessee's usage/performance?