Project **Leases**

Topic **Accounting for Purchase Options**

Objective

1. The purpose of this paper is to discuss the accounting by lessees and lessors for purchase options included in a lease contract.

2. This paper analyzes the accounting for all purchase options, including both options that the lessee has a significant economic incentive to exercise (which would usually include bargain purchase options) and options that the lessee does not have a significant economic incentive to exercise (which would usually include non-bargain purchase options).

3. This paper is structured as follows:

   (a) Summary of staff recommendations

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

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

   (d) Staff Analysis

   (e) Staff recommendations

   (f) Appendix A – preliminary draft wording relating to the accounting for purchase options

(g) Appendix B – illustration of in the accounting for a lease with a bargain purchase option.

Summary of Staff Recommendations

4. The staff have mixed views as to whether a purchase option should be accounted for as an ultimate renewal option, or whether a purchase option should only be accounted for upon exercise.

5. A majority of staff members think that purchase options are the ultimate renewal option. These staff members are persuaded primarily by the economic similarities between an option to purchase an underlying asset and an option to extend the lease of an underlying asset. The exercise price of the option should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments when there is a significant economic incentive to exercise a purchase option. Therefore, lease payments would usually include the exercise price of a bargain purchase option but usually exclude the exercise price of a non-bargain purchase option.

6. However, other staff members think that purchase options should be accounted for as a termination of the lease contract and the purchase of the underlying asset. The result of this view is that all purchase options would be accounted for only upon exercise, consistent with the proposals in the ED. Therefore, lease payments would exclude the exercise price of all purchase options. Those staff members were persuaded by the argument that an option to purchase the underlying asset is a termination of the lease agreement, and results in the purchase/sale of the underlying asset when the option is exercised.

Summary of Proposals in the leases Exposure Draft

7. Under the proposals in the leases Exposure Draft (ED), the exercise price of any purchase option, regardless of whether the purchase option is a bargain, is not considered to be a lease payment and is, therefore, excluded from the lessee's liability to make lease payments and the lessor's right to receive lease payments.

8. Further, the ED scopes out any contract in which the lessee has exercised its purchase option. At that point, the contract ceases to be a lease and is considered to be a purchase by the lessee and a sale by the lessor.

9. Under the ED, a lease with a bargain purchase option is considered to be a purchase/ sale even if the option has not been exercised, and therefore is not within the scope of the leases standard.

Summary of Feedback

10. The ED excluded leases with bargain purchase options from its scope. Respondents had mixed views on the proposal to account for all other non-bargain purchase options only when they are exercised. Some respondents agreed with the proposal that a purchase option should not be accounted for as a purchase/sale until a future event, the exercise of the option, has occurred.

11. However, many respondents and workshop participants proposed that the accounting for purchase options should be consistent with the accounting for options to extend or terminate a lease. In expressing these views, many respondents supported consistency in the measurement approach and estimate techniques in measuring the different components of a lease contract.

12. These respondents further argued that this approach would recognize that:

    (a) purchase options are in substance the same as ongoing renewal options and therefore should be accounted for in a similar manner; and

    (b) bargain purchase options should be recognized and treated the same as non-bargain purchase options, thereby avoiding establishing a new bright-line between leases and in-substance purchases/sales.

13. The following excerpts from comment letters are representative of the concerns expressed:

> We see no valid reason to treat options to purchase and options to extend a lease differently and are concerned that the proposals regarding purchase options result in very different accounting for scenarios that are similar. Under the proposals, the presence of a bargain purchase option results in treating the arrangement as a purchase; but when the option is not considered a bargain purchase option, then it is to be ignored until it is exercised. This difference in treatment is likely to give rise to application issues. Therefore, we disagree with the proposal that options to purchase should be ignored until they are exercised. (CL #697)
>
> We believe that purchase options should be accounted for in the same way as options to extend or terminate the lease. Purchase options provide the lessee with the contractual ability to acquire additional rights associated with the leased asset, and should therefore be considered an extension of the lease term on a basis similar to renewal options. Consistent with our views related to renewal options, which are discussed in further detail in our response to question 8, we believe that the right-of-use asset and liability to make lease payments should only include purchase options for which exercise is reasonably certain to occur. Requiring purchase options to be accounted for separately from options to extend or terminate a lease introduces a distinction between economically similar arrangements that would add unnecessary complexity to lease accounting. We also believe the exclusion of purchase options complicates the definition of lease term and lease payments.
>
> We recommend that the boards clarify whether or not a purchase option should be a consideration in determining the lease term, both at lease inception and upon reassessment. Take for instance a lease with a 10-year lease term that provides the lessee with a purchase option at the end of five years, and assume the purchase option is not considered a bargain purchase option at the inception of the lease. Is such a lease considered cancellable at the end of five years (i.e., is one of the possible lease terms five years)? If the lessee expects to exercise the purchase option at the end of five years (i.e., the exercise is considered more likely than not), is the lease term only five years, even though that term can only occur under the contract if the lessee exercised the purchase option? If five years is a possible term, is some portion of the purchase option included as a termination payment? (CL #74)

User Feedback Received

14. User views on the proposals in the ED were mixed. Some users thought that a purchase option terminates a lease contract and, therefore, should be excluded from lease payments. Other users highlighted that purchase options are

economically similar to options to extend a lease and should be accounted for on a consistent basis.

Private Company Consideration

15. Private company views on the proposals in the ED were likewise mixed. The reasons given by private companies for supporting or disagreeing with the proposals regarding purchase options are generally consistent with those of public companies.

Staff Analysis

Overview

16. Purchase options give the lessee the option to purchase the underlying asset on, or after, a specified date. The exercise price of the option may be below, above, or at the fair value of the underlying asset at the date of exercise.

17. The staff note that under current guidance in IAS 17 and Topic 840, the existence of a bargain purchase option results in a lease being classified as a capital/finance lease and the exercise price for that option is included in minimum lease payments.

18. The staff note that the existence of a purchase option is one of the indicators that the boards are currently considering in determining whether a lease is a finance lease or an other-than-finance lease.

19. For example, in a lease with a bargain purchase option, if the lessor expects the asset to be purchased by the lessee at the end of the lease term, then a lessor would apply the derecognition approach to lessor accounting and the lessor would fully derecognize the asset.

20. The staff also notes that at the joint Board meeting held in February 2011, the boards tentatively decided on the following definition of lease term:

> The lease term is the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.

21. The staff have analyzed the following two approaches for the accounting for purchase options for both lessees and lessors:

    (a) Approach A: If there is a significant economic incentive to exercise the purchase option, the exercise price of the purchase option would be included in lease payments. If there is no significant economic incentive to exercise the purchase option, the exercise price would be excluded from lease payments.

    For a lessee, if it is determined that there is a significant economic incentive to exercise the purchase option, the right-of-use asset would be amortized over the economic life of the underlying asset. The carrying amount of the right-of-use asset at the purchase option exercise date becomes the carrying value of the fixed asset. For a lessor, the transaction would be subject to the derecognition approach. The asset would be derecognized at the inception of the lease and no residual asset would be recognized (full derecognition).

    (b) Approach B: The lease would be terminated and a purchase of the underlying asset would occur upon exercise of a purchase option. That is, the purchase option, regardless of whether there is, or is not, an incentive to exercise it, is accounted for only upon exercise. This is consistent with the proposals in the ED.

Approach A—Account for purchase options as renewal options

22. Approach A views a purchase option as an ultimate renewal option for the remainder of the underlying asset's economic life. Therefore, the accounting for a purchase option should be consistent with the accounting for options to extend a lease.

23. In accordance with Approach A, the lease term would be the economic life of the underlying asset and the exercise price of the purchase option would be included in lease payments if there is a significant economic incentive to exercise the purchase option.

24. The staff notes that the majority of options that would meet this threshold at lease inception are bargain purchase options. Other purchase options could meet this threshold after lease inception, for example, if the option were for the purchase of an underlying asset that has appreciated during the lease term, such as land or when a significant leasehold improvement is added to the underlying asset.

25. The staff notes the following advantages to Approach A:

    (a) More closely reflects the cash flows expected from the contract.

    (b) Addresses the concerns that a purchase option is economically similar to ongoing renewal options.

    (c) Acknowledges that the pricing of a purchase option is interrelated with the pricing of other terms in the lease contract; a lease with a bargain purchase option would require larger periodic payments during the lease term. In other words, the pricing of the lease is such that a portion of the periodic lease payments (excluding the exercise price of a purchase option) relate to prepaying for the ownership of the asset.

    (d) The pattern of the lessee's expense would reflect the lessee's expectation that the asset will be purchased and used through the end of its economic life. See the example in Appendix B.

    (e) When the purchase option is "in-the-money", the amount recognized as a cost basis for the purchased asset at the date that the purchase option is exercised is closer to its actual value (see Appendix B for an illustration). This is particularly the case when the option is considered to be a bargain.

(f) It is consistent with the boards' decision on lease term option penalties. Lease term option penalties, although they are payments related to terminating a lease, are to be included in lease payments unless there is a significant economic incentive to renew an option to extend the lease. The exercise of a purchase option also terminates the lease and, under Approach A, is included in the lease payments when there is a significant economic incentive to exercise.

(g) Most constituents agreed that purchase options (other than bargain purchase options) should not be accounted for until exercised. In accordance with Approach A, purchase options for which the lessee has no significant economic incentive to exercise would not be accounted for until they are exercised.

(h) It is consistent with the boards' tentative decision that lease payments should include amounts expected to be payable under residual value guarantees (RVGs). Some respondents identified that structuring opportunities may exist if RVGs (put options held by lessors) and purchase options are accounted for inconsistently.

Lessees

26. The staff notes the following disadvantages to Approach A for lessee accounting:

(a) Approach A includes an amount that is not part of the ongoing lease payments in the lessee's right-of-use asset and liability for lease payments. The exercise price of a purchase option is a portion of the consideration for a potential purchase transaction.

(b) The purchase price, which is included in the measurement of the lessee's right-of-use asset, would be amortized over the life of the underlying asset. If the purchase option is eventually not exercised, the amortization of the asset may not reflect the economics of the usage of the right-of-use asset. However, the staff notes that this disadvantage also applies to the accounting for options to extend or terminate a lease.

Lessors —Performance Obligation Approach

27. The staff notes that, when there is a bargain purchase option, a lessor would likely apply the derecognition approach to lessor accounting. However, the staff also considered that there might be some cases where the lessor applies the performance obligation approach to a lease with a bargain purchase option (for instance, when the option is not a bargain at inception but becomes a bargain subsequently). The staff identified the following disadvantages of Approach A for lessors applying a performance obligation approach.

    (a) It would include a possible purchase transaction in the measurement of the receivable and performance obligation.

    (b) It may be inappropriate for a lessor to determine whether the lessee is likely to exercise an option to purchase the underlying asset until the purchase option is exercised. That is, the lessor may not have information to determine that a lessee will exercise a purchase option.

    (c) It is unclear if a lessor applying the performance obligation approach would recognize revenue over the economic life of the asset or the term over which lease payments are made. If it is the former, this would be consistent with the pattern in which the lessee recognizes the amortization of the right-of-use asset. The staff acknowledge that it does not appear appropriate that a lessor should be recognizing revenue in periods after all cash has been collected and the underlying asset has been transferred. However, the staff note that this would only be an issue if the lessor were applying the performance obligation approach to lessor accounting; a lease with a bargain purchase option would normally result in a lessor applying the derecognition model.

(d) It grosses up the receivable and performance obligation for the exercise price of the purchase option. This would result in the recognition of revenue associated with the purchase option, through the amortization of the performance obligation, even if the purchase option were not to be exercised. However, the staff note that this disadvantage also applies to the accounting for options to extend or terminate a lease.

Lessors —Derecognition Approach

28. When a significant economic incentive to exercise a purchase option exists, the staff thinks a lessor would usually apply the derecognition approach to lessor accounting.

29. In applying the derecognition approach, Approach A would require the initial measurement of the lessor's residual asset to include an assessment of whether an option to purchase includes a significant economic incentive to exercise; if so, little to no value would be attributed to the residual asset.

30. Revisions to the existence of a significant economic incentive to exercise the purchase option would lead to a new derecognition/recognition event. That means that the lessor would derecognize/reinstate a portion of its residual asset. The amount of the underlying asset derecognized/reinstated would be based upon the relative fair value of what has been transferred (the receivable) and what has been retained (the residual asset). Revenue and cost of sales would be increased or decreased upon each reassessment.

31. The staff notes the following disadvantages to Approach A when a lessor applies a derecognition approach:

(a) The underlying asset (and its residual value asset) would not be recognized by the lessor if, at the beginning of the lease, it was determined that it there is a significant economic incentive for a purchase option to be exercised.

(b) The approach grosses up the receivable. That is, the receivable (and any revenue) would be larger than if purchase options were only recognized when exercised.

(c) Under this approach, revenue would be recognized (1) ahead of a purchase option being exercised and (2) based on purchase options that include a significant economic incentive to exercise. However, the staff note that this disadvantage also applies to the accounting for options to extend or terminate a lease.

Approach B—Account for purchase options as termination options

32. Approach B does not view purchase options as the ultimate renewal option. Instead, Approach B, which is consistent with the ED, views purchase options as terminating the lease contract and purchasing or selling the underlying asset.

33. Under Approach B, the lease term would exclude any periods beyond the exercise date of the purchase option regardless of whether or not there is a significant economic incentive to exercise the purchase option.

34. Additionally, under Approach B, the assets and liabilities recognized by a lessee and lessor would exclude the exercise price of all purchase options. Purchase options would be recognized only upon exercise. Consequently, at that time, the contract is no longer a lease, but a purchase/sale of the underlying asset.

Lessees

35. The staff notes the following advantages of Approach B for lessees:

(a) It does not include the exercise price of a purchase option that can be avoided. Therefore, Approach B avoids grossing up the lessee's right-of-use asset and liability for the exercise price of a purchase option that may, or may not, be exercised.

(b) It avoids the need to "unwind" the accounting if it is later determined that the purchase option is not exercised.

36. The staff notes the following disadvantages of Approach B for lessees:

    (a) It excludes the exercise price of a purchase option that the lessee may intend to exercise in the lessee's assets and liabilities. Therefore, Approach B potentially understates the expected cash flows of the lease.

    (b) When the purchase option is "in-the-money", the amount recognized as the cost basis for the purchased asset on exercise of the purchase option is lower than the value of the fixed asset (see Appendix B for an illustration). This is especially pronounced when the option is considered a bargain.

    (c) Under Approach B, a lessee's amortization expense is front-loaded because it does not reflect that the asset will be purchased and used for the remainder of its economic life. That is, the lessee is not reflecting the prepayment for the purchase of the asset that it has made through paying higher lease payments during the lease term. Also see Appendix B for an illustration of the pattern of profit or loss expense.

Lessors —Performance Obligation Approach

37. Under Approach B, a lessor applying the performance obligation approach would exclude the exercise price of a purchase option in its lease receivable and corresponding performance obligation.

38. The staff notes the following advantages of Approach B for lessors applying the performance obligation approach:

    (a) It avoids including any purchase options in the receivable and corresponding performance obligation.

    (b) It avoids the need to "unwind" the accounting if it is later determined that the purchase option is not exercised

39. The staff note the following disadvantages of Approach B for lessors applying the performance obligation approach:

    (a) It does not reflect the effect of purchase options on the face of the financial statements until they are exercised. Therefore, Approach B potentially understates the expected cash flows of the lease.

Lessors —Derecognition Approach

40. Under Approach B, a lessor applying the derecognition approach would not include the exercise price of a purchase option in its lease receivable.

41. The staff notes that the advantages of Approach B for a lessor applying the derecognition approach are similar to the advantages of a lessor under a performance obligation approach discussed in paragraph 37.

42. The disadvantages also are similar to those discussed in paragraph 38.

Cost basis of the underlying asset upon exercise of a purchase option

43. Under Approach A, if there is a significant economic incentive to exercise a purchase option, the lessee's right of use asset would be amortized over the underlying asset's economic life. The cost basis of the underlying asset at the time of exercise of the purchase option would be the unamortized cost basis of the right-of-use asset prior to the exercise of the purchase option.

44. Under Approach B, the cost basis of the underlying asset when the purchase option is exercised is the exercise price of the option.

45. This is illustrated in the example in Appendix B.

Staff recommendations

46. The majority of the staff recommends Approach A, that is, a purchase option should be considered to be the same as an ultimate renewal option and, therefore, accounted for by lessees and lessors in the same way as an option to extend or terminate a lease. Consequently:

    (a) Purchase options should not be accounted for as separate assets or liabilities.

    (b) If there is a significant economic incentive to exercise a purchase option, then:

        (i) The lease term over which the lessee's right-of-use is amortized is the economic life of the underlying asset.

        (ii) The lessor applies the derecognition approach to lessor accounting and, because the lessor expects the lessee to purchase the asset, the lessor derecognizes the entire asset.

        (iii) Lease payments should include the exercise price of the purchase option.

    (c) A lessee and a lessor should reassess the accounting for a purchase option only when there is a significant change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise the purchase option.

47. Supporters of Approach A put the most weight on the argument that options to purchase an underlying asset are economically similar and linked to options to extend a lease. That is, purchase options are the ultimate renewal option. Supporters of Approach A, think that the pattern of the lessee's expense is most reflective of the economic usage of the asset, with amortization of the asset recognized on a consistent basis over the lessee's expected use of the asset.

48. Those that support Approach A also think the concerns expressed by proponents of Approach B, namely that including the purchase options in lease payments could result in significant variability, including profit/loss variability, have been mitigated by establishing the threshold for measurement at a relatively high level of "significant economic incentive to extend". They note that many of these concerns are also applicable to the Boards' tentative decisions on the accounting for renewal options. They also believe the concerns that lease payments are inappropriately grossed up by lessors are alleviated by the fact that, in general, only the relatively nominal exercise prices of bargain purchase options will be included in lease payments.

49. Other staff members prefer Approach B. Supporters of Approach B put the most weight on the argument that the purchase of an underlying asset is the termination of a lease. In addition, supporters of Approach B would not include purchase options as assets and liabilities in lease contracts because of the uncertainty of whether they will be exercised (particularly for lessors). They also note that under the derecognition approach, the revenue associated with a purchase option would not be recognized until the option is exercised. Finally, Approach B avoids the grossing up of the receivable, the right-of-use asset, and liability for the exercise price of the purchase option.

Question 1
Should purchase options be accounted for when the lessee has a significant economic incentive to exercise or should they be accounted for only upon exercise?

Appendix A: preliminary draft wording relating to the accounting for purchase options

The preliminary draft wording including in this appendix has been prepared by the staff to help the boards in reaching decisions regarding the accounting for purchase options. The preliminary draft wording takes the wording from paragraphs 15, 36, and 53 of the ED and 'marks-up' changes to that wording to reflect the approaches described in this paper

Approach A*:*

> When there is a significant economic incentive to exercise a purchase option, the lease term is the remaining economic life of the underlying asset. The exercise price of such a purchase option ~~included~~ shall be included as ~~in a lease is not~~ a lease payment ~~and the purchase option is not included~~ in determining the present value of lease payments and payable/receivable.

Approach B*:*

> The exercise price of a purchase option included in a lease is not a lease payment and the purchase option is excluded in determining the present value of lease payments payable/receivable.