Reassessment of Options in a Lease

Objective

1. The purpose of this memorandum is to discuss how lessees and lessors should reassess whether a lessee has a significant economic incentive to exercise:

   (a) An option to extend or terminate a lease

   (b) An option to purchase the underlying leased asset.

2. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Summary of the proposals in the *Leases* Exposure Draft (ED) and relevant decisions reached in redeliberations

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

   (d) Staff analysis

      (i) What constitutes a significant economic incentive to exercise an option to extend or terminate a lease or purchase an underlying asset?

      (ii) Should there be different thresholds for options to extend or terminate a lease and options to purchase the underlying asset?

      (iii) How would reassessment be accounted for?

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB 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.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each Board has completed its full due process, including appropriate public consultation and formal voting procedures

Summary of staff recommendations

3. When evaluating whether a lessee has a significant economic incentive to exercise (a) an option to extend or terminate a lease or (b) a purchase option, the staff recommends that a lessee and lessor should include contract-based, asset-based, market-based and entity-specific factors in evaluating whether a lessee has a significant economic incentive to exercise an option to extend or terminate a lease.

4. The staff recommends that the same definition of "significant economic incentive" should be used in assessing whether a lessee is going to exercise an option to (a) extend or terminate a lease or (b) purchase the underlying asset for both initial and subsequent evaluation.

5. The staff recommends that, consistent with proposals in the ED, changes in lease payments arising from a reassessment of whether the lessee has a significant economic incentive should result in a lessee adjusting its obligation to make lease payments and a lessor adjusting its right to receive lease payments. Furthermore, it would also result in:

    (a) A lessee adjusting its right-of-use asset

    (b) A lessor, when applying the performance obligation approach, adjusting its performance obligation. This assumes that the Boards retain some version of the performance obligation approach proposed in the ED.

    (c) A lessor, when applying the derecognition approach, adjusting the carrying amount of the residual asset. The method of adjustment would depend on what the Boards decide for lessor accounting under the derecognition approach.

Summary of the proposals in the *Leases* Exposure Draft (ED) and relevant decisions reached in redeliberations

Options to extend or terminate a lease

6. 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. The ED proposes 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). That 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. At the February 2011 Board meeting, the FASB and the IASB decided that the lease term should be defined, for both lessees and lessors, as follows:

> The lease term is the noncancellable 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.

8. The Boards decided that a lessee and a lessor should reassess the lease term 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 any options to extend or terminate the lease.

Options to purchase the underlying leased asset

9. Under the ED's proposals, the exercise price of any purchase option, regardless of whether the purchase option is a bargain, is not considered a lease payment and is excluded from the lessee's liability to make lease payments and the lessor's right to receive lease payments. Further, the ED scopes out of the leases guidance any contract in which the lessee has exercised its purchase option. At that point, the contract ceases being a lease and is accounted for as a purchase by the lessee and a sale by the lessor.

10. At the March 2011 Board meeting, the Boards decided that lessees and lessors should include the exercise price of a purchase option (including bargain purchase options) in the initial measurement of the lessee's liability to make lease payments and the lessor's right to receive lease payments, if the lessee has a significant economic incentive to exercise the purchase option. If it is determined that the lessee has a significant economic incentive to exercise the purchase option, the right-of-use asset recognized by the lessee should be amortized over the economic life of the underlying asset, rather than over the lease term.

11. At the March 2011 Board meeting, the Boards indicated a preference for specifying the same reassessment guidance for purchase options as for options to extend or terminate a lease. However, the Boards instructed the staff to seek input through targeted outreach on the costs and benefits of requiring reassessment, including whether it would be appropriate to have a different reassessment threshold for purchase options and options to extend or terminate a lease. The Boards were primarily interested in whether changes in market rental rates or asset values could lead to ongoing reassessments in subsequent periods of whether a lessee has a significant economic incentive to exercise a fixed price purchase or extension option that was at market at lease commencement.

Summary of feedback including comment letters and other outreach

12. Regarding reassessment of the lease term, many constituents (especially preparers and auditors) expressed concerns with, and demonstrated in workshops, the cost of complying with the proposals in the ED. Although the staff acknowledges that the Boards' tentative decisions in redeliberations, which raised the recognition threshold for periods under term options, mitigate those concerns to varying degrees, the staff thinks those concerns are still valid.

13. Because the ED proposes that options to purchase an underlying leased asset not be accounted for unless exercised, constituents did not communicate any concerns regarding the accounting (specifically the reassessment) for purchase

options. However, based upon further outreach performed, the staff thinks those concerns are similar to those relating to the reassessment of term options.

14. In addition, because of the Boards' tentative decisions on the accounting for purchase options, there may be additional complexity with lessor accounting for purchase options upon reassessment. For instance, if it is subsequently determined that a purchase option will not be exercised, a lessor applying a derecognition-based approach would have to recognize a residual asset that was previously not recognized.

15. Constituents generally thought that the accounting for options to extend/terminate a lease should be consistent with the accounting for options to purchase the underlying leased asset.

User feedback

16. Users generally think that reassessment is important to ensure that financial information reflects management's most recent evaluation of economic circumstances and its impact on committed cash flows.

Private company feedback

17. Private companies and not for profits were concerned with the costs of reassessment. However, as noted above, many of those concerns are partially mitigated by the Boards' redeliberation decisions to date. That is, there is a higher threshold for which companies would have to reassess lease term and the exercise of purchase options.

Targeted outreach feedback

18. After the Boards' tentative decisions relating to when and how to account for options to (a) extend or terminate a lease and (b) purchase the underlying leased asset, the staff received feedback during targeted outreach activities.

19. During these targeted outreach activities, there was significant support for the Boards' decisions. Many of those targeted outreach participants expressed support for reassessing whether "significant economic incentives" to exercise

options exist, observing that as long as the Boards' intent is that this is a relatively high threshold, many of the cost-benefit concerns relating to reassessment that were communicated during the feedback on the ED have been addressed.

20. However, during the targeted outreach, participants requested that the Boards:

    (a) Provide further application guidance on what constitutes a significant economic incentive to exercise an option

    (b) Consider when an assessment of significant economic incentive would lead to a different conclusion to the assessment of 'reasonably certain' or 'reasonably assured' in present IFRSs and U.S. GAAP

    (c) Consider addressing the implications of volatile market prices relating to the lease or purchase of the underlying asset (specifically when the underlying asset is real estate, rather than equipment) when applying the significant economic incentive indicators.

Staff analysis

What constitutes a significant economic incentive to exercise an option to extend a lease or purchase an underlying asset?

21. The Boards instructed the staff to perform additional outreach on the evaluation of market rate fluctuations in determining whether a lessee has a significant economic incentive to exercise an option. Although the Boards' instruction was for the staff to perform outreach specifically as it related to market rate fluctuations and their impact on the reassessment of purchase options, the staff thinks the results of that outreach also are relevant to the reassessment of options to extend or terminate a lease.

22. In performing the analysis, the staff identified types of factors that could be considered economic incentives to exercise an option. These factors are comparable to those presented to the Boards in previous meetings:

    (a) Contract-based factors: Terms that are written into the lease contract that could create a significant economic incentive to exercise an option at the date of commencement, or subsequently if there is a change in the lease contract. Contract-based factors include the following examples:

(i) The contract calls for a substantial penalty for terminating the lease earlier than the contractual lease term.

(ii) The contract calls for the lessee to incur material costs to restore the asset prior to returning it to the lessor.

(iii) The payments during the extension period are sufficiently lower than the payments in the initial period, indicating that a portion of the payments in the initial period economically represent the consideration paid for an in-the-money extension option.

(iv) The purchase option exercise price is low enough to indicate that a portion of the payments in the initial period economically represent the consideration paid for an in-the-money purchase option (bargain purchase option).

(b) Asset-based factors: Characteristics of the underlying leased asset that exist either at lease commencement or subsequently that could create a significant economic incentive to exercise an option. Asset-based factors include the following:

(i) There are significant leasehold improvements installed by the lessee during the lease term that are expected to still have significant economic value when the option to extend the lease or purchase the asset becomes exercisable.

(ii) Significant leasehold improvements are installed by the lessor to customize an asset for the lessee, with the costs of such improvements passed onto the lessee in the form of increased lease payments during the initial lease term, and those improvements continue to provide significant benefits at the end of that initial lease term. In this case, the lessee would need to consider the fact that it would have to make higher payments in a lease at a new location to achieve the same level of customization and may conclude that it would be more economical to extend the lease at the current location.

(iii) A hospital has a five-year lease with a fixed-payment extension option for a specialized medical facility. The facility is in a geographic location that is critical to the lessee (e.g., proximity to the main hospital operations) with no other viable locations within a reasonable distance. The main hospital operations are located in buildings that are either owned or leased for longer terms than the facility with the five-year lease.

(c) Market-based factors: Market rentals for comparable assets could create a significant economic incentive to exercise an option. This would include fluctuations in the market rental rates or asset values occurring after lease commencement. The staff acknowledges that an assessment of whether a contract-based factor, such as a fixed price purchase or extension option, constitutes a significant economic incentive at lease commencement must be evaluated relative to market prices estimated at commencement.

(d) Entity-specific factors: This would include factors such as historical practice of the entity, management intent and common industry practice.

Contract-based factors

23. Contract-based factors are agreed upon by the lessee and lessor during contract negotiation. Thus, the staff thinks that those factors would be considered in the evaluation of whether a lessee has a significant economic incentive to exercise an option to extend/terminate a lease or an option to purchase an underlying leased asset. The results of such evaluation would generally not change unless the contract itself changes.

Asset-based factors

24. The staff thinks that asset-based factors exist on or subsequent to lease inception. Thus, they should be considered in the evaluation of whether a

lessee has a significant economic incentive to exercise an option to extend/terminate a lease or an option to purchase an underlying leased asset.

Market-based factors

25. Market-based factors could give a lessee a significant economic incentive to exercise an option. However, some staff think that requiring them to be part of the assessment of whether the lessee has a significant economic incentive to exercise an option could be challenging.

26. The following example illustrates the issue. Lessee A has a 10-year lease for its corporate headquarters in a large metropolitan area with annual payments of CU150,000. The lease has a 5-year renewal option at the same annual payment of CU150,000. During the 10 years, the following occurs to annual market rates for the lease of comparative real estate:

    (a) At the end of year 3, there is an increase in demand. The annual market rate increases to CU300,000.

    (b) At the end of year 6, a local recession drives the annual market rate to CU50,000 per year.

    (c) At the end of year 8, because of tax incentives instituted by the local jurisdiction to stimulate the economy, an increase in demand results in the market rate increasing to CU320,000 per year.

    (d) At the end of year 10, the market rate is still CU320,000. However, Lessee A has decided that it has changed its business model to lower costs by decentralizing its management. It now estimates that it needs a much smaller space for its corporate headquarters and does not exercise the option to extend the lease term.

27. This fact pattern illustrates some of the concerns expressed by Board members and outreach participants regarding accounting for fluctuations in market rates after lease commencement. The staff discusses the consequences of this fact pattern in describing the alternative accounting approaches in paragraph 30.

Entity-specific factors

28. The Boards have decided that entity-specific factors such as past practice and management intent would not result in the recognition of payments under extension and purchase options in the lessee's liability to make lease payments. The Boards concluded that not including entity-specific factors in the assessment of lease term leads to more objective analysis, because it does not depend on the assessment of future business conditions or management intent, which could easily be altered by external economic circumstances.

Staff analysis

29. The staff thinks that, conceptually, contract-based, asset-based, and market-based factors above could all be considered as giving rise to an economic incentive for the lessee to exercise an option to extend a lease or purchase an underlying asset. Since an obligating event has already occurred (entering into the lease contract) creating an existing or standby obligation, these factors have an effect on measurement.

30. The staff do think that entity specific factors could be included in the assessment of whether a lessee has a significant economic incentive to exercise an option for the following reasons:

    (a) The staff thinks that, conceptually, entity-specific factors could also result in economic incentives. For instance, historical or common industry practice may make it reasonably certain that management will exercise an option to extend a lease. The underlying premise is that the lessee will need that asset to continue its existing business operations. Excluding entity-specific factors because of volatility results in financial statements that misrepresent the economics of the arrangements and provides misleading information to investors.

    (b) The staff thinks that it is not appropriate to exclude into account entity-specific factors, because they would need to be taken into account when assessing whether contract-specific, asset-specific, and market-based factors result in significant economic incentives to the lessee.

31. The staff have identified the following approaches for evaluating if a lessee has a significant economic incentive to exercise an option to extend the lease:

    (a) Approach A: Consider contract-based, asset-based, and market-based factors when evaluating if a lessee has a significant economic incentive to exercise an option. In considering the market-based factors in the example provided in paragraph 26, Lessee A would include the optional period at the end of year 3, reverse it at the end of year 6, include it at the end of year 8, and then reverse it when the option is not exercised at the end of year 10.

    (b) Approach B: Consider contract-based and asset-based factors, but consider market-based factors when evaluating if a lessee has a significant economic incentive to exercise an option only if market rates change near the option exercise date. In the example provided in paragraph 26, Lessee A would include the optional period only at the end of year 8 and then reverse it when the option is not exercised at the end of year 10. Under this approach, the market changes at the end of year 3 and year 6 would be ignored. The premise behind Approach B is that market rates become more reasonably predictable as the option exercise date approaches.

    (c) Approach C: Consider contract-based and asset-based factors, but do not consider changes in market-based factors after lease commencement when evaluating if a lessee has a significant economic incentive to exercise an option. In the example provided in paragraph 26, Lessee A would not adjust the lease payments during the lease term.

    (d) Approach D: Consider all factors when evaluating if a lessee has a significant economic incentive to exercise an option. As there are no entity-specific factors in the fact pattern presented in paragraph 26, Lessee A would apply an Approach identical to Approach A.

Staff recommendation

32. The staff recommends Approach D. Under Approach D, an entity is required to assess the economics of the pricing of the lease transaction, taking into consideration all factors – contract-based, asset-based, market-based and entity-specific – when evaluating if a lessee has a significant economic incentive to exercise an option. The staff thinks that an appropriate assessment would often require taking into consideration a combination of factors, because those factors are interrelated. For instance, an assessment of contract-based factors, such as a fixed price purchase or extension options, must include a consideration of market rates in determining whether such contract-based factors constitute significant economic incentives for the lessee to exercise an option.

33. Adopting an approach that excludes market-based and entity-specific factors (for instance, Approach C) might make it less likely that a lease term would change due to a reassessment. Some may view this as a practical solution to address the comments from constituents that expressed concerns about the costs of reassessment, especially the complexity of accounting for the impact of reassessment when a lessor applies a derecognition approach. However, the staff thinks that excluding market-based and entity-specific factors results in financial statements that could potentially misrepresent the economics of the arrangements and provides misleading information to investors. Since the Boards decided to limit when reassessments are to be performed to only situations in which a "significant" economic incentive exists to exercise an option to extend or terminate a lease, cost concerns expressed by preparers are mitigated.

Question 1
The staff recommends including contract-based, asset-based, market-based and entity-specific factors in evaluating whether a lessee has a significant economic incentive to exercise an option to extend or terminate a lease or purchase the underlying asset. Do the Boards agree with the staff recommendation?

Should there be different thresholds for options to extend or terminate a lease and options to purchase the underlying asset?

34. Constituents noted that the threshold for options to (a) extend or terminate a lease and(b) purchase the underlying asset should be the same for both initial and subsequent evaluation. The staff does not see a reason to establish different recognition thresholds for different types of options that that may be economically similar (for instance, bargain renewals through the end of an underlying asset's economic life are economically similar to a bargain purchase option).

35. The staff recommends that the thresholds for evaluating a lessee's economic incentive to exercise options to extend or terminate a lease and options to purchase the underlying asset should be the same for both initial and subsequent evaluation.

Question 2
The staff recommends that the thresholds for evaluating a lessee's economic incentive to exercise options to extend or terminate a lease and options to purchase the underlying asset should be the same for both initial and subsequent evaluation. Do the Boards agree? Why or why not?

How would reassessment be accounted for?

36. The proposals in the ED require that changes in lease payments due to a reassessment should result in a lessee adjusting its obligation to make lease payments and a lessor adjusting its right to receive lease payments. Furthermore, it would also result in:

    (a) A lessee adjusting its right-of-use asset

    (b) A lessor, when applying the performance obligation approach, adjusting its performance obligation

    (c) A lessor, when applying the derecognition approach, adjusting the carrying amount of the residual asset.

37. Constituents generally agreed with the approach proposed in the ED. They acknowledged that when there is a change in lease payments because of a

change in the expectation that an option will be exercised, the change should be reflected as a change in the assets and liabilities of lessees and lessors. That is because, for lessees, the change reflects the lessee's expectation to acquire more or less benefit from the right to use the underlying asset. For lessors that do not apply a derecognition approach, the change reflects the lessor's expectations of an adjustment to future revenue. However, there are some concerns with lessor reassessment, based on the approaches in the ED:

(a) Under the performance obligation approach to lessor accounting, because the income pattern required in the ED results in a lessee recording more expense in earlier periods (lessor recording more revenue in earlier periods), there is some concern that changes in lease payments due to reassessments could distort the profit/loss statement. This concern would not exist if the Boards were to adopt a method whereby a lessor recognizes lease revenue on a straight-line basis.

(b) Under the derecognition approach to lessor accounting, the impact of a reassessment could distort the profit/loss statement more significantly than under the performance obligation approach. The amount of gain recognized at lease commencement may be overstated, if at a later date it is determined that the lease payments are lower than they were initially expected to be. Conversely, the amount of gain recognized at lease commencement may be understated, if at a later date it is determined that the lease payments are higher than they were initially expected to be.

38. However, the staff thinks that those concerns are somewhat mitigated because of the following:

(a) The Boards' tentative decisions on options should make reassessment less frequent than under the proposals in the ED.

(b) The Boards are considering allowing certain lessors to recognize profit or loss on some leases on a 'straight-line' basis.

39. The staff recommends that the Boards reaffirm the proposals in the ED on accounting for reassessments.

Question 3
The staff recommends that the Boards reaffirm the proposals in the ED that require that changes in lease payments due to a reassessment should result in: a) A lessee adjusting its right-of-use asset b) A lessor, when applying the performance obligation approach, adjusting its performance obligation c) A lessor, when applying the derecognition approach, adjusting the carrying amount of the residual. Do the Boards agree? Why or why not?